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CHAPTER 14

Increasing Small Plan Formation: A Blueprint for Congressional Action for the Next Five Years

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The views expressed in this chapter are strictly those of the authors.

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SYNOPSIS

§ 14.01 IMMEDIATE NEED FOR INCREASED SMALL PLAN FORMATION

Congress recognizes the immediate need for a larger percentage of small businesses to offer qualified retirement plans. Coverage of employees who work for small business lags far below that of employees of larger entities. This is true even though many of these employees work full time. According to the Small Business Administration (SBA), in 1997 small businesses represented over 99% of all employers, created nearly all of the new net jobs and accounted for 51% of the private sector output. Further, the SBA estimates that small businesses employ 53% of the private sector work force.[1] Yet fewer than half of the employees working for a small business have access to a retirement plan, and as the size of the business decreases, the coverage figures decrease correspondingly. It is estimated that less than one-third of employees working for firms with fewer than 25 employees are covered by a retirement plan, and only about one-half of employees working for firms with between 25-99 people are covered. In comparison, over 80% of employees working for firms with over 100 employees are covered by a retirement plan.[2]

The actual retirement plan coverage picture may not be as bleak as these figures indicate, since retirement plans are not required to cover part-time employees, employees under age 21 or transient employees. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the

[1] For the purposes of this chapter, a small business is defined as a business with 100 or fewer employees. *See* Small Bus. Ass'n, *Small Business Answer Card*, www.sba.gov/AVDO.

[2] Christopher Conte, American Savings Education Council, The National Summit on Retirement Savings: Agenda Background Materials (1998) (unpublished briefing) (on file with the American Savings Education Council).

entire workforce and that percentage of the workforce that is actually eligible to participate in a retirement plan. When these ineligible employees are excluded, the coverage numbers improve, but it is clear that small business retirement plan coverage is significantly lagging below that of its larger counterparts. Most critically, this lack of coverage is occurring in the fastest growing sector of our economy.

In 1999, the Congressional Research Service issued a report for Congress[3] which provides an excellent overview of the current coverage trends for retirement plans.[4] A review of the data presented confirms the lack of adequate coverage of small business employees in retirement plans. For example, in 1997, 83.3% of employees who worked for companies which had 100 or more employees were covered by a pension or retirement savings plan. In contrast, 58.1% of employees who worked for companies which had 25 to 99 employees were covered by such a plan. Only 30.3% of employees in companies with fewer than 25 employees were covered by a retirement plan.[5] Clearly, the size of the company determines the likelihood of its employees being covered by a retirement plan.

The report indicates that unlike coverage, participation in a retirement plan is fairly constant regardless of the size of the employer. In 1997, 88.2% of employees who worked for companies that employed 100 or more employees and sponsored a pension or retirement savings plan *actually participated* in the plan. 85.5% of employees in companies with 25 to 99 employees which sponsored such a plan *participated* and 84.8% of employees in firms with under 25 employees *participated*.[6] These data

[3] Patrick J. Purcell, CRS Report for Congress, "Pension Coverage: Recent Trends and Current Policy Issues" (1999).

[4] This report is relying on data through 1997. Thus, in the small business area, it is not picking up the additional plan sponsorship and thus, coverage, generated by the new SIMPLE plan as well as by some of the important simplifications that have been accomplished in the last several retirement plan bills enacted by Congress. One would expect that a report relying on data through 2001 would show some real gains in coverage of small business employees. If the pension reform legislation currently under consideration in Congress, the Comprehensive Retirement Security and Pension Reform Act of 2001, H.R.10, and the Retirement Security and Savings Act of 2001, S. 742, is enacted, coverage would be expected to increase significantly.

[5] *Id.*, at Table 3, Panel A, entitled "Participation in Pension or Retirement Savings Plans by Size of Firm" at 13.

[6] *Id.*, at Table 3, Panel B, entitled "Percentage of Employees in Firms that Sponsored a Plan who Participated in the Plan" at 13.

illustrate that when a small business sponsors a retirement plan, the employees participate at just about the same levels as in larger companies. Thus, once a small business has chosen to sponsor a retirement plan, meaningful participation results. To achieve greater coverage, therefore, the system must be made attractive to small business.

Interestingly, once a small business sponsors a qualified retirement plan, employees frequently receive excellent benefits. In fact, employer contribution levels in small business plans are often higher than those offered by larger entities. For instance, small business plans typically provide contributions for staff employees at levels of five, six, seven or even higher percentages of compensation. These high levels of contributions are driven by the desire of the business owners and key employees to receive sufficient contributions for their own retirement benefits. Present laws require that significant contributions be given to non-key employees in order for the key employees to benefit to any meaningful degree.[7] As will be discussed in more detail below, these significant contributions for the staff employees result from the anti-discrimination rules under I.R.C. § 401 and not the top-heavy rules found under I.R.C. § 416. The top-heavy rules today are largely duplicative of the existing non-discrimination rules governing the qualified retirement plan system.

In addition to company contributions, retirement plans can offer the small business employee another advantage. SIMPLE and 401(k) plans enable the small business employee to save for his or her own retirement in a tax advantaged setting through payroll deductions. Intuitively, one anticipates that if an employee can reduce his or her paycheck by the amount of desired savings prior to receiving the cash in hand, the odds are the money will, in fact, be saved rather than spent. The authors have heard countless small business employees state how much easier it is to save by payroll deduction than by any other method.

Enacting the legislation pending before Congress is essential to encouraging small businesses to establish qualified retirement plans.

[7] The terms "key" and "non-key" as used in this chapter, unless otherwise indicated, are not those defined in the top-heavy rules in I.R.C. § 416(i). Rather as used in this chapter, "key" employees are those employees that the owners of a small business would deem key to running the business and "non-key" employees are those not essential to the operation of the business. As in all other businesses, the small business owners want to provide sufficient benefits and incentives to keep the key employees satisfied with their current employer so they will not move elsewhere. This problem is particularly acute in that small businesses often serve as the training ground for employees who move on to jobs with larger business entities where they perceive there is greater job security and better benefits.

These provisions have been debated by Congress for the last five years. Time and time again they have passed both houses of the Congress with resounding bi-partisanship support. Sadly, the issue lacks "sex appeal" with the press and is given little coverage. Worse, if a work-based payroll deduction plan is not available, employees often postpone saving for retirement. When employees are young, retirement seems 1,000 years away; by the time it becomes a reality, it's too late to save sufficient funds. Encouraging wider availability of retirement savings plans, regrettably, does not garner the interest and support it should have with the general public.

The authors for purposes of this chapter have assumed that H.R. 10 and S. 742 have been enacted into law. These bills have been discussed in great detail by many experts, the vast majority of whom believe that the legislation will provide sufficient incentives to attract small businesses to the qualified retirement plan system while stripping away unnecessary burdens. Thus, the focus of this chapter is not a discussion of those provisions, but of additional reforms which may be needed to increase small business plan formation after those provisions have already been enacted into law.

Ironically, the small business sector, which lags behind so greatly in sponsoring retirement plans, perhaps has the greatest need to sponsor these plans. Small businesses seldom offer non-qualified deferred compensation plans, stock option plans or retiree health insurance. Indeed, often the only benefit the small business employee receives upon retirement is his or her retirement plan account balance. If the small business does not sponsor a retirement plan, the employee often leaves the company with nothing. We know the savings rate in America is below the desired amount. The Employee Benefit Research Institute (EBRI) reports that in 1998, defined contribution assets represented 43.8% of the total financial assets for those families which had defined contribution assets.[8] So absent a retirement plan account balance, the small business employee likely will not have sufficient savings for adequate retirement income. This means the retired small business employee will be relying upon Social Security and his or her personal savings for his or her retirement income and will, in all probability, come up short.

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[8] Craig Copeland and Jack Van Derhei, Employee Benefit Research Institute, Personal Account Retirement Plans: An Analysis of the Survey of Consumer Finances, Issue Brief (July, 2000).

Social Security was never intended to provide all of the income needed in retirement, except perhaps for individuals at the lowest income levels. Social Security replaces a smaller proportion of earned income as earned income levels increase. Thus, for employees in the middle and upper middle income levels, Social Security alone simply does not provide sufficient income to replace earned income. Other retirement income streams are necessary. Congress is beginning to recognize the need to "fix" the voluntary retirement plan system so that small business will begin to sponsor retirement plans in larger numbers, and their employees will have sufficient income sources, other than Social Security, to provide for their needs.

§ 14.02 THE BIG PICTURE: IRA BASED PLANS VS. TRUST BASED PLANS

Small business has made it clear to Congress time and time again that it cannot easily accommodate additional administrative burdens. Unfortunately, qualified retirement plans impose additional burdens by way of required forms and governmental regulations. To deal with this problem, Congress has, over the last several years, developed an IRA based "retirement" plan.[9] The most successful of these plans is known as the SIMPLE plan.[10] This plan was developed in large part by the Office of Advocacy, SBA, the delegates to the White House Conference on Small Business, and various small business associations.[11] While this chapter will cover the SIMPLE plan in more detail, the important point to grasp here is that the very structure which makes the SIMPLE desirable

[9] The predecessor to the SIMPLE, the first popular IRA based retirement plan, was the SEP (Simplified Employee Pension). The SEP was created by the Revenue Act of 1978 under I.R.C. §408(k), effective for years beginning after December 31, 1979. This plan never caught on and has largely been supplanted by the SIMPLE which is attracting the attention of small business. The major brokerage houses report that significant numbers of SIMPLEs have been opened in the last two years.

[10] The SIMPLE plan was created by the Small Business Job Protection Act of 1996 under I.R.C. §408(p), effective January 1, 1997.

[11] Jere Glover, then Chief Counsel, Office of Advocacy, SBA, recognized the acuteness of the small business plan formation problem early on. He brought together a number of the small business associations and small business plan experts to find out what could be done to solve the problem. At the 1995 White House Conference on Small Business, the 7th recommendation set forth a number of suggestions as to how to improve the viability of the qualified retirement plan system for small business. Special mention must go to National Federation of Independent Businesses, which played a leading role in the development of the SIMPLE plan.

from the viewpoint of the small business owners also makes it a "lesser" plan from the viewpoint of ensuring retirement income security for retired small business employees.

Congress understands the tension between the simplicity of the SEP or SIMPLE (both of which are IRA based plans) and the advantages afforded by a qualified retirement plan (a trust based plan). Small businesses operate lean and mean. They cannot accept additional administrative burdens easily. The IRA based plans are almost maintenance-free. The small business simply goes to a bank or a brokerage house and sets up separate IRAs for each eligible employee. The company makes the correct contribution into each separate IRA and then walks away from the accounts. Unfortunately, this low administrative burden comes at a price.

In a qualified retirement plan, such as a 401(k) plan, the employer holds funds in a trust. Because the funds are held in a trust, employees cannot simply access their account balances whenever they determine they are in need of funds. Indeed, employees can access these funds in only two ways. First, in some circumstances, they can take a loan. If the plan allows loans and the employee complies with all of the statutory requirements, then he or she may remove certain limited savings through a written plan loan.[12] Second, the employee may receive distributions if an event occurs which, under the law, permits distribution. These events include hardship (if the plan allows hardship distributions), death, disability, retirement or termination of employment. Statutorily defined hardship distributions include, for example, distributions needed to assist with keeping a house or dealing with a medical emergency. Essentially, in a qualified retirement plan (a trust based plan), once funds are contributed to the plan, the employee, in most situations, is forced to maintain the funds in the plan until retirement.

In contrast, with IRA based plans, such as a SEP or a SIMPLE, funds are owned by the employee, not by a trust. Accordingly, employees can remove their funds from the brokerage house or bank *at any time, in any amount and for any reason.* True, removed funds will be subject

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[12] I.R.C. §72(p)(2)(A). Essentially the amount of the loan is subject to two limitations, both of which must be satisfied. First, the new loan, plus the highest outstanding balance on other loans from the plan at any time during the year preceding the new loan, cannot exceed $50,000. Second, the new loan, plus the current outstanding balance on other loans from the plan at any time during the preceding year, cannot exceed the greater of 50% of the participant's vested account balance and $10,000.

to a 10% penalty. (This is also the case for a hardship distribution from a 401(k) plan.) Nonetheless, the employee retains total access to these funds.

The impact of the forced savings feature of a qualified retirement plan should not be underestimated. Preliminary and totally unofficial data suggest that individuals freely access SEPs and SIMPLE plans and that the 10% penalty does not represent a significant barrier. In fact, concern over the ease with which employees can remove savings from an IRA based plan led to the 25% penalty on withdrawals from a SIMPLE during the first two years an individual participates in the SIMPLE IRA. Congress imposed this larger penalty to encourage participants to accumulate a meaningful IRA account balance. The hope was that seeing the balance accumulate would induce the employee to leave the SIMPLE balance alone. Notwithstanding the steep penalty, however, employees retain easy access to their SIMPLE IRA account balances. There is a distinct difference between complying with the statutory requirements for a loan or hardship distribution, including the need expressly to ask the employer for the loan or distribution, and having the power, independent of others, to remove money at whim from one's own IRA.

Because the defined contribution plan in effect "locks" employer and employee contributions into a qualified retirement plan trust, an employee might well prefer the SIMPLE or SEP over the 401(k) plan. If the goal, however, is to encourage long-term retirement savings, then Congress needs to ensure that the 401(k) continues to be the more attractive plan to employers. One way to make the 401(k) plan comparatively more attractive is to allow significantly larger annual contributions to a 401(k) plan than to a SIMPLE. It is critical, in the authors' opinion, that Congress maintains at a minimum the existing proportionate differential between contributions allowed to the SIMPLE and those allowed to a 401(k) plan.

The goal, of course, is to encourage more small businesses to offer retirement plans. A very small company that cannot absorb additional administrative burdens should be encouraged to join the system via the SIMPLE. But the laws should encourage the company to join the "real" qualified retirement system, probably through the 401(k) safe harbor plan, as soon as possible. In other words, even though a small business will probably begin with the SIMPLE as a start up plan, it should be encouraged, primarily by larger contribution limits, to "graduate" to the 401(k) plan as soon as possible. In this way, retirement savings funds will be locked into the plan. Thus, the current proportion of contribution limits, $6,000 for a SIMPLE and $10,500 for a 401(k), should, at a minimum, be maintained. The authors would even increase the amount allowed under the 401(k) as compared to the SIMPLE in order to encourage the small business to "graduate" to a plan that brings with it more administrative burdens.

Unlike the SIMPLE, which has an IRA chassis,[13] the qualified retirement plan requires a trust vehicle to hold its assets. The trustees of a qualified retirement plan are bound under the law to operate in a prudent fashion. To ensure that businesses meet their fiduciary obligations, Congress requires a business to maintain records of trust assets. IRS Form 5500 elicits information to enable the Department of Labor (DOL) and Internal Revenue Service (IRS) to make sure the funds are being handled correctly. In a defined contribution plan,[14] each plan participant has a separate account balance inside the trust fund. Thus, the single qualified retirement plan trust is accumulating contributions, earnings and forfeitures for all plan participants until individual account balances are paid out pursuant to an event permitting distribution. These IRS and DOL forms should be reviewed to see if, at least for the small business plan, they can be simplified and made less burdensome.

§ 14.03 MICRO CHANGES CAN HAVE A MACRO IMPACT

Because qualified retirement plans are subject to a myriad of technical, micro-focused rules, relatively small changes ("micro" changes) in the qualified retirement plan system can bring about a substantial or "macro" result. A change in a single technical rule can have a dramatic impact. For instance, changes to the funding requirements for defined benefit plans in the 1980's initially appeared innocuous. Small businesses soon realized, however, that they could no longer fund the plan in a level

[13] There is also a SIMPLE 401(k) plan, but it is seldom used. It has the same contribution limitations of a SIMPLE IRA with the complexity costs generated by a trust based plan. Thus, there is no incentive for a company to adopt the 401(k) SIMPLE.

[14] Defined contribution plans include the 401(k) plan, profit sharing plan, money purchase pension plan and the target benefit plan. The cash balance plan, which looks like a defined contribution plan, is actually a hybrid plan. Although it rests upon a defined benefit chassis, the cash balance plan, like a defined contribution plan, provides plan participants with individual account balances. It is the authors' experience that plan participants are much more comfortable having their own account balance and often view the defined benefit plan, where all benefits will be paid out of one trust, with suspicion. *See* § 14.10, *infra*.

fashion. Funding would first be depressed for several years and would then jump up to a level that the small business could not absorb. As a result, small businesses left defined benefit plans in droves. This simple change in funding requirements, along with cutbacks in limits for key employees, increases in required contributions for non-key employees and increased actuarial requirements, virtually eliminated the small business defined benefit plan.

§ 14.04 SPECIFIC PROPOSALS FOR SIMPLIFICATION

[1] Repeal the Top-Heavy Rules

A top-heavy plan is virtually synonymous with a small business plan. Because of the mechanical mathematical tests utilized to determine top-heavy status, which largely depend upon the number of key employees who are employed by the company as compared to non-key employees, almost all small business plans are top-heavy.[15] Most small businesses have a much higher percentage of key employees as compared to non-keys than their larger counterparts. In fact, because the definition of key employee is largely based upon owning a significant percentage of the company, few employees in a large business are ever deemed key employees within the meaning of the top-heavy rules. Ironically, the "key employee" in a small business probably receives compensation in line with middle management in a larger company, and the earning potential of the key employee in the small business is by no means equivalent to that of top management in a larger firm. Thus, the top-heavy rules impose additional costs and administrative burdens disproportionately on small business plans.

[15] A key employee is defined under the top-heavy rules as an employee who at any time during the plan year or any of the four preceding plan years is (i) an officer receiving more than 50% of the dollar amount specified in §415(b)(1)(A) (currently $35,000), (ii) one of the top ten employees with annual compensation of more than the dollar amount specified in §415(c)(1)(A) who owns the largest interests in the employer, (iii) a 5% owner, or (iv) a 1% owner with annual compensation of more than $150,000. I.R.C. §416(i). The current pension reform legislation before Congress would change these rules somewhat. It appears likely that this legislation will delete the top ten owner rule and the four year lookback rule for identifying key employees. In addition, under the pending legislation, an employee would not be treated as a key employee based on his or her officer status unless the employee earns $85,000 or more. These changes reduce the pool of possible key employees in larger businesses, but do not significantly affect who would be deemed a key employee by a small business. For example, if a small business has five equal owners, they are all deemed key employees, even if each makes $25,000. Few, if any, employees in a very large enterprise own 5% of the company.

When the top-heavy rules were enacted,[16] there was no limitation on the amount of compensation that could be taken into account for plan purposes. Today the maximum amount is lower for all plans than the amount originally enacted only for top-heavy plans. When the top-heavy rules were enacted, no base percentage was required for an integrated plan (that is, a plan using permitted disparity). Today, both defined contribution and defined benefit plans must provide all employees with some base percentage upon which the contribution for the highly compensated and/or key employees must be measured. Similarly, at the time the top-heavy rules were enacted, vesting schedules frequently provided no vesting for the first nine years of service and 100% vesting upon completion of the tenth year. This was referred to as ten year cliff vesting. Another popular vesting schedule at the time was the "4-40 schedule." This provided no vesting for the first three years of service, 40% vesting upon completion of the fourth year of service, 5% for the next two years and then 10% for each additional year of service thereafter. Today the longest vesting schedule allowed under the law for a plan of any size is seven year graduated vesting or five year cliff vesting.[17]

In other words, all of the top-heavy rules have been "copied" from the original concept and applied to all plans. Today only two items are affected by the top-heavy rules. First, the top-heavy rules mandate certain required minimum contributions. In a top-heavy defined contribution plan, the employer must make a plan contribution equal to 3% of compensation for every non-key employee who is a participant in the plan, unless the highest plan contribution for a key employee is less than 3%, in which case the highest percentage contribution for any key employee becomes the minimum contribution for the non-key employees. However, because of the anti-discrimination requirements, today the top-heavy required contribution does not, in effect, increase contributions made to non-key employees.[18] In the defined benefit area, the required

[16] The top-heavy rules were added by the Tax Equity and Fiscal Responsibility Act of 1982 under I.R.C. § 416, They became effective for plan years beginning after December 31, 1983.

[17] I.R.C. §411(a)(2). Seven year graded vesting means that the plan participant receives 20% vesting after three years of service, with an additional 20% of vesting for each year of service thereafter. Five year cliff vesting means no vesting for the first five years of service and 100% vesting thereafter.

[18] There are some additional regulatory rules in the top-heavy area which can impact contributions for staff employees, but they operate in a fashion detrimental to non-key

minimum contributions are potentially more meaningful. However, as previously discussed, few small businesses sponsor defined benefit plans. Thus, the required minimum contributions in this context are virtually a moot point.

Second, a top-heavy plan must vest benefits at least as rapidly as either: (i) no vesting for the first two years of service and 100% vesting upon the completion of the third year of service (referred to as "three year cliff vesting") or (ii) no vesting for the first year of service and 20% vesting upon completion of each year of service thereafter (referred to as "six year graded vesting"). Compared to the vesting schedules allowed for all other retirement plans (five year cliff and seven year graded), the top-heavy vesting schedules do not offer employees significant advantages. The administrative burdens imposed by the top-heavy rules are difficult to justify in light of the meager benefits.

Politically, however, repeal of the top-heavy rules is not currently likely. Several powerful trade associations believe the top-heavy rules are delivering significant benefits for their members. Thus, we move to the more likely scenario — changes needed if the top-heavy rules are not repealed.

[2] Additional Changes If Top-Heavy Rules Are Not Repealed

[a] *Small Business Plan Participants Should Be Able to Participate in the 401(k) Portion of the Plan Immediately Without Triggering the Top-Heavy Minimum Contribution*

The top-heavy rules discourage small businesses from allowing employees to become immediately eligible to participate in a top-heavy 401(k) plan in which the company is making plan contributions. In the normal retirement plan world (that is outside the top-heavy rules), merely allowing a new employee to become eligible to participate in the 401(k) portion of a plan immediately upon employment would not, by itself, trigger any additional company contributions. In a top-heavy plan, in contrast, a non-key employee who is merely eligible to participate in the 401(k) portion of the plan must receive the 3% top-heavy minimum contribution even if he or she is not eligible to receive any other employer

employees. These are described in § 14.04 [2], *infra*. Some experts believed that the top-heavy rules increased the contributions for non-key employees in some "new comparability" plans. Under certain fact patterns, this conceivably was true. However, since IRS issued Notice 14-2000, they are unable to have any further impact in this area.

contribution (i.e, a profit sharing contribution or a match contribution).[19] For example, if a small business sponsored a top-heavy profit sharing/ 401(k) combination plan which had a one year wait for eligibility for the profit sharing portion and immediate eligibility for the 401(k) portion, most practitioners believe that every non-key employee would be entitled to receive the 3% top-heavy contribution regardless of whether the employee chose to make 401(k) contributions. Other practitioners believe that only the non-key employees who actually participate in the 401(k) option are entitled to receive the 3% top-heavy contribution. Unfortunately, as is the case with many of the obscure top-heavy rules, there are many advisors who are not even aware of this issue. Because of this requirement, knowledgeable small business retirement plan advisors tell their clients to have a one year wait for both the 401(k) portion and profit-sharing and/or match portion of the plan. This hurts the first year employees by keeping them out of the 401(k) portion of the plan for the first year, thereby delaying their chance to save in a tax free environment.[20] If they were employed by a larger entity, they likely would not encounter this problem because the top-heavy rules would not apply.

[b] *Allow Small Businesses, Like their Larger Counterparts, to Sponsor 401(k) Employee Pay All Plans*

Perhaps the most unfair rule in the context of top-heavy 401(k) plans was imposed on small business through the regulations on employee pay-all plans.[21] This rule converts 401(k) contributions made by key employees into employer (profit sharing) contributions, thus triggering the top-heavy minimum contributions. In practical effect, the key employees are precluded from making 401(k) contributions to an employee pay-all plan even if these employees would have been allowed to do so under the ADP rules. Because this rule only applies to top-heavy plans, it primarily affects small business.[22] This is simply unfair to small business. If a larger entity (that is, one which is essentially exempt from the top-heavy rules) sponsors an employee pay-all plan, all employees

[19] Treas. Reg. § 1.416-1, Q & A M-7 and M-10 (as amended in 1992); 29 U.S.C. § 1002(7) (1999) (ERISA § 3(7)).

[20] This rule would not be changed by the comprehensive retirement plan legislation currently before the House and the Senate.

[21] Treas. Reg. § 1.416-1, Q & A M-20 (as amended in 1992).

[22] The authors have never been able to come up with an acceptable rationale for this rule.

(highly compensated, keys or otherwise) can make 401(k) contributions allowed by the ADP tests without triggering any profit sharing contribution. The very same plan, in the small business context, triggers a 3% top-heavy contribution for the non-key employees, if the plan is top-heavy.[23]

Because of this rule, most small businesses simply do not offer employee pay-all 401(k) plans. *This represents a real lost opportunity to encourage small businesses to offer qualified retirement plans.* These plans would allow small business employees to defer up to $10,500 (or such higher limits as may obtain if the law is amended) if allowed under the anti-discrimination tests (ADP tests). Small business owners likely would sponsor employee pay-all 401(k) plans, notwithstanding the administrative burdens and expenses, if they knew they could participate in the plan like other employees.

[c] *401(k) Match Safe Harbor Plan Should Be Exempt from Top-Heavy Rules*

The second 401(k) safe harbor, the "match safe harbor,"[24] should be exempt from the top-heavy rules. This provision is included in H.R. 10, but not in S. 742. Because there is a chance that it will not be included in a pension reform bill, it is important to understand why this change is needed. If Congress wants to breathe life into the match safe harbor plan passed in 1996,[25] it must make this change. Why? Currently, under

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[23] The comprehensive retirement plan legislation currently being considered by both the House and the Senate, while doing away with a few of the overkill elements contained in the top-heavy rules, retains this rule, as well as the required minimum contributions and the accelerated vesting schedules. These requirements, in addition to the peculiar rules mentioned above, rankle small business owners. The top-heavy rules are one of the primary reasons why small business owners maintain that the qualified retirement plan system discriminates against them and small businesses. As mentioned above, the vast majority of small business plans are top-heavy because of the mechanical mathematical tests utilized to determine top-heavy status which largely depend upon the number of key employees as defined under I.R.C. § 416, employed by the company compared to the number of non-key employees.

[24] The House and Senate are considering comprehensive retirement plan legislation which, while eliminating a few of the absurdities contained in the top-heavy rules, retains this rule, as well as the required minimum contributions and the accelerated vesting schedules. These requirements rankle small business owners. They cause small business owners to maintain that the qualified retirement plan system discriminates against them.

[25] Small Business Job Protection Act of 1996, Pub. L. 104-188, 110 Stat. 1755 (codified in scattered sections of 26 U.S.C.).

the 401(k) match safe harbor, a small business is required to make a top-heavy contribution AND the prescribed safe harbor match. Under the 3% non-elective safe harbor, the same contribution satisfies both the top-heavy rule and the safe harbor rule. Unless the match contribution is exempt from the top-heavy requirements, small business simply will not use the match safe harbor. Unlike their larger counterparts, they will, in effect, have only one safe harbor from which to choose, one whose total cost to the employer is dependent upon the independent choices made by employees.

In this area, Congress needs to ask the folks in the trenches what impact the change will have rather than rely on the opinions of those lacking practical experience. Some people with little technical understanding of the top-heavy rules or of small business contend that exempting the match safe harbor from the top-heavy requirements will hurt non-highly compensated employees of a small business. These people contend that if a small business were to sponsor a top-heavy 401(k) match safe harbor plan, the company would have no incentive to encourage employee contributions since the company would have to match these contributions. These people further argue that the company might not even inform their employees about the 401(k) plan. It is astonishing that this argument is still being advanced in 2001! One probably could find a handful of businesses that sponsor a 401(k) plan without informing their non-highly compensated employees. However, the 401(k) plan is usually seen as a valuable employee benefit. Employers are more likely to tout the plan as an important part of the overall compensation package than to hide it. To contend that small business employees would hide the availability of a 401(k) plan presumes that small business owners are likely to be dishonest and prone to avoid of the law. This is an archaic and erroneous assumption. Interestingly, although the same misguided logic could also be applied to the SIMPLE plan, the authors have never heard it advanced in that area.

Ironically, when Congress passed the two 401(k) safe harbors, most pension experts and others working on the legislation believed that both plans would be attractive primarily to small businesses. Because the match safe harbor is not exempt from the top-heavy rules, however, it is our observation that virtually no businesses, large or small, are using this safe harbor.

[d] *Family Attribution for Key Employees in a Top-Heavy Plan Should Be Repealed*

Like the provision to exempt the match safe harbor from the top-heavy rules, repeal of the family attribution rules is contained in H.R. 10, but not in S. 742. Under the family attribution rules, a husband, wife and children under age 19 who work together in a family or small business are treated as one person for certain plan purposes.[26] This rule discriminates unfairly against spouses and children employed in the same family business or small business.

Again we find the critics of this change have little understanding of small businesses. They contend that the small business owners will put their non-working spouses on the payroll so that the spouses can be covered by the plan. Then, under the coverage tests, the small business owners will be able to choose to not cover one or more "real" employees. This type of thinking should make many small business persons see red. Here again it rests on the assumption that small business owners are dishonest and are trying to avoid providing benefits to employees. It also assumes that small business owners, over 70% of whom to date have avoided the retirement plan area, will not only be enticed to sponsor a plan, but will identify and engage a plan administrator who is similarly dishonest and is willing to explain the complicated top-heavy and family attribution rules so that the business owners can avoid covering one or two employees! These arguments strain credulity, and would appear naive except for their being advanced in all seriousness by intelligent people.

[e] *The Recommended Changes Could be Accomplished by Repealing the Top-Heavy Rules for Defined Contribution Plans*

Since the top-heavy rules provide only slight benefits in the defined contribution plan area (e.g., slightly accelerated vesting schedules), the authors suggest repealing the top-heavy rules for defined contribution plans, while maintaining the rules for defined benefit top-heavy plans.

26 I.R.C. §§ 416(i)(B)(iii) and 318.

[3] Additional Changes Needed to Improve 401(k) Safe Harbor Plans

[a] *Repeal Notice Requirement for the 3% Non-Elective Safe Harbor Plan*

The statutory notice requirement in the context of the 3% non-elective safe harbor plan serves no purpose and should be removed. Treasury and IRS have worked around this requirement as much as possible.[27] However, the notice requirement is a statutory requirement. Thus, Treasury and IRS are not capable of removing it. The notice requirement serves no purpose with respect to the 3% non-elective safe harbor. It is at best a nuisance and at worst a trap for the unwary.

As already noted, there are two 401(k) safe harbors. One is a prescribed company match to employee 401(k) contributions; the other is a non-elective 3% contribution. Under a match safe harbor, the size of the employer's contribution on behalf of an employee's account is directly linked to the size of the employee's contribution. Under this arrangement, an employee may very well change his or her behavior and contribute more to his or her 401(k) plan knowing that a match is going to be made. Under a non-elective 3% contribution, however, every eligible employee receives the non-elective contribution whether or not the employee makes 401(k) contributions. Knowing that an employer will make a 3% contribution at the end of the year regardless of whether or not the employee contributes to the plan will not stimulate employee contributions. If anything, it could depress employee contributions since the employee might be satisfied with the employer's contributions alone. The notice requirement, however, may have an inadvertent chilling effect on a company's ability to use the safe harbor. Unless an outside advisor informs a small business that it must give a fairly extensive written notice to employees about the safe harbor by a certain date and the company complies with the notice requirement, the company may not be able to take advantage of the safe harbor for an entire year.[28]

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[27] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #1.

[28] I.R.S. Notice 98-52, 1998-46 I.R.B. 16 at V.C.

[b] *The 3% Non-Elective Safe Harbor Contribution Should Apply to Employees Who Either Work 1,000 Hours or are Employed on the Last Day of the Year*

Treasury and IRS have determined that the statutory language used in the 3% non-elective safe harbor requires that the 3% non-elective contribution be paid to every non-highly compensated plan participant regardless of whether the participant has completed 1,000 hours of service or is employed on the last day of the plan year.[29] In contrast, employers generally are required to make other contributions, for example, profit sharing contributions, only to employees who either have worked 1,000 hours of service and/or are employed on the last day of the plan year. In contrast, employers must make top-heavy minimum contributions only for employees who were employed on the last day of the plan year.[30] Similarly, employers relying on the 3% non-elective safe harbor should be required to make non-elective contributions only for participants who either have 1,000 hours of service in the applicable year or are employed on the last day of the plan year.

[c] *For Real Simplification, Repeal the ADP and ACP Tests and Eliminate the Need for the Safe Harbors*

Since the dollar amount which an employee can contribute to a 401(k) plan is relatively low, there is no need for the actual deferral percentage (ADP) or actual contribution percentage (ACP) tests.[31] Given the current political environment, repeal of the ADP and ACP tests is unlikely. Nonetheless, this single change would save countless administrative dollars, many of which would likely flow back into the plan on behalf of employees.

[4] Additional Changes Needed to Further Simplify the Required Minimum Distribution Rules

On January 10, 2001, IRS issued new proposed regulations with respect to I.R.C. §401(a)(9).[32] These regulations significantly improve

[29] *Id.*

[30] Treas. Regs. § 1.416-1, Q&A M-10.

[31] I.R.C. §402(g). This amount is scheduled to increase slowly in the pension reform legislation currently before the Congress. The authors believe that even if the amount is $15,000, there is probably no need for the ADP testing. Perhaps if the catch up provision is enacted, then at that point some anti-discrimination testing would be appropriate.

[32] 66 Fed. Reg. 3928 (2001).

and simplify the existing rules. We suggest only three additional improvements.

[a] *Exempt a Minimum Amount from the Required Minimum Distribution Rules*

Some minimum aggregate amount of retirement plan and IRA assets should be exempt from the minimum distribution rules. For example, if an individual has a total of $300,000 of IRA and retirement plan assets and Congress determines that accounts with an aggregate balance below $200,000 are exempt from the minimum distribution rules, then this individual would be required to receive minimum distributions until his or her aggregate balance dropped below $200,000. At that point, the individual would be free to remove whatever amount he or she deemed appropriate or nothing at all if the individual so determined. Taxpayers with aggregate balances below the designated amount would not need to deal with the required minimum distribution rules at all. They would be able to maintain their remaining funds in a tax deferred environment until the funds were actually needed, and would not be forced to remove funds simply to comply with the minimum distribution rules.

[b] *Extend to 5% Owners the Rule Deferring Distributions Until Actual Retirement*

Employees, other than 5% owners, may delay distributions from qualified retirement plans until actual retirement if that date is later than the date that otherwise would be the employee's required beginning date. This rule should be extended to 5% owners.[33] By and large a 5% owner is a small business owner. If the small business owner is still working, this rule in effect requires the small business owner to remove retirement funds sooner than he or she would need them. There is no apparent policy rationale for this result. First, this approach is financially wasteful since the account owner is forced to withdraw retirement assets prior to retirement. When the business owner actually does retire, he or she will have fewer assets in the plan. Since the withdrawn assets are reduced by income taxes, only the after-tax dollars are available for re-investment and the appreciation on these investments is subject to additional tax as interest, dividends or capital gains are realized. This deleterious impact is compounded by the fact that small businesses seldom provide retirement income streams other than by means of the retirement plan.

[33] I.R.C. § 401(a)(9)(C).

[c] *Allow Direct Lineal Descendants of a Plan Participant, in Addition to a Spouse, to Roll-Over a Plan Distribution to an IRA*

Direct lineal descendants of a participant, in addition to a spouse, should be able to roll-over a plan distribution to an IRA. Today, if a participant dies and names his or her spouse as the beneficiary, the spouse can "rollover" the retirement plan assets into an IRA rather than receive payments from the participant's retirement plan. This often allows the surviving spouse to delay distributions from the plan and to reduce the required minimum distributions once the surviving spouse reaches his or her required beginning date. On the other hand, if a participant dies and names his or her children as the beneficiaries, the children cannot roll over the assets into an IRA and prepare a new beneficiary designation. Indeed, in many cases the children will be forced to take the distribution in one lump sum. In this situation, the assets in the retirement plan are reduced by estate taxes in the parent's estate and further reduced by immediate income tax since all plan assets are included in the child's taxable income. Federal and state income taxes and federal and state estate taxes can reduce the plan distribution by up to 85%. In essence, the government confiscates the lion's share of the funds and the children receive roughly 15%. Because of this heavy tax burden, financial advisors often encourage older taxpayers not to contribute to a retirement plan. To encourage further savings by these taxpayers, direct lineal descendants of these taxpayers should also be allowed to rollover inherited qualified retirement plan accounts to an IRA. The required minimum distributions for the lineal descendant would then be based upon the joint life expectancies of the descendant and an individual who is ten years younger than the descendant. Although the government would still receive the bulk of the retirement account if the descendant chooses to withdraw a lump sum, at least the descendant has the option to withdraw the assets over time.

The authors do not agree with the recent Joint Committee staff recommendations with respect to the minimum distribution rules.[34] The Joint Committee recommends that all distributions after a participant's death should be distributed within five years of the participant's death.

[34] Testimony of the Staff of the Joint Committee on Taxation Concerning a Study of the Overall State of the Federal Tax System and Recommendations for Simplification (April 26, 2001) (hereinafter Joint Committee Staff Testimony). This report sets forth many thought provoking suggestions. The authors by and large have commented only upon the few that we think would cause the most problems in actual practice.

This unforgiving rule could force the surviving spouse to remove funds from a tax deferred vehicle before the funds are needed, thereby increasing the risk that the surviving spouse's stream of retirement income will run out during his or her lifetime. This rule is even more damaging for lineal descendants since estate and income taxes virtually confiscate the retirement funds.

[5] Eliminate I.R.C. § 404(a)(7)

I.R.C. §404(a)(7) is an additional deduction limitation imposed on companies that sponsor a defined benefit plan *and* a defined contribution plan. When a company chooses to sponsor both types of plans, then it is limited to a corporate deduction equal to 25% of the eligible participants' compensation. Both the defined benefit plan and the defined contribution plan, individually, of course, are subject to a myriad of other limitations. Interestingly, only a profit sharing plan has a deduction limit. A stand alone defined benefit plan has no such limitation, nor does a money-purchase pension plan. Thus, when a company chooses to adopt a defined benefit plan with either a money-purchase or a profit sharing plan, this 25% deduction limit springs into being.

This extra limitation often hurts the older employees whose benefits are cut back in the defined benefit plan. Worse, this limitation is often the reason why a business chooses to sponsor only a defined benefit or only a defined contribution plan. This is unfortunate since it is clear that younger, more transient employees greatly prefer the defined contribution plan, particularly when combined with a 401(k) feature, while the older, long term employees often prefer the defined benefit plan. The authors believe that any type of limitation which precludes or discourages a business from sponsoring an array of plans which are attractive to various groups of employees should be eliminated. This will allow a company, if it deems appropriate, to sponsor both types of plans to accommodate the needs of all of its employees.

[6] Further Changes to Distribution Rules Needed

Congress should allow distributions to be made from any type of qualified plan,[35] including 403(b) plans, whenever an employee ceases

[35] ESOPs, including S ESOPs, are outside the scope of this chapter. The authors are not suggesting that the change discussed above should be extended to ESOPs. There clearly are S ESOPs which are in no way abusive. These should be encouraged. The authors also believe that there are no valid reasons for requiring S corporations to revoke

employment with the employer or any affiliated member of the employer under I.R.C. §§ 414(b), (c) or (m). The successor 401(k) plan rules are particularly troublesome. Despite the tremendous efforts of Treasury and IRS to remove unnecessary roadblocks, these rules still cause problems. The authors suggest that the successor 401(k) rules be changed: distributions should be allowed if they occur due to any plan termination, even if the plan termination is caused by an acquisition of the business through a stock or asset sale, unless the acquisition is a mere sham to get around the 59 rule. Interestingly, the Joint Committee recommends[36] that the age requirement in the 401(k) plan should be lowered from 59 to 55. The authors do not agree. The country will be better served if participants are required to keep their retirement funds in the retirement plan until participants are closer to retirement age. Indeed, generally, the country will be better served if participants are encouraged to retain retirement funds in their retirement plans for longer, rather than shorter, periods. If we were a nation of savers, then lowering the age requirement might have little impact. Since we are not, however, the authors believe that employees should be encouraged to retain funds inside retirement plans until the participant reaches age 59½.

[7] Change 410(b) Rules to 1,000 Hours, Not 500 Hours

The Joint Committee staff recommends that employees who are excluded from participation in qualified retirement plans should be disregarded in applying the minimum coverage and general nondiscrimination rules.[37] We agree. Today, when applying these tests, employees who are excludable from plan coverage are still counted for § 410(b) purposes if they have more than 500 hours of service in that year.[38] As a result of this Treasury regulation, the company must compile data on employees who worked 1,000 or more hours of service (to determine who is eligible for a contribution), and on employees who worked at least 501 hours but less than 1,000 hours (to determine whether the plan has met its required coverage tests). Requiring additional data may not seem like a major undertaking, but in the world of small plans, every additional burden placed on the small business owners must be weighed

their S corporation status and remain C corporations for five years in order to obtain §1042 treatment. This topic, however, is so significant that it deserves its own chapter.

[36] *See* Joint Committee Staff Testimony, *supra* note 32.

[37] *Id.*

[38] Treasury Regs. § 1.410(b)

against what is to be gained, particularly since many small businesses view the qualified retirement plan system as burdensome and not cost effective. Interestingly, this Treasury regulation represents a dramatic departure from the statutory framework. Pragmatically, however, this change may well have to be made by Congress. This change will streamline the system by removing an additional layer of complexity.

[8] Reporting Requirements: Form 5500

The Form 5500 is administratively burdensome and might well prove a deterrent to small businesses considering switching from a SIMPLE IRA to a 401(k) safe harbor. Whereas with the SIMPLE IRA the annual reporting requirements are imposed primarily on the IRA trustee or custodian, with a 401(k) plan significant reporting requirements are imposed on the employer. These reporting requirements are so daunting that many small businesses simply may not be able to handle these forms internally. They will need to engage outside benefits advisors, at considerable cost, to ensure compliance. This form should be reviewed carefully to see if it can be simplified significantly for small businesses, particularly for plans with fewer than twenty-five employees. The objective would be to devise a form that provides the IRS and Department of Labor with sufficient information to monitor compliance matters but that can be readily completed by the owners or the company's accountant without relying upon a retirement plan expert.

[9] Where Appropriate, Simplification Should be Voluntary, Not Compulsory; The Qualified Retirement System Requires Flexibility so that Employers Can Best Meet the Needs of Their Employees

Many changes which are intended to simplify the qualified retirement plan system should be optional. The 401(k) safe harbors are an excellent example of an optional simplification. Although these safe harbors create an alternative to the cumbersome ADP and ACP tests companies, are free not to utilize these alternatives. Indeed, many companies will choose not to use the safe harbor because they consider a 3% employer contribution or required match contribution too high a price to pay for the reduced administrative burdens. Many companies expend significant time and money on their retirement plan software and/on employee communications. For these companies the cost of new software and written communication materials for employees may exceed the prospective administrative savings offered by the safe harbor. Thus, what may look like simplification to Congress may end up costing companies countless dollars and time. By making these intended simplifications optional, companies retain the flexibility to decline the "savings" of the perceived "simplification."

The Joint Committee staff recommends that (1) a "single definition of compensation should be used for all qualified retirement plan purposes, including determining plan benefits, and (2) compensation should be defined as the total amount that the employer is required to show on a written statement to the employee, plus elective deferrals and contributions for the calendar year. The recommendation would eliminate the need to determine different amounts of compensation for various purposes or periods."[39] On its face, this would appear to be a welcome change, but for many plans, particularly larger plans, this change would require a rewrite of extensive employee communications and a substantial rewrite of their retirement plan software. This would not be a simplification at all for these plans. If this change were optional, true simplification would be achieved. The plans that prefer to stay with the status quo are allowed to do so; those that elect to utilize the streamlined definition of "compensation" are also allowed to do so.

§ 14.05 PROPOSALS FOR ADDITIONAL BENEFITS WHICH COULD BE PROVIDED THROUGH THE QUALIFIED RETIREMENT PLAN SYSTEM

[1] Long Term Care

Clearly one of the major challenges facing our Nation in the next three decades will be the care of our elderly. Congress should analyze the qualified retirement plan system to see if it can accommodate a long term care component. For instance, one can imagine a 401(k)/Long Term Care Plan whereby an employee could make 401(k) contributions to the 401(k) account and could also make contributions to a long term care account. Funds accumulated in the long term care account, as in the 401(k) account, would grow tax deferred, and qualified contributions by the employees would be exempt from income tax. Upon the employee's retirement, disability or termination of employment, the employee would be allowed to roll over the long term care account to a new kind of long term care IRA. Money in these long term care accounts could be used either to purchase a long term care policy or to defray long term care

[39] *See* Joint Committee Staff Testimony, *supra at note 32.*

costs, including rehabilitation expenses, nursing home costs and costs incurred at home for necessary care.

[2] Retiree Health Care

Similarly, the 401(k) plan could be utilized to allow employees to make pretax contributions to a retiree health care account. This would enable employees to afford supplemental health insurance after retirement. The 401(k) feature could be expanded to include a second account into which the employee could make contributions for his or her retiree health care. This could operate essentially as a Medical Spending Account (MSA).[40] Funds accumulated in the retiree health care account would, as with the 401(k) account, grow tax deferred, and qualified contributions by the employees would be exempt from income tax. Upon the employee's retirement, disability or termination of employment, the employee would be allowed to roll over the retiree health care account to either a new kind of health care IRA, the long term care IRA or possibly an MSA. Money in the retiree's health care accounts could be used to purchase supplemental health insurance, to defray major medical expenses that are not covered by insurance (possibly even if needed prior to retirement) or perhaps for long term care costs.

The permissible maximum annual contribution to a retiree health care account would, of course, need to be determined by Congress after taking into account projections of the costs that the nation would have to absorb in the next two or three decades if retirees cannot provide for those long term care or medical expenses not covered by the Government. The lost tax revenues resulting from incremental contributions to long term health care and retiree health care accounts (in addition to the § 415 limits which apply to profit sharing and 401(k) contributions) may be smaller than the increased governmental expenditures needed in the next few decades to provide long term care and retiree medical care to retirees who lack adequate savings to provide for this care themselves.

Unfortunately, legislative changes to the pension system are viewed in the context of loss of short term revenue to the government. Because of the way tax bills are scored, the revenues that may be generated in future years when assets are withdrawn from the retirement plans are largely ignored. Similarly, the scoring does not take into account reduction in future government expenditures and increased tax revenues that may result if taxpayers are financially more secure during retirement.

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[40] Prop. Treas. Regs. § 1.125.

Not only will financially secure taxpayers not qualify for needs based government transfers, such as Medicaid, but they will be stronger consumers, resulting in increased tax revenues. Finally, the scoring is never corrected to adjust for reality. Thus, if a provision is scored as a revenue loser and ends up being revenue neutral or a revenue raiser, no adjustments are ever made to allow future tax bills to recoup either the hypothetical loss or take into account any revenue generated.

The authors believe that a sea change is needed in how we view our loss of tax revenue due to increased retirement contributions by employees and employers. This revenue is not "lost," it is merely deferred. Further, the short term loss of those tax dollars may do more for the income security for our taxpayers in their retirement than almost any other change in the tax code. For example, reducing the marriage penalty may provide extra dollars to raise living standards for families in the short term. But these families are not likely to use a significant portion of those dollars to save for retirement, medical disasters or long term care. Instead they will rely on Social Security and a company sponsored retirement plan. The relatively few dollars that would be required to make *all* the changes that are recommended in this chapter would return far higher dividends to the country's well being than almost any other tax expenditure.

[3] 401(k), Long Term Care and Retiree Health Care Accounts for Defined Benefit Plans

To allow for long term care and retiree health care accounts in a defined benefit plan might require allowing these plans to add a 401(k) feature. Employers could then provide a conventional 401(k) feature without having to adopt a separate profit sharing plan. Technically, this could be accomplished by treating the 401(k) (or 401(k)/Long Term Care feature, or 401(k)/Retiree Health Care feature) as a separate defined contribution plan which would be tested only by using defined contribution discrimination testing. Each portion of the plan should be tested separately based on existing rules; there should be no additional testing or restrictions applied because the company would be deemed to be operating a defined benefit and defined contribution plan.[41]

[41] For instance, § 404(a)(7) should not apply. In fact, the authors suggest that this provision be repealed entirely.

§ 14.06 PROPOSALS TO ENCOURAGE MOVEMENT FROM A SIMPLE PLAN TO A QUALIFIED RETIREMENT PLAN

[1] SIMPLE IRAs

SIMPLE IRA plans, established under Section 408(p) of the Code, provide a simplified, tax-favored retirement plan for small business. The plan must be operated on a calendar year basis and is available for employers who have no more than 100 employees who earned $5,000 or more in compensation during the previous calendar year.[42] For purposes of this requirement, all employees employed at any time during the calendar year are taken into account, whether or not they are eligible to participate in the SIMPLE IRA plan.

Essentially, the SIMPLE IRA is a qualified salary reduction arrangement which includes certain employer contribution requirements and requires that all contributions be made to a SIMPLE IRA account for the employee.[43] Under the arrangement, the employee may elect to receive cash or have the employer contribute a certain percentage (up to $6,000, indexed for inflation)[44] of the employee's compensation[45] to the employee's SIMPLE IRA account.[46] In addition, the employer must either make matching contributions or nonelective contributions to the SIMPLE IRA on the employee's behalf. The employer is required to match 100% of the employee's deferral up to 3% of the employee's compensation.[47] Alternatively, the employer may elect to make a nonelective contribution of 2% of compensation for each eligible employee who has at least $5,000 of compensation from the employer for the year.[48] The employer must notify employees of this election prior

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[42] I.R.C. §408(p)(2)(C)(i)(I).

[43] I.R.C. §408(p)(1)(B).

[44] The current limit is $6,500.

[45] Compensation taken into account is limited by the compensation limitation of I.R.C. §401(a)(17), that is, $150,000 annually, indexed for inflation. In 2000, the annual compensation limit was $170,000.

[46] I.R.C.§408(p)(2)(A)(ii).

[47] I.R.C. §408(p)(2)(A)(iii).

[48] This nonelective contribution may be reduced to not less than 1 percent for a calendar year if the employer notifies employees of the lower percentage prior to the 60 day election period for the affected year. The employer may not make this election if it would result in the nonelective percentage being lower than 3% for more than 2 of the years in the 5 year period ending with the year under consideration. I.R.C. §408(p)(2)(C)(ii).

to the 60 day period preceding the beginning of the calendar year for which the election will be effective.[49]

[2] Eliminate the Single Plan Requirement

For a SIMPLE IRA to be a qualified SIMPLE plan, the employer may not maintain a qualified plan[50] with respect to which contributions were made or benefits accrued for service in the same year for which contributions are made to the SIMPLE IRA plan[51] In essence, the employer may not make contributions under a SIMPLE IRA and contribute to any qualified retirement plan in the same calendar year.[52]

This provision is unduly restrictive and hampers the ability of small business to switch from a SIMPLE IRA to a trust-based qualified retirement plan such as a safe-harbor 401(k) plan. Taken literally, this provision would invalidate the SIMPLE IRA for the entire calendar year if the employer, at any time during that calendar year, maintained a qualified retirement plan to which contributions were made (by the employee or employer) or benefits accrued for service in the same calendar year. The authors can appreciate, from a public policy perspective, a concern that contributions to a SIMPLE IRA and a qualified retirement plan not be made based upon the same compensation. The authors see no reason, however, why the SIMPLE IRA should be invalidated for the entire year if the employer chooses to switch from the SIMPLE IRA to a similar cash or deferred arrangement in the middle of the calendar year, as long as the same compensation is not taken into account under both plans.

For example, assume that an employer offers a SIMPLE IRA for calendar year 2002 and notifies employees that it will make 100% matching contributions up to 3% of compensation. Assume that the employer decides to terminate the SIMPLE IRA program as of June 30, 2002, and institute a safe harbor 401(k) plan as of July 1, 2002. Under the safe harbor plan, the employer will either make a 3% nonelective

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[49] I.R.C. § 408(p)(2)(B)(i).

[50] For this purpose a qualified plan is any plan, contract, pension or trust described in I.R.C. §219(g)(5)(A) or (B). I.R.C. §408(p)(2)(D)(ii).

[51] I.R.C. §408(p)(2)(D)(i).

[52] The SIMPLE IRA is not disqualified if the other plan to which the employer contributes funds in the calendar year covers only §410(b)(3) employees (e.g., employees covered by labor union collective bargaining) and those §10(b)(3) employees are not covered by the SIMPLE IRA plan.

employer contribution or a match contribution of 100% of elective contributions up to 3% of compensation plus 50% of nonelective contributions for the next 2% of compensation. (If the employer elects an enhanced matching formula, the safe harbor requirements ensure that the total rate of match at each and every level of elective contribution must be at least as high as that under the basic match formula. Hence, the enhanced matching formula can leave the employee no worse off than the basic match formula.)[53]

Under any of these approaches to meet the safe harbor requirements, the employee will receive at least the same contribution by the employer (if not more) than under the SIMPLE IRA. Moreover, under the 401(k) safe harbor plan, the employee generally has the opportunity to defer more compensation and receive more contributions than under the SIMPLE IRA.[54] Thus, the employee is not harmed and may well be significantly benefitted.

[3] Allow Rollovers from a SIMPLE IRA to a Qualified Retirement Plan at Any Time

During the two year period beginning on the date on which an employee first participates in a SIMPLE IRA maintained by the employer, the employee may rollover his or her SIMPLE IRA only to another SIMPLE IRA.[55] Thereafter, the employee may rollover the account balance to a SIMPLE IRA or a regular IRA.[56] Distributions to

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[53] I.R.C. §401(k)(12).

[54] Under the SIMPLE IRA, the employee may elect to defer a percentage of compensation (based on a definition of compensation that takes into account only $150,000 of compensation, adjusted for inflation), up to $6,000, indexed for inflation. Under the 401(k) plan, the employee's contributions are subject to different limitations. The employee's elective contributions under all plans in which the employee participates (even if not maintained by the same employer) during any taxable year, where the plans offer salary reduction arrangements (including simplified employee pensions and SIMPLE plans) are limited to $7,000, adjusted for inflation. The amount in 2001 is $10,500. Elective contributions in excess of this limit are included in the employee's gross income. Under a 401(k) CODA, the employee's elective contribution is also subject to the limitation on annual additions. I.R.C. §416(c)(1). The limitation is the lesser of $30,000 or 25% of compensation. Thus, employees with incomes in excess of approximately $27,300 would generally be able to receive larger additions to their 401(k) accounts than to SIMPLE IRAs in a calendar year.

[55] *Id.*

[56] I.R.C. § 408(d)(3)(G).

qualified retirement plans or to the employee will be treated as withdrawals rather than rollovers. As such, they will be subject to income tax. Withdrawals during the first two years of participation may be subject to a 25% early withdrawal penalty.[57] Later withdrawals may be subject to a 10% penalty. Moreover, withdrawn amounts that are subsequently contributed to a regular IRA or a qualified retirement plan would be taken into account in determining whether total contributions during the calendar year exceed the employee's contribution limits for the new IRA or plan. For example, an employee who had an account balance of $100,000 in a SIMPLE IRA could rollover this entire balance to another SIMPLE IRA or (if the employee had participated in the SIMPLE IRA for at least two years) to a regular IRA. The employee could not, however, rollover or directly transfer the $100,000 from the SIMPLE IRA to a roll-over account in the 401(k) plan.

Pending legislation[58] would allow tax free rollovers from a SIMPLE IRA to a 401(k) after the first two years of participation. The authors recommend that these rollovers be allowed even during the first two years of participation. This would facilitate movement of retirement plan assets from an IRA vehicle, which the employee can readily access prior to retirement, to the more protected environment of a qualified retirement plan trust. Moreover, the change would ensure that employees who have not participated in a SIMPLE plan for at least two years, either because they only recently decided to participate in their employer's SIMPLE IRA or have only recently been employed by the employer, are not penalized if the employer terminates the SIMPLE IRA plan in favor of a qualified retirement plan. Even these employees would be allowed to roll over their SIMPLE IRA to the new qualified retirement plan. The authors are concerned that if the recently participating employee is instead required to maintain his SIMPLE IRA account for up to two years after the employer has discontinued the SIMPLE IRA plan, the employee may find withdrawal of the SIMPLE IRA balance irresistible. Yet, the authors find no significant countervailing public policy for disallowing a direct rollover from the SIMPLE IRA to the employer's new qualified retirement plan. There is, of course, the risk that some individuals would try to use the rollover to circumvent the 25% penalty on an early withdrawal. If this were a major concern to Congress, then perhaps the qualified retirement plan would have to be required to segregate funds

[57] I.R.C. § 72(t)(6).

[58] H.R. 10 and S. 742.

coming in from a SIMPLE for the balance of the two years so that no distributions could be made from those funds except for death, disability or attainment of retirement age. Of course, if additional administrative burdens are placed upon the plan administrator, the plans would have to be given the option not to accept the SIMPLE rollovers.

§ 14.07 NEW PLANS NEEDED TO ATTRACT SMALL BUSINESS TO THE VOLUNTARY QUALIFIED RETIREMENT PLAN SYSTEM? PERHAPS THE SIMPLE PLUS!

Whether additional plans are needed to entice small business into the qualified retirement plan system is a difficult question. The authors believe the answer is "maybe." One can imagine a plan that would fall between the IRA based plans (think SIMPLE) and the 401(k) plan. The new plan would be designed so that employees could not easily withdraw account balances (as they can in a SIMPLE IRA), but employers would not be overwhelmed with or deterred by new administrative burdens. The 401(k) safe harbor would seem to offer the best chassis to ensure that plan assets would be retained inside the plan until an event permitting distribution under the law (unlike the IRA where the employee can access the funds at any time). The purpose of this new plan design would be to offer an attractive alternative to the SIMPLE as a starter plan for small businesses who are just entering the qualified retirement plan system.

The new plan, however, would differ from a traditional 401(k) or even 401(k) safe harbor. The plan would limit employer contributions to a set amount. This amount would be more than a SIMPLE, but less than a "normal" 401(k) or 401(k) safe harbor. These differentials in the contribution limit are important. The contribution limit should be sufficiently larger than that for a SIMPLE IRA so that the employer remains enticed to move from the SIMPLE to this new plan, but sufficiently less than that for a 401(k) so that the 401(k) remains an attractive alternative when the employer is ready to adopt a more administratively complex plan. As with the SIMPLE, the company would have a choice between a match contribution or a profit sharing contribution. In addition, the employer would have limited flexibility to reduce profit sharing contributions temporarily. The plan would be treated entirely differently than a regular qualified retirement plan for reporting purposes. The financial institution that offers the plan would submit reports to IRS on an individual participant basis rather than on a plan basis. This ensures that the small business would have not have additional recordkeeping burdens or be responsible for forms such as a 5500. To facilitate reporting to the IRS and the employee, the financial institution would probably establish separate accounts for each participant. These would probably resemble IRA accounts. The plan document would be required to have an IRS determination letter upon which the small business could rely. There would be no "fine print" requiring the small business to have the plan reviewed by an attorney and to request its own determination letter. Neither loans nor hardship distributions would be allowed. Eligibility provisions would be simple enough that small business owners could easily understand which employees were eligible for the plan. The financial institutions would be required to provide assistance in determining who is eligible. Vesting could be one hundred percent (100%) or three year cliff (e.g., easy for the company and the financial institution to determine). The only "responsibilities" the small business would assume would be to make the contributions to the financial institution in a timely manner and to notify the financial institution when an employee was eligible to receive a distribution from the plan due to death, disability, retirement at a set age or termination of employment. The financial institution would then, at the participant's direction, either transfer the funds to an IRA or pay them outright to the participant. No other pay-out options would be available. The financial institution would assume all liability with respect to ensuring that all investment options offered to the participants were prudent. A company could sponsor this plan at any time. There would be no barriers to discourage a small business to graduate at any time, even mid-year, from a SIMPLE to this plan. Further, there would be no disincentives or barriers to discourage a small business from graduating from this plan to a regular qualified retirement plan.

The authors believe that flexibility is critical to maintaining a healthy qualified retirement plan system. Accordingly, this plan would not replace either the SIMPLE or the 401(k) safe harbors;[59] it would merely be one more option available to small business. Complexity in the qualified retirement plan system is not due to additional choices or voluntary safe harbors; rather it is due to overlapping, complex laws that are not easily susceptible to correct interpretation or implementation by experts in the field. The regular 401(k) or 401(k) safe harbor would provide greater flexibility to the company and employees. Among other

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[59] This plan would, as a practical matter, supplant the 401(k) SIMPLE plan because it would provide better benefits for the employees than those allowed under a 401(k) SIMPLE without additional administrative burdens.

things, a 401(k) plan would allow an employer to make greater contributions for its employees, allow for loans or hardship distributions or allow more extensive pay-out methods. (This is not an exhaustive list). These items would provide the incentive for a small business to accept the responsibilities inherent in a trusteed plan.

§ 14.08 ADDED INCENTIVES TO BRING SMALL BUSINESSES INTO THE QUALIFIED RETIREMENT PLAN SYSTEM

As this goes to press, Congress is considering major changes to the estate tax system which, among other things, would increase the amount exempt from estate taxation (the unified credit), reduce rates and possibly repeal the entire estate tax system in 2011. Exempting retirement plan and IRA assets from estate taxation, while estate taxes still exist, would encourage increased small plan formation. Accountants generally advise small business owners whether or not the company should adopt a retirement plan. Presently, an owner is often better served by taking bonuses and paying current income taxes than by establishing a retirement plan. The attendant administrative burdens (many of which have to be absorbed in-house) and costs (including contributions for all of the staff members) often exceed the value to the company and the owner of offering a retirement plan.[60] Absent other factors, such as employee demand, the tax advantage of establishing a plan is so slight, if it exists at all, that the owners (with the guidance of their accountants) often opt for the bonuses. No question bonuses are far simpler.

Bonuses appear even more attractive once the accountant explains that funds left in an IRA or a retirement plan upon the owner's death may be reduced 85% by estate and income taxes, particularly if the participant is not survived by a spouse and the plan requires a lump sum distribution.[61] The children are not allowed to roll the assets over to an IRA.

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[60] Under the ratio percentage test of §410(b) a company is not required to cover 100% of its eligible employees. In reality, however, very few small plans exclude certain employees even though allowed to do so. The reason is simple: unlike in the context of a larger business, where employees do not know the benefits other employees are getting, the small business employees know the benefits available to others (as well as everything else going on in the company!) As a practical matter, it is almost impossible to exclude certain employees from the plan without adversely affecting employee morale.

[61] If the retirement plan provides for installment payments, income taxation is deferred until each installment is received. However, often a small business cannot survive a key owner's death. If the business does not survive, the plan will be terminated and the

Thus, the assets are subject to immediate income taxation and estate taxation. Faced with these confiscatory tax rates, the owner often concludes that he or she would do better investing a bonus and engaging in careful estate planning to eliminate or reduce estate tax at the owner's death.

If the small business owner does establish a plan to which he or she consistently contributes, after a number of years, the owner's accountant may eventually advise that the owner has accumulated "too much" in his retirement plan. The concern is the same as above -if the owner should die prematurely, the government could receive 85% of the retirement plan assets through immediate imposition of estate and income taxes. The owner will be encouraged to reduce contributions or terminate the plan (which, of course, adversely affects all of the plan participants). If the retirement plan assets were not subject to estate tax, so that future savings were mainly benefitting the family rather than the government, there would be no such thing as "too much" retirement plan assets, and business owners would not be encouraged to limit or terminate existing retirement plans.

§ 14.09 SUGGESTIONS WITH RESPECT TO EMPLOYEE EDUCATION AND DEPARTMENT OF LABOR SAFE HARBORS FOR INVESTMENT OPTIONS

Employees would be well served if the Department of Labor (and possibly the Office of Advocacy at the Small Business Administration and certain non-profit entities, such as the American Savings Education Council (ASEC) and/or EBRI) expanded their webpages to include basic investment information and education. These websites could provide basic information explaining investment choices, such as mutual funds, stocks, bonds and money market funds. They could explain the differences between growth, value and balanced funds and large cap and small cap funds. They could set up an easy to understand interactive asset allocation model and help employees determine their own tolerance for risk. This information would be valuable for all employees, but would be particularly useful for small business. Small businesses could give

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children will be required to take a lump sum distribution. This will trigger immediate income taxation.

the webpage address(es) to their employees and encourage them to visit the page(s).[62]

Americans need to understand that saving for retirement is essential. They can, of course, consider the funds they have paid into Social Security as savings for their retirement, but they must recognize that these dollars will, in the vast majority of cases, not entirely replace their earned income. In fact, the more one earns during one's working years, the smaller percentage Social Security payments will represent of the total amount of income needed to replace earned income. Social Security must be enhanced by personal savings and there is no better place to save than in a 401(k) plan. Participation in a qualified retirement plan is often an important component of an overall savings strategy. Educating workers about the impact of early and periodic savings is an area where efforts should be increased.

To encourage businesses to offer qualified retirement plans, the DOL should provide voluntary ERISA §404(c)[63] safe harbors for businesses. Satisfying the safe harbor would ensure that the business has met the fiduciary standards of § 404(c). Many small businesses are concerned about the fiduciary liability inherent in establishing a trusteed plan such as a 401(k). Section 404(c) was originally established to alleviate trustees' and plan sponsors' fear of liability with respect to plan investment. Unfortunately, because of the way this section has been implemented, many advisors consider it impossible to determine whether a company has met the § 404(c) requirements.

A clear, voluntary safe harbor could eliminate these fiduciary risks. Such a safe harbor could, for instance, require the plan to provide at least

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[62] A quick search of the Web will bring up a wealth of basic investment information. One can easily find, whether through the Securities and Exchange Commission or commercial websites, information explaining investment choices such as mutual funds, stocks, bonds and money market funds. Growth, value and balanced funds are described, as are large, medium small cap funds. In addition, free investment seminars, often sponsored by community organizations or financial advisors, are widely available. Community colleges often offer longer consumer oriented courses on investments. These generally address asset allocation, risk tolerance, basic financial analysis concepts and common investment myths and mistakes. Thus, for many employees, the problem is less getting basic information about investing as much as developing investment discipline. On the other hand, some employees are not willing to expend time or energy to understand investment choices. Nevertheless, if a DOL sanctioned site were available, a small business could direct employees to information without worry that the provider was marketing its own products or giving biased information.

[63] 29 U.S.C. § 1104(a) (1999).

eight investment choices, for example, at least one money market fund, one stock index fund, a balanced stock fund, a balanced bond fund and a large cap value fund. The plan would be free to offer different investment options in addition, but at least a minimum variety of selections would be required. The safe harbor could require that all investments be offered by one or more financial institutions which had more than a stated minimum amount of dollars under management. There could be additional objective standards regarding stated loans or commissions. Perhaps a second voluntary safe harbor could be designed to allow the plan to offer a choice of a few different life style funds.

To be effective, any safe harbors would have to set forth clear guidelines and should not rest upon a facts and circumstances standard. This type of standard affords small business no meaningful assistance. Only voluntary safe harbors with clear cut rules can afford small business the necessary comfort regarding liability while still offering employees investment choices.

§ 14.10 THE SMALL BUSINESS CASH BALANCE PLAN

The cash balance plan has received a lot of press lately, mostly negative.[64] Virtually all of the coverage has dealt with a relatively few major companies converting their existing defined benefit plan into cash balance plans and how some of the older employees are dissatisfied with the change. Of course, many of the younger employees are thrilled with the change, but that story doesn't seem to get the same level of attention.

Cash balance plans are not inherently "bad" plans. Any plan offers certain advantages and disadvantages to employees. Some appeal more to older or longer term employees and others better suit a younger or more transient employee. Young and transient employees, for example, often have no interest in a defined benefit plan. They are uncomfortable with these plans since these plans have no clearly identifiable account balances and no right to contribute to or make investment choices with regard to their accounts. Moreover, the defined benefit plan heavily favors older and long term employees. For the younger, more transient employee, the plan is seen as providing little benefit.

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[64] It's a shame that the press doesn't seem to give nearly the coverage to highlighting the need to save for retirement and the major success stories in the retirement plan world, such as the 401(k) plan. Without exaggeration, the 401(k) plan has brought the stock market to small business employees.

Due to legislative changes in the 1980's, small business by and large has no interest in the defined benefit plan. For this reason, small businesses are not confronting the same conversion issues as are large companies. Some small businesses, however, do sponsor cash balance plans. Often, this is the plan of choice as it blends the best of the defined contribution and defined benefit worlds.

The cash balance plan looks like a defined contribution plan built upon a defined benefit chassis. The plan is essentially a defined benefit plan, but unlike a defined benefit plan it provides separate account balances for each plan participant. By providing individual account balances, cash balance plans give employees a "proprietary" interest in the plan. At the same time, the cash balance plan offers many of the safeguards of a defined benefit plan. Of greatest importance, the investment risk is assumed by the employer rather than the employee. The authors hope that in the zeal to deal with a problem unique to larger companies, the cash balance plan, which may be an ideal plan for many employees, is not thrown out with the wash water.[65]

§ 14.11 THE FUTURE—PHASED RETIREMENT

This chapter will not discuss phased retirement in any detail. We simply want to bring to the reader's attention a significant challenge facing our country. In the future more older employees may choose to slow down at their current jobs by working part time or to transition into retirement rather than go from full time work to full time retirement. Retirement plans and health insurance coverage will probably need some redesign to accommodate this change. For example, if an employee chooses to stay on as a part time employee after reaching retirement age, the employer may want the retirement plan to offer the employee the choice to begin receiving benefits while working or to defer benefits until actual retirement. Creating this choice is consistent with a broad policy, which the authors advocate, of not requiring employees to take retirement plan distributions before they retire. On the other hand, employees should have the flexibility to receive partial payments from the plan to make up for lost wages. A defined benefit plan, for example, could allow an employee during this transition period to receive installment payments

[65] The problem of converting a large defined benefit plan into a cash balance plan has received significant of attention from the press. Unfortunately, some of the reporters do not understand the technicalities of defined benefit plans. As a result, some of this reporting has been inaccurate and somewhat inflammatory.

in the amount designated by the employee. Upon full retirement, the accrued benefit could be used to purchase an annuity, or, if the plan provided for a lump sum distribution, could be rolled over to an IRA. Final pay average plans, early retirement subsidies, non-discrimination tests and other issues will all require careful consideration. But if the goal is to allow these individuals to continue working while they are productive and want to do so, then the technical rules should be reworked to accommodate this important change in our Nation's workforce.

§ 14.12 CONCLUSION

Outlining possible legislative changes for the next five years is a somewhat daunting task. Concerned advocates of increased savings for retirement will find additional and often better ways of solving the problems presented. Further, we have undoubtedly missed some important items. Others we have purposefully not mentioned. Some issues, for example, IRAs, are beyond the scope of this chapter. On the other hand, IRAs must be taken into account in pension reform legislation. Other issues, while important to change in the future, are simply too narrow in scope to address in a chapter of this length. For instance, requiring an individual, upon attaining age 35, to remake his or her election out of a qualified pre-retirement survivor annuity affords no meaningful additional employee protection and could, we believe, be safely eliminated. Our purpose here was not to survey every conceivable reform or address every imperfection. Rather, we sought to address some structural changes that might induce more small businesses to offer qualified retirement savings plans for their employees.

The qualified private retirement plan system is remarkably successful. With passage of pension reform legislation by Congress, and the changes outlined above, the authors believe that small businesses will embrace qualified private retirement plans so that small business employees will receive the significant benefits of retirement plan coverage.