NEW YORK UNIVERSITY— Proceedings of the Fifty–Seventh Institute on Federal Taxation

Employee Benefits and Executive Compensation

ALVIN D. LURIE
Chairperson
New York, New York

1999

MATTHEW BENDER

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:

Raymond Camiscioli, J.D., at .... 1-800-252-9257 (Ext. 2118)
Carole Weintraub, C.P.A., at .... 1-800-252-9257 (Ext. 2143)

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 1999 By New York University.
All Rights Reserved. Printed in United States of America.
No copyright is claimed in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material exceeding fair use, 17 U.S.C. § 107, may be licensed for a fee of one dollar per page per copy from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (508) 750-8400.

MATTHEW BENDER

MATTHEW BENDER & COMPANY, INCORPORATED
Editorial Offices
2 Park Avenue, New York, NY 10016-5675 (212) 448-2000
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200

CHAPTER 2

The State of Small Business Retirement Plans: 25 Years After ERISA*

PAULA A. CALIMAFDE
JULIE A. SCHEJBAL

Ms. Calimafde is a partner in the law firm, Paley, Rothman, Goldstein, Rosenberg & Cooper, Chartered ("Paley, Rothman"), in Bethesda, Maryland where she heads the Qualified Retirement Plan Department. She received her B.A. degree from Swarthmore College, Swarthmore, Pennsylvania and her J.D. degree from Catholic University, Washington, D.C. She has more than twenty years of experience in employee benefits law, including qualified and non-qualified retirement plans, and also specializes in estate planning (particularly estate planning with respect to retirement plan assets). In addition to writing numerous articles and outlines for continuing legal education courses, Ms. Calimafde is a frequent witness before Congress, particularly the House Ways and Means Committee and the Senate Finance Committee, on such topics as "Private Retirement Plans and Oversight of the Internal Revenue Service," "Pension Access and Simplification Issues," and "Increasing Savings for Retirement." Ms. Calimafde is the current Chair, past President and a member of the Board of Directors of the Small Business Council of America, Inc., the only national non-profit organization which represents the interests of privately owned businesses exclusively in the tax and employee benefits area; a member of the Board of Directors of the Small Business Legislative Council (1992-), and a Past Chair (1988-1990) and Vice Chair (1986-1988) of the Closely Held Committee of the ABA Tax Section. In 1986, Ms. Calimafde was elected at the Maryland State Conference to serve as a delegate to the White House Conference on Small Business. She was subsequently appointed by the White House Conference to serve as one of eleven National Commissioners of the 1986 White House Conference on Small Business. As such, she chaired the Payroll Costs Session at the National Conference, which covered qualified retirement plans, employee benefits and social security, among other issues. In 1995, Ms. Calimafde was appointed by the White House to serve as a Presidential Delegate at the 1995 White House Conference on Small Business. In this capacity, she was instrumental in drafting and promoting many of the recommendations in the tax and employee benefits area which emerged in the top 20 recommendations. In 1998, Ms. Calimafde was appointed by the Majority Leader of the Senate, the Honorable Trent Lott, to participate in the 1998 National Summit on Retirement Income Savings

* The views expressed in this article are strictly those of the authors. The authors would like to express their appreciation to Ms. Katherine M. Glenn, Ms. Margaret McBurney, Ms. Jean Walker and Mr. Brandon Hadley for their efforts in preparing this article.

Ms. Schejbal is of counsel to the Law Offices of Rose Crunkleton and an adjunct member of the business faculty at the University of Phoenix, Columbia, Maryland campus and a former member of the employee benefits department at Paley, Rothman. She received her B.S. degree from the University of Maryland - College Park, College Park, Maryland, and her J.D. from Duke University, Durham, North Carolina.

SYNOPSIS

§ 2.01 **Introduction**

§ 2.02 **Lack of Coverage**

- [1] **The Numbers Game**
- [2] **Contribution and Administrative Costs**
- [3] **Tax Code**
- [4] **Lack of Interest from Employees**

§ 2.03 **The Evolution of the Small Business Retirement Plan**

- [1] **The 1980's — Constant Revision of the Tax Laws Underpinning the Private Retirement System**
- [2] **What Factors Led to this Onslaught of Legislation in the 1980's?**
  - [a] **Congress Faced a Serious Budget Deficit**
    - [i] **How Could a Major Change be Relatively Unimportant to Large and Mid-size Companies while Devastating to Small Companies?**
  - [b] **Congress Wanted to Rid the Qualified Retirement System of Abuses and Make it More Equitable**
- [3] **The Top-Heavy Rules and How They Were Designed to Primarily Impact Small Business Retirement Plans**
  - [a] **What is a Top-Heavy Plan?**
  - [b] **What's the Difference Between a "Key" Employee and a "Highly Compensated" Employee?**
  - [c] **What are the "Special Rules" for a Top-Heavy Plan?**
    - [i] **Vesting**
    - [ii] **Minimum Required Contributions**
    - [iii] **Compensation Limited to $200,000**
    - [iv] **Complex Rules When a Non-Key Employee is a Participant in Both a Defined Contribution Plan and a Defined Benefit Plan**
    - [v] **Legislative History of the Top-Heavy Rules**
- [4] **A System that Confounded the Best and the Brightest**

[5] Termination of Existing Plans and Dramatic Slowdown of New Plans

§ 2.04 The Beginnings of Change

§ 2.05 Perception by the Owners and Key Employees That Retirement Plan Money is Less Attractive Than Other Assets

§ 2.06 The Much Maligned 5% Owner and the Professional Corporation

§ 2.07 Why is the Small Business Defined Benefit Plan on the Most Endangered List?

§ 2.08 Types of Retirement Plans Available to Small Business

[1] SIMPLE Plans

[a] Employer/Employee Contributions

[b] Employee Eligibility

[c] SIMPLE 401(k) Plans

[d] Drawbacks of SIMPLE IRAs

[i] The 100-Employee Limitation

[ii] Contribution Limitations

[iii] Creditor Protection

[e] SIMPLE Plans Exempt from the Top-Heavy Rules

[f] SIMPLE IRA is an IRA, Not a Qualified Retirement Plan

[g] From a Tax Policy Viewpoint, Which is Preferable — the SIMPLE, the SEP or a Qualified Retirement Plan?

[h] Does Small Business Need any Other Plans?

[2] Simplified Employee Pensions

[a] Employee Eligibility

[b] Contributions

[c] Drawbacks of SEPs

[i] 100% Participation

[ii] 100% Vesting

[iii] Tax Filing Requirements

[3] 401(k) Plans and the New Safe Harbor Provisions

§ 2.09 The 1995 White House Conference on Small Business

§ 2.10 The National Summit on Retirement Savings — June 1998

§ 2.11 Small Business Jobs Protection Act and Taxpayer Relief Act of 1997 Have Begun the Process of Simplification and Increased Incentives

[1] The I.R.C. § 401(k) Safe Harbor

[2] The Repeal of Family Aggregation

[3] The Repeal of the I.R.C. § 4890A Excise Tax

§ 2.12 What Further Reforms are Needed to Restore Full Health To the System?

[1] Increasing the § 415 Limits and the § 401(a)(17) Limit

[2] 401(k) Changes
[a] Increase the I.R.C. § 401(k) Contribution Limit
[b] Exempt Match Safe Harbor from Top-Heavy Rules
[c] The Qualified Plus Contribution is an Exciting Concept
[d] Exclude 401(k) Contributions from the I.R.C. § 404 15% Deduction Limit
[e] Repeal of the Complicated "Multiple Use Test"
[f] Employee-Pay-All 401(k) Plans for Small Business Should be Allowed
[g] Catch-up Contributions
[3] Increase I.R.C. § 404 Deduction Limit From 15% to 25%
[4] Top-Heavy Rules
[5] Required Minimum Distribution Rules
[6] Lineal Descendants Should Be Allowed to Roll-Over Inherited Plan Assets to an IRA
[7] All (or a Portion) of Retirement Assets Should Be Exempt From Estate Taxes
[8] Eliminate I.R.C. § 404(a)(7)
[9] Allow Plan Loans for S Corporation (Sub-S) Owners, Partners and Sole Proprietors
[10] Repeal of 150% of Current Liability Funding Limit
[11] User Fees and Tax Credits
§ 2.13 Conclusion

§ 2.01 INTRODUCTION

Small businesses are a dynamic and vibrant force in today's United States economy.[1] 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, SBA estimates that small businesses employ 53% of the private sector workforce.[2]

Yet, it is estimated that less than half of the employees working for a small business have access to a retirement plan,[3] and as the

[1] For the purposes of this article, a "small business" is defined as a business with 100 or fewer employees.

[2] U.S. SBA, *Small Business Answer Card,* (visited Mar. 12, 1999) http://www.sba.gov/AVDO.

[3] 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).

size of the business decreases, the coverage figures decrease correspondingly. It is estimated that only 19% of employees working for firms with less than 25 employees are covered by a retirement plan and only 48% of employees working for firms with between 25 and 99 people are covered by a retirement plan. This is compared to 83% of employees working for employers with over 100 people.[4]

Thus, a worst-case analysis would reflect that roughly one quarter of the private sector workforce in the United States has little or no access to a company-sponsored retirement plan and may be overly dependent on Social Security for their retirement security. This is of real concern inasmuch as it is becoming increasingly clear that Social Security will not be adequate to fund the type of retirement most baby boomers envision.[5]

In this chapter, we will examine the state of small business retirement plans 25 years after the enactment of ERISA. We will analyze why there is a lack of retirement plan coverage in the small business arena. We will review the various retirement plan options available to small businesses, including the 401(k) plan, the SIMPLE IRA and the SEP IRA. The chapter will conclude with recommendations for increasing retirement plan coverage for small business employees.

§ 2.02 LACK OF COVERAGE

[1] The Numbers Game

Many small businesses would like to provide retirement plans for their employees and believe that retirement plans aid in attracting and retaining top employees. As we know, however, the retirement plan coverage rate for small businesses lags far behind the retirement plan coverage rate of their larger counterparts.

---

[4] *Id.*

[5] "Social Security has never provided an adequate income. With changes already enacted to increase the retirement age, and assuming no payroll taxes increases, the baby boomers' benefit will be an average of just under 30 percent of income instead of today's 42 percent. This will require individuals to work longer and to save more. . ." *Retiring Baby Boomers: Meeting the Challenges: Hearings Before the Senate Spec. Comm. On Aging,* 105th Cong. 1 (Mar. 6, 1997). Nor was Social Security ever intended to provide total retirement income security.

The actual retirement plan coverage picture may not be as bleak as the figures set forth above indicate. Retirement plans cover only employees who meet certain eligibility requirements. Generally, to be eligible to participate in a retirement plan, an employee must be (i) over age 21; (ii) have worked at least one year with his/her current employer;[6] and (iii) have worked at least 1,000 hours per year for the employer.[7] Thus, part-time employees, employees under age 21 and transient employees are generally not eligible to participate in a retirement plan. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the 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 quite dramatically. *When using statistics that only deal with the eligible workforce, it is estimated that 42% of the eligible small business workforce participates in a retirement plan and that 50% of the small business workforce is offered retirement plan coverage.*[8]

Regardless of the interpretation of the numbers, there is a lack of retirement plan coverage in the small business sector. This exists for a variety of reasons. These reasons include among others: (i) the cost of contributions to a retirement plan; (ii) administrative costs; (iii) the tax laws and regulations governing the system; and (iv) employee apathy.[9]

---

[6] "A trust shall not constitute a qualified trust under §§ 401(a) if the plan of which it is a part requires, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of the following dates -(i) the date on which the employee attains age of 21; or (ii) the date on which he completes 1 year of service." I.R.C. §§ 410(1)(A)(i) and (ii) (CCH 1998).

[7] "For purposes of this subsection, the term 'year of service' means a 12-month period during which the employee has not less than 1,000 hours of service." I.R.C. § 410(3)(A) (CCH 1998).

[8] Bureau of Labor Statistics, Employee Benefits Small Business 1996 USDL 98-240 and Bureau of Labor Statistics, Employee Benefits Small Business 1997 USDL 99-02.

[9] David M. Kemps, "Barriers that Keep Small Employers From Sponsoring Retirement Plans at 1-3" (1998) (unpublished briefing paper, on file with author).

[2] Contribution and Administrative Costs

Contribution and administrative costs can be significant, particularly for a small business. Small businesses are often wary of instituting a retirement plan because of the large anticipated expenses and the necessity of earmarking sources of capital to meet these expenses. Often the small business would prefer to use this capital elsewhere (e.g., to reinvest in the business).

In a defined benefit plan, a future retirement benefit is projected for each participant and the company is *obligated* to make annual contributions to the retirement plan in order to fund it properly. These contributions are mandatory and must be made regardless of the profitability of the business in a given year.[10] Thus, a small business may be reluctant to commit to a defined benefit plan if there are concerns as to the ability of the business to meet its future defined benefit obligations. The same is basically true of a money-purchase pension plan and a target benefit plan.

A profit-sharing plan or a 401(k) plan (which has a profit-sharing chassis) does not obligate the company to make a contribution every year.[11] Thus, these plans allow the small business to determine whether it can afford to make a contribution to the plan in a given year and if so, how large the contribution will be. Because of the operation of the top-heavy rules, however, a small business cannot sponsor an employee-pay-all 401(k) plan unless the key employees are excluded from participating.[12] Nevertheless, it is a mistake to assume that the costs for these types of plans are insignificant. Unless the business is fairly stable and profitable, the small business owner may find it difficult to sponsor even these flexible retirement plans.

Example: Micro, Inc. ("Micro") a small business with four employees, sponsors a profit-sharing plan. The plan allows for a maximum employer contribution of 15% of total compensation. The total 1999 compensation for Micro's employees is $282,000. Micro has one owner, who is the highest-paid employee and receives compensation of $160,000. All of the employees are eligible to

[10] I.R.C. § 412(a) and (b) (CCH 1998).

[11] I.R.C. § 412(h)(i) (CCH 1998).

[12] *See*, Top-Heavy discussion, § 2.03[3][c], Treas. Reg. § 1.416-1 M-20 Q&A Top-heavy regs.

participate in the plan. If Micro wishes to make the maximum 15% contribution on behalf of each employee, Micro's total 1999 contribution to the profit-sharing plan would be $42,300. In addition to the contribution costs, retirement plans are expensive to administer. Administrative costs include: (i) costs of designing and preparing the retirement plan, summary plan description and amendments thereto; (ii) investment fees to manage the retirement plan assets; (iii) record-keeping costs; (iv) processing distributions and loans from the retirement plan; and (iv) educating participants.[13] According to a 1996 study by the Hay Group, a small business with 15 employees faced $9,299 in yearly administrative costs for a defined benefit plan (or $620 per employee); while an employer with 10,000 employees faced $683,258 in yearly administrative costs for a defined benefit plan or ($68 per employee).[14] Defined contribution plans are less expensive to administer but are still costly for small business. The same Hay Group study found that a small business with 15 employees could expect annual administrative expenses for a defined contribution plan in the range of $4,308 (or $287 per employee) while the employer with 10,000 employees could expect annual administrative costs for a defined contribution plan of $491,868 (or $49 per employee.).[15]

[3] Tax Code

ERISA and the Internal Revenue Code contribute to the lack of coverage. The rules and regulations governing the retirement plan system are complex and often require an ERISA expert to interpret.[16] The rules and regulations also change from time to time. This requires retirement plans to be updated and amended. This also

---

[13] Kemps, *supra* note 11 at 2.

[14] Conte, *supra* note 4 at 20.

[15] *Id.*

[16] *See e.g.*, I.R.C. § 416(g)(1)(A), Top Heavy Plan Requirements: "(1) In General-(A) Plans Not Required to be Aggregated. -Except as provided in subparagraph (B), the term "top-heavy" means, with respect to any plan year-(i) any defined benefit plan if, as of the determination date, the present value of the cumulative accrued benefits under the plan for key employees exceeds 60 percent of the present value of the cumulative accrued benefits under the plan for all employees, and (ii) any defined contribution plan if, as of the determination date, the aggregate of the accounts of key employees under the plan exceeds 60 percent of the aggregate accounts of all employees under such plan."

adds to the administrative costs. Currently, the IRS is requiring no fewer than seven amendments[17] to retirement plans as a result of the Small Business Job Protection Act ("SBJPA").[18] Contrary to common sense, small business plans are singled out for extra burdens and complexity via the top-heavy rules.[19]

[4] Lack of Interest from Employees

Interestingly, small business employees (other than the owners and key employees) themselves also contribute to the lack of retirement plan coverage. Despite being in the employees' best interests, studies have found that employees are apathetic about retirement plans and their own retirement security. One survey found that 22% of small business owners stated lack of employee demand as the primary reason they did not offer retirement plans. In addition, 49% of small business owners would give the matter serious consideration if employees were to demand a retirement plan.[20] An EBRI/Gallup Poll found that 64% of employees ranked health insurance as the most important employee benefit while only 18% ranked a retirement plan as the most important benefit. Five percent of the employees rank child care as the most important benefit.[21] When deciding to offer a retirement plan to its employees, the small business is faced with: (i) contribution costs; (ii) administrative costs which on average are higher than those of its larger counterparts; and (iii) a complex set of rules and regulations that only a specialist can understand. Yet, most of the employees are not particularly appreciative of this employee benefit. There is little wonder why a small business may choose not to establish a retirement plan.

---

[17] *See, e.g.*, SBJPA Supplemental Amendments for Plan Termination (Oct. 20, 1997) (unpublished paper on file with IRS Ohio Key District).

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

[19] *See*, Top-Heavy discussion, *supra*, § 2.03[3][c].

[20] Conte, *supra* note 4 at 20.

[21] *Id.* at 19.

§ 2.03 THE EVOLUTION OF THE SMALL BUSINESS RETIREMENT PLAN

After the enactment of ERISA, small business retirement plans continued to gain in popularity. We say this even though other prominent advisors maintain that the qualified retirement plan system never worked effectively in the small business context. We know from tax advisors from all over the country that retirement plans for small businesses were being established in record numbers after ERISA and prior to The Tax Equity and Fiscal Responsibility Act of 1982.[22] Since many small businesses use prototypes offered by the major brokerage houses and insurance companies, we can only surmise that if tax lawyers and pension administrators were drafting new plans in record numbers, these institutions must have also witnessed tremendous growth. Some of the data intended to support the proposition that small business was not really adopting retirement plans during this time is flawed. The data is based upon a time period that precedes the boom period of the late 70's, when plans were being adopted in record numbers.

Stable small businesses were adopting plans because it became evident to the owners of these businesses that a qualified retirement plan was the best way to save for retirement and to retain good staff employees. Costs of the plan were in good balance with the benefits to be derived from the plans—so plans were being adopted. Fees paid to administrators and pension specialists were reasonable. Most importantly, companies were able to take actions knowing what the results would be. The system was working.

Even though ERISA enacted sweeping changes in the qualified retirement system, the changes were accepted by most small businesses that sponsored retirement plans. ERISA required faster vesting and shorter waiting periods than prior law.[23] By and large, however, small business plans continued relatively unchanged. At that time a qualified retirement plan could be fully integrated with

[22] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26, 28, 31 and 42 U.S.C.).

[23] Prior to the enactment of ERISA, qualified retirement plans were not required to provide participants with vested rights in the retirement plan until participants reached normal retirement age. S. Rep. No. 93-383, (1973), *reprinted in* 1974-3 C.B. Supp. 123.

Social Security.[24] After enactment of ERISA, most small businesses retained their plans and restated them to comply with the new law.[25]

Immediately after ERISA, the rules governing the qualified retirement plan system were relatively straightforward and government regulation was not overly burdensome.

[1] The 1980's — Constant Revision of the Tax Laws Underpinning the Private Retirement System

Starting in the 1980's, the voluntary private retirement system began to be slowly buried by a relentless layering of complex tax laws. Congress began to amend and revise the tax laws governing retirement plans at an alarming rate. In the quest to find short-term revenue to offset the budget deficit, the long-term impact of a bill on the retirement system was not given sufficient consideration or weight.[26]

In the 1980's, Congress passed the following major laws which had a significant impact on retirement plans: The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA");[27] The Deficit Reduction Act of 1984 ("DEFRA");[28] The Retirement Equity Act of 1984 ("REA");[29] The Tax Reform of 1986 ("TRA 86");[30] The

[24] Otherwise eligible employees who earned below the Social Security wage base did not earn any benefits in the qualified retirement plan.

[25] It was not unusual for these plans to be about 20 pages in length. Today most retirement plans are in the 50-75 page range due largely to the additional laws imposed since ERISA.

[26] Paula A. Calimafde, "The Impact of the Top-Heavy Rules on Small Business: Are They Justified Particularly in Light of the Tax Reform Act of 1986?" (1987) (U.S. SBA) (App. A citing *Effect of TEFRA on Private Pension Plans: Hearings in the Tax and Equity and Fiscal Responsibility Act of 1982 Before the Subcomm. on Savings, Pensions, and Investment Policy*, 98th Cong. (1983).). *Effect of TEFRA Hearings* hereinafter cited as "TEFRA Hearings."

[27] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26, 28, 31 and 42 U.S.C.).

[28] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26, 28, 31, 40 and 42 U.S.C.).

[29] The Retirement Equity Act of 1984, Pub. L. No. 98-397, Stat. 98 Stat. 1426 (codified as amended in scattered sections of 26 and 29 U.S.C.).

[30] The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 1951, 1964-65, 1995 (codified in scattered sections of 19, 26, 28, 29, 42, 46 and 49 U.S.C.).

Omnibus Budget Reconciliation Act of 1986 ("OBRA 87");[31] The Omnibus Budget Reconciliation Act of 1987 ("OBRA 87");[32] The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA");[33] and The Revenue Reconciliation Act of 1989 ("RRA").[34] This was simply too much change for any system to assimilate properly.[35]

The frequency and complexity of these changes in the retirement plan area were greatly exacerbated by IRS regulations which were at times (i) untimely, (ii) effective retroactively, and/or (iii) difficult to comprehend even by ERISA specialists. Due largely to the rapidity of statutory changes, regulatory guidance was sometimes not issued until after the plans had to comply with the law change. In some cases, the change was so incomprehensible that IRS basically had to suspend operation of the law until it figured out what to do with the change.[36] This action by IRS was taken in an attempt to accommodate the companies sponsoring retirement plans, but it reflects the utter chaotic state of affairs at that time.

---

[31] The Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (codified in scattered sections of 5, 7, 12, 15, 16, 26, 30, 31, 42, 45, 46 and 49 U.S.C.).

[32] The Omnibus Budget Reconciliation Act of 1987 (Revenue Reconciliation Act of 1987), Pub. L. No. 100-203, 101 Stat. 1330 (codified in scattered sections of 1, 2, 5, 7, 16, 19, 20, 22, 26, 29, 30, 33, 38, 42 and 45 U.S.C.).

[33] The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 1346 (codified in scattered sections of 26 and 42 U.S.C.).

[34] The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2301 (codified in scattered sections of 26 U.S.C.).

[35] Harold Apolinsky, Esq., a well respected practitioner, wrote in 1990 to Mr. Gideon at the Department of the Treasury, "You may recall that Wilbur Mills insisted that there be 15 years between major tax laws. We had the 1939 Code, the 1954 Code, and what we thought (erroneously by today's standards) was a major tax bill in 1969. Such a time frame allows the taxpayers, their advisors, and those of you in tax administration to become comfortable with the system. It is constant change which is the problem." Letter from Harold Apolinsky (1990) (on file with author). Mr. Apolinsky has also determined that from 1982 through 1998 there have been over 12,026 changes made to the Internal Revenue Code! Compliation of Tax Law Changes from 1981-1998 by Harold Apolinsky (updated 1998) (on file with author).

[36] *See, for example*, I.R.C. § 401(l) amended by Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 1951.

[2] What Factors Led to this Onslaught of Legislation in the 1980's?

What prompted the onslaught of complicated legislation which precipitated a decline in small business plan coverage? Several factors came together which resulted in a deadly combination for small business retirement plans.

[a] *Congress Faced a Serious Budget Deficit*

Congress looked for "easy" money — revenue which came from areas that either few noticed or few understood. The qualified retirement plan system based on technical provisions found in the tax code and in ERISA was particularly vulnerable. Few people understood the tax laws upon which the system rested. The vast majority of Americans never noticed nor understood the seemingly innocuous tinkerings of Congress on an obscure system until it was too late.

Large business entities which had a powerful presence in Congress were not overly alarmed with the initial changes. Most changes, such as the imposition of the top-heavy rules, seemed to primarily affect small business retirement plans.[37] At this time big business was well represented in Congress while small business was perceived as relatively unimportant by Congress.

By the end of the 1980's both of these factors would change. As Congress continued to change the tax laws underpinning the qualified retirement plan system, the actual changes themselves, as well as the sheer number of the changes, began to adversely affect larger plans also. Many of the changes that were contained in the top-heavy rules began to apply to larger plans, though by entirely different laws. For example, the top-heavy vesting schedule which was applicable primarily to small business retirement plans required that benefits vest at least as rapidly as under either of these alternative schedules: (i) 100% vesting upon completion of three years of service; or (ii) 20% vesting after two years of service, 40% vesting after three years of service, 60% vesting after four years of service, 80% vesting after five years of service and 100% vesting

[37] *See* Top-Heavy rules discussion, *supra* § 2.03[3][c]].

after six years of service.[38] When these rules applied only to small business plans they were ignored by larger businesses as inapplicable and thus unimportant. At this time large plans often had vesting schedules where an employee received no vesting for the first nine years of service and upon completion of the tenth year received 100% vesting. In other words, at the end of ten years, the employee had earned the right to his or her account balance or accrued benefit. Another popular vesting schedule at this time for larger entities was the so-called "4-40" schedule which provided no vesting for the first three years of service, 40% vesting upon completion of the fourth year of service, 5% additional vesting for the next two years and then 10% for each additional year of service thereafter. At the end of eleven years, a participant had entirely earned his or her account balance or accrued benefit.

TRA 86, however, changed the vesting schedules for *all* plans (except those that were top-heavy) so that benefits had to vest at least as rapidly as under either of these alternative schedules: (i) 100% vesting upon completion of *five* years of service; or (ii) 20% vesting after *three* years of service, 40% vesting after four years of service, 60% vesting after five years of service, 80% vesting after six years of service, and 100% vesting after seven years of service.[39] The differential between these vesting schedules and the top-heavy vesting schedules is fairly de minimis. It began to dawn on the larger business entities that the top-heavy vesting concept had been extended to all plans.

Similarly, prior to TEFRA, a plan could be integrated with Social Security so that only those employees who had compensation in excess of the Social Security taxable wage base received a contribution. An example of an acceptable contribution formula at this time would have been: 5.7% of a participant's compensation in excess of the Social Security taxable wage base. This type of plan design was not available to top-heavy plans because of the top-heavy rules which require a minimum benefit. Thus a top-heavy plan would

[38] I.R.C. § 416(b) as amended by The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26, 28, 31 and 42 U.S.C.).

[39] I.R.C. § 411(a)(2) as amended by The Tax Reform Act of 1986, Pub. L. No. 99-509, 100 Stat. 1951, 1964-65, 1995 (codified in scattered sections of 19, 26, 28, 29, 42, 46 and 49 U.S.C.).

have had a formula such as the following: 3% of a participant's compensation below the Social Security taxable wage base and 8.7% of compensation above the Social Security taxable wage base.[40] TRA 86 imposed a new integration formula which required that all employees had to receive a contribution even if their compensation did not exceed the Social Security taxable wage base.[41] Rather than requiring a minimum benefit as the top-heavy rules did, the new integration formula simply required that a portion of the contribution be made on participants' compensation below the Social Security taxable wage base (or on all compensation). For example, an acceptable TRA 86 contribution formula for an integrated profit-sharing plan that was not top-heavy was the following: 2.85% of compensation below the Social Security taxable wage base and 5.7% of compensation above.

To a significant extent, the impact of this provision is almost identical to that of the minimum benefit in a top-heavy plan. The only differential is found in a plan that has an excess percentage of less than 6%, because a non-top-heavy plan will be allowed to integrate below 3%, so it is possible that a staff employee would receive a benefit of less than 3%. For example, a non-top-heavy plan could have a contribution formula of 2% of compensation below the taxable wage base and 4% above the taxable wage base, whereas a top-heavy plan would either have a contribution of 2% of all compensation (i.e., not integrated) or 3% of compensation below the taxable wage base and 6% above.

Again, the trend was clear — the top-heavy rules themselves would not be imposed on the plans of larger business entities, but the same concepts would be extended by different means. Larger business entities now began to follow the pension legislation with real interest.

At the same time, small business began to gain in political power. By 1989, with the repeal of the so-called Section 89 rules that Congress had been attempting to impose on the business community with respect to health care, it was clear that small business was now a major political force.[42] Unfortunately, by this time the damage

[40] I.R.C. § 416(c)(2) (CCH 1998).

[41] I.R.C. § 401(l) (CCH 1998).

[42] Small business became a political power due in part to the exploding growth

had already been done. It was not until the mid-1990's that courageous members of Congress realized they could simplify the retirement system and begin to restore it to its former vitality.[43]

[i] *How Could a Major Change be Relatively Unimportant to Large and Mid-size Companies while Devastating to Small Companies?*

An example of a change that had a devastating impact on small business retirement plans while being only moderately significant to large businesses was the cutback in retirement plan contributions enacted in 1982. Prior to TEFRA, the defined contribution limit on annual additions to a participant's account was $45,475 and the defined benefit limit was $136,425. TEFRA reduced the defined contribution limit to $30,000 and the defined benefit limit to

---

in this sector combined with a retrenchment in the big business sector. The National Federation of Independent Businesses ("NFIB") became a major small business association representing literally hundreds of thousands of small business. The Small Business Legislative Council ("SBLC") was and is comprised of 100 trade and professional small business associations. National Small Business United ("NSBU"), the National Association of Women Business Owners ("NAWBO") and the National Association of the Self-Employed ("NASE") became active. The Small Business Council of America ("SBCA") arose which specialized in protecting the interests of small business in the technical tax, employee benefits and healthcare areas. The American Society of Pension Actuaries ("ASPA") representing actuaries and plan administrators many of whom catered to the small business market began to take an interest in federal tax legislation affecting retirement plans. The Association of Private Pension and Welfare Plans ("APPWP") and The Profit Sharing/401(k) Council of America ("PSCA") both of which represented large and small enterprises were also influential in this regard. Also crucial were the White House Conferences on Small Business in 1986 and in 1995. These conferences brought together almost 2000 small business delegates from all over the country who hammered out 60 recommendations for Congress to consider. The Office of Advocacy of the U.S. Small Business Administration (in particular the Chief Counsel, Frank Swain, for the 1986 Conference and Jere Glover, for the 1995 Conference) played a major role in the success of these conferences and in assisting small businesses in getting the recommendations implemented into law.

[43] Special mention must be made of Congressman Rob Portman, Congressman Ben Cardin, Congresswoman Nancy Johnson, Congressman Earl Pomeroy, Senator Bob Graham, Senator Jim Jeffords, Senator Chuck Grassley and Senator Bill Roth. All of these members of Congress and their staff members have worked tirelessly to bring reform and simplification to the voluntary retirement system.

$90,000.[44] Larger businesses were able to provide meaningful retirement benefits for their key employees through non-qualified plans. Due to the cutback in benefits that could be provided by the defined benefit plan, after TEFRA many large and mid-size employers depended less upon their defined benefit plan to provide benefits for their key employees and more on non-qualified deferred compensation plans. Non-qualified plans are not subject to the I.R.C. § 415 limits.[45] Because the non-qualified plans benefitted only the top-paid employees, a lack of interest by the company in the defined benefit plan resulted. There was little incentive to increase benefits since the increases could not benefit the key employees or the highly compensated employees. On the other hand, many larger and mid-size businesses did continue the defined benefit plans even though benefits stayed fairly static.

What happened to small business retirement plans, however, was catastrophic. The cutbacks in benefits occurred at the same time that additional burdens (i.e., the top-heavy rules) and complex regulations were being imposed. Small business perceived the system as biased against the key employees and the owners. It was perceived as too expensive as well as difficult, if not impossible, to understand. The small business owners determined that the costs outweighed the benefits to be derived for the key employees. Accordingly, existing plans were terminated in droves and new plans were not established.

[b] *Congress Wanted to Rid the Qualified Retirement System of Abuses and Make it More Equitable*

Proponents of the top-heavy rules believed that these rules were necessary to cut back on the "tax shelters" (i.e., qualified retirement plans) for the "rich" professionals (e.g., doctors and lawyers) and to ensure that more of the benefits were distributed to the staff employees. The reasoning was that a qualified retirement plan which covered one doctor and two or three nurses and allowed the doctor to build up a large retirement benefit amounted to an undesirable tax subsidy. The goal of the tax subsidy underlying the

---

[44] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97—248, 96 Stat. 324 (codified as amended in scattered sections of 26, 28, 31 and 42 U.S.C.).

[45] I.R.C. § 457 limits non-qualified plans somewhat but it is applicable to tax-exempt entities only.

qualified retirement plan system was to promote retirement plan coverage for all employees. Many individuals, however, believed that the tax subsidy was not achieving the desired goal since benefits for key employees were too high while benefits for staff employees were too low. Hence, the top-heavy scheme was created to make sure the staff employees received real benefits. Other provisions of TEFRA severely reduced the contributions or benefits the highly compensated employees could otherwise receive.

Did the rules work? Yes, to a limited extent, but at a cost of extensive complexity and substantial dollars spent on plan amendments and administration.

Example: An actual situation illustrates the problems inherent in the top-heavy rules. This situation involved a successful restaurant, gift and antique shop operation in a busy suburb. The company had two stockholders, four or five managers and 50 to 60 staff employees. It sponsored a money purchase pension plan and a defined benefit plan. The pension administration firm used by this company determined that the plans were top-heavy and the costs of maintaining the defined benefit plan with the 2-percent defined benefit minimum benefit prohibitive. The company then hired an attorney to review the pension administration firm's findings. The attorney realized that the administration firm had not reviewed the employee census for the preceding four plan years and had missed two key employees who had received distributions from the plans three years prior. The attorney also discovered that the plans had not been aggregated together to determine top-heavy status. The attorney concluded that the plans were not top-heavy in the determination year, but would have to be reviewed fairly regularly because the plans were close to becoming top-heavy, particularly if the company offered stock to one of its key managers which it had planned to do. The company was informed that as required by the new law both plans would have to be amended to include all of the top-heavy rules. These amendments cost about $3,000 to implement. As a result, $6,000 poorer due to legal and pension administration fees, this company, its plans and employees were exactly where they were when they started this exercise. Perhaps the employees were lucky, however, for if indeed the plans had been determined to be top-heavy, the company would surely have terminated its defined benefit plan.

What can be learned from this example? First and foremost, the proponents of the top-heavy rules forgot that small business is not synonymous with "rich" doctors and lawyers. They forgot the manufacturers, the retailers, the construction companies, and the other business services, much less the "poor" doctors and lawyers. They did not understand the real life situation of a small business attempting to comprehend the morass of top-heavy rules and to implement them correctly. The proponents of the top-heavy rules forgot that most small business owners did not make $200,000.[46] They neglected to realize that small business was already overwhelmed in regulatory paperwork and would not graciously accept additional complexity and paperwork in the area of their retirement plans.

Instead of the top-heavy rules, a few clear rules applicable to all plans would have been far more effective and could have accomplished the same reforms. The problems which were deemed most abusive — integrating staff employees out of a plan by Social Security and designing a very "rich" defined benefit plan for the owners of a small business could have been curbed far more effectively by two or three provisions such as the integration provisions contained in the TRA 86 and the phase-in of the maximum defined benefit limitation over ten years of participation in the plan also contained in TRA 86.

Is the small plan merely a tax shelter? This allegation is not only unfair, but destructive. Referring to small plans as tax shelters is the type of comment newspaper reporters pick up and bandy about while the true economic substance of the plan goes unnoticed. The qualified retirement plan, whether small or large, creates significant rights for the plan participants and generates significant costs for the company. Funds in a retirement plan are not tax sheltered, rather they are tax deferred until the participants receive them, at which time they are brought into the participant's gross income. Practitioners who specialize in the small business retirement plan area know that plans which benefit the owners of small businesses also provide significant benefits for the staff employees.

---

[46] Two hundred thousand dollars was the limit put in place by the top-heavy rules with respect to top-heavy plans. I.R.C. § 416(d) repealed by The Tax Reform Act of 1986, Pub. L. No. 99—514, 100 Stat. 1951, 1964—65, 1995 (codified in scattered sections of 19, 26, 28, 29, 42, 46 and 49 U.S.C.).

[3] The Top-Heavy Rules and How They Were Designed to Primarily Impact Small Business Retirement Plans

Finally, a word about top-heavy plans — the so-called "suspect" plans from Treasury's viewpoint. Probably 80 to 90 percent of all plans sponsored by a privately held company are top-heavy. This is because of the simple mathematical test which is used by the Internal Revenue Code.[47] It should not be a surprise that non-key employees leave more often than owners and key employees. People think of top-heavy plans as extremely small but companies with 100 to 200 employees can be top-heavy or in all likelihood will become top-heavy in the next few years. Most small business owners will be able to retire with some security only if they have funded a retirement plan at fairly generous levels or are able to sell their business. Retirement benefits in the small business context are provided primarily by the retirement plan; this is not true for key employees in a large company. In the large company context, other vehicles provide most of the retirement savings for top management. Because of the tax code, most small businesses are not able to use the non-qualified plans such as golden parachutes, non-qualified excess benefit plans or top-hat plans utilized by larger business entities. Because of this, most top-heavy plans provide valuable benefits for all employees — both highly compensated and non-highly compensated. It is not unusual for a small business retirement plan to provide benefits far in excess of five percent of compensation, though this is unusual for the larger business plans.

[a] *What is a Top-Heavy Plan?*

A top-heavy plan is one in which the combined account balances or the present value of accrued benefits[48] for "key employees"[49]

---

[47] I.R.C. § 416 (CCH 1998).

[48] "Account balance" is a term relevant to defined contribution plans. Defined contribution plans include money-purchase pension plans, profit-sharing plans, (including 401(k) plans) and target benefit plans. The amount of contributions which can be made on behalf of each participant is limited by I.R.C. § 415(c)(1). The amount a participant receives at the time of separation from service is equal to his vested portion of the total contributions made by the employer plus earnings on those contributions and forfeitures, if applicable. Treas. Reg. § 1.416—1 T—24 Q&A. This is what is referred to as the participant's account balance. "Accrued benefit" is a term which is generally used in the context of a defined benefit plan. A defined benefit plan promises a designated benefit at retirement so the concept

exceed 60% of the combined accounts or accrued benefits for all employees under the plan. To determine whether a plan is top-heavy, certain plans sponsored by the employer are required to be aggregated and others are allowed to be aggregated. In order to determine if a plan is top-heavy, the key employees of the employer for the plan year and the four preceding plan years must be ascertained.[50]

Once a determination is made as to who is a key employee, the company must then calculate the account balances or the present value of accrued benefits for each of the key employees and non-key employees. In order to make this calculation, among other things the company must take into account distributions made to any key employee during the four-year look-back period. Generally, the smaller the company, the more likely it is that the plan(s) it sponsors will be top-heavy. This is merely a function of mathematics—the fewer the staff employees as contrasted to shareholder/employees and officers, the more likely it is that 60% of the account balances or accrued benefits will be attributable to key employees.

For example, a company with 10,000 employees which has shareholders that are not employees and a small group of officers who are receiving their retirement benefits primarily in the form of nonqualified deferred compensation will never have a top-heavy plan. A new company with 15 employees in which five are

---

of account balances and earnings is not meaningful in the context of this type of plan. Rather there is a single fund for the entire plan which pays out the promised benefits upon retirement or other events permitting distributions. The company relies on an actuary to determine what contributions are necessary to keep the plan properly funded to meet the retirement obligations. Participants accrue their retirement benefits either on the basis of years of service or years of participation in the plan. Treas. Reg. § 1.416—1 T—25 Q&A. To complicate matters further, the term "accrued benefit" technically also encompasses the term "account balance" in the defined contribution context. Treas. Reg. § 1.416—1 T—24 Q&A.

[49] A key employee is 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 $30,000), (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) (CCH 1998).

[50] *Id.*

shareholders or officers, however, will almost always have a top-heavy plan. This is why the top-heavy rules are deemed discriminatory toward small to mid-size companies.

[b] *What's the Difference Between a "Key" Employee and a "Highly Compensated" Employee?*

TRA 86 made significant changes in existing law which affected the top-heavy rules either directly or indirectly. One of these changes was the development of a new classification of employees called "highly compensated employees."[51] These are employees who at any time during the year or the preceding year: (i) were 5% owners (same definition as that under top-heavy plans); (ii) earned more than $75,000 annually; (iii) earned more than $50,000 annually and were in the top 20% of employees ranked on the basis of compensation, or (iv) were officers who received 150% of the dollar limit on annual additions to a defined contribution plan (currently $30,000).[52]

There were qualifications and definitions for each of these categories. For example, no more than 50 employees were treated as officers (or if less, the greater of three employees or 10% of the employees). Another example — to determine the top-paid group (top 20% of employees), an employer may exclude: (i) employees who have not completed six months of service; (ii) employees who usually work less than 17-1/2 hours per week or fewer than six months a year; (iii) employees covered by a collective bargaining agreement; and (iv) employees who have not attained age 21. The definition of "highly compensated employees"

[51] I.R.C. § 414(q)(1) (CCH 1998).

[52] This has been modified by SBJPA. For plan years beginning after December 31, 1999, a highly compensated employee includes highly compensated active employees and highly compensated former employees. A highly compensated active employee means any employee who — (A) was a 5-percent owner (as defined in Section 416(i)(1) of the Code) of the employer at any time during the current or the preceding year, or (B) for the preceding year — (i) had compensation from the employer in excess of $80,000 (as adjusted by the Secretary pursuant to Section 415(d) of the Code, except that the base period shall be the calendar quarter ending September 30, 1996), and (ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year. I.R.C. § 414(q)(1) as amended by SBJPA of 1996, Pub. L. 104—188, 110 Stat. 1755 (codified in scattered sections of 26 U.S.C.A.).

under TRA 86 is more inclusive than the definition of "key employees" under TEFRA because it includes employees who do not own any interests in the employer but who are deemed to be highly compensated. Initially two of the four categories of employees were identical as between key employees and highly compensated employees: officers and 5% owners. The counterpart to the key employee definition of one of the top ten employees owning the largest interests in the employer is the provision in the highly compensated definition for the top 20% of employees based on compensation who receive more than $50,000. The corresponding provision to the key employee definition of a 1% owner having annual compensation in excess of $150,000 is any employee with compensation in excess of $75,000. The highly compensated definition, even though broader, is basically a parallel provision to the key employee definition.

For small-to-mid-size plans, maintaining the two separate, but parallel, concepts of key employees and highly compensated employees created additional complexity. For example, the top-heavy key employee concept requires a plan administrator to "look back" over the current plan year and the preceding four plan years to determine who is included as a key employee. To determine whether the plan is, in fact, top-heavy, distributions made within the look-back period are added back to key employee account balances. If a non-key employee during the plan year was a key employee during any prior plan year, for example, then the present value of the account balance is not taken into account. Now the plan administrator must also look to the present plan year and back one preceding plan year to determine who is a highly compensated employee. In all likelihood, this group will not have the same members as that of the key employee group. Next the plan administrator must determine whether the coverage and discrimination tests are met with respect to the highly compensated group of employees. One wonders what the tax policy underlying this type of parallel classification could be.

[c] *What are the "Special Rules" for a Top-Heavy Plan?*

Basically, a top-heavy plan must use accelerated vesting schedules, provide minimum benefits and limit compensation for plan

purposes to $200,000. This limit has now been dropped to $150,000, indexed for inflation (currently $160,000).[53]

[i] *Vesting*

Vesting is a concept which rewards employees for their length of service with the employer. Credit is given for each year of service, which is generally defined as 1,000 hours of service during a twelve-month period.[54]

A top-heavy plan must vest benefits at least as rapidly as the following alternative schedules: (i) no vesting for the first two years of service and 100% vesting upon completion of the third year of service, or (ii) no vesting for the first year of service and 20% vesting upon completion of each year of service thereafter.[55]

Small-to-mid-size plans have traditionally had faster vesting schedules than large plans because of the concern that the smaller plan could be deemed to be discriminatory in operation. If upon audit IRS determined that a plan discriminated in operation in favor of the owners of the business or the highly compensated employees, then the plan would be disqualified. For instance, discrimination in operation could be found in a small plan if after ten years of operation, no employee other than the owners or highly compensated employees had ever vested under the plan or there were a series of staff employee firings just before the staff employees would have entered the plan.

[ii] *Minimum Required Contributions*

The second special requirement for top-heavy plans is that they must provide minimum required contributions in the case of a defined contribution plan or minimum required accrual of benefits in the case of a defined benefit plan. In a 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 percentage contribution for a key employee is less than 3%, in which case the highest actual percentage for any key employee becomes the minimum contribution.

---

[53] I.R.C. § 401(a)(17) as amended by Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103—66, 107 Stat. 312 (1993).

[54] I.R.C. § 411(a) (CCH 1998).

[55] I.R.C. § 416(b) (CCH 1998).

Example: A top-heavy money-purchase pension plan requires a contribution for each participant equal to 1% of his or her compensation. The required minimum contribution in this plan is 1% because no key employee receives a contribution greater than 1%. On the other hand, if a plan allows any key employee to receive a contribution of greater than 3%, then all non-key employee-participants must receive a 3% minimum contribution (of course the employees can receive more — they just can't receive less).

For a defined benefit plan, the participant must receive an accrued benefit which, when expressed as an annual retirement benefit, is equal to 2% multiplied by the participant's years of service, but not in excess of 20%.[56] In the context of a top-heavy defined benefit plan, the non-key employees must accrue this minimum benefit even if it is more than the normal retirement formula under the plan. This means staff employees can receive more than the key employees receive under the plan.[57]

Example: Assume the normal retirement formula in a top-heavy defined benefit plan is 1.25 percent of compensation multiplied by years of service. Under the top-heavy rules, the non-key employees are required to receive a 2 percent per year of service accrued benefit which in the illustration would be.75 percent greater than that received by the key employees. (This was one type of plan that was terminated shortly after the top-heavy rules not only because the plan became too expensive to operate, but also because it was deemed inequitable since the highly compensated employees received less than the non-key employees.)

[iii] *Compensation Limited to $200,000*

The third major provision of the top-heavy rules was that a participant's compensation in excess of $200,000.00 cannot be taken into account under the plan.[58] As discussed above, this provision has been superceded by I.R.C. § 401(a)(17), which applies to all qualified retirement plans.[59]

---

[56] I.R.C. § 416(c)(1) (CCH 1998).

[57] Treas. Reg. § 1.416—1. M—5 Q&A.

[58] I.R.C. § 416(d) amended by the Tax Reform Act of 1986, Pub. L. No. 99—514, 100 Stat. 1951, 1964—65, 1995 (codified in scattered sections of 19, 26, 28, 29, 42, 46 and 49 U.S.C.).

[59] Interestingly, I.R.C. § 401(a)(17) does not apply to SIMPLE IRA plans.

[iv] *Complex Rules When a Non-Key Employee is a Participant in Both a Defined Contribution Plan and a Defined Benefit Plan*

There are a number of complicated rules which apply when a non-key employee is a participant in both a defined benefit plan and a defined contribution plan. Set forth below are portions of a Treasury regulation[60] which expanded the statutory language of I.R.C. § 416(h) beyond recognition. Note the effect of these regulations is to dramatically increase the minimum required contributions and/or benefits in certain cases and creates a basic bias against small business defined benefit plans as opposed to defined contribution plans.

M—12 Q. What minimum contribution or benefit must be received by a non-key employee who participates in a top-heavy plan?

A. . . . In the case of employees covered under both defined benefit and defined contribution plans, the rules are more complicated. Section 416(f) precludes, in the case of employees covered under both defined benefit and defined contribution plans, either required duplication or inappropriate omission. Therefore, such employees need not receive both the defined benefit and the defined contribution minimums. There are four safe harbor rules a plan may use in determining which minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans. Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied. Another approach that may be used is a floor offset approach[61] under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan. Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis[62] that the plans are

[60] Treas. Reg. § 1.416—1 G—12 Q&A and M—14 Q&A.

[61] Rev. Rul. 76—259, 1976—2 C.B. 111.

[62] Rev. Rul. 81—202, 1981—2 C.B. 93. This approach was superceded by Treas. Reg. §§ 1.401(a)(4).

providing benefits at least equal to the defined benefit minimum. Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the I.R.C. § 416 minimums.

[v] *Legislative History of the Top-Heavy Rules*

The top-heavy rules were not included in either the House or Senate Bill. They were introduced in the Conference Committee. There were no public hearings prior to enactment. There are no comments in the Conference Report which would indicate Congressional purpose or intent.[63] Eight months after passage, the Senate Subcommittee on Savings, Pensions and Investment Policy convened hearings. Almost all testimony was against the top-heavy rules. Outright discrimination against small business, complexity, high costs, and frequency of change were all cited as reasons why these rules should be repealed.[64]

[4] A System that Confounded the Best and the Brightest

As the 1980's drew to a close, the laws governing the retirement plan system confounded the "best and the brightest" — the elite of the pension world. Few, if any, retirement plan specialists could honestly say that they completely understood retirement law at this time or the more important ancillary, that the plans they represented were operating in compliance with the law. Not only were the practitioners who worked exclusively in this area baffled but so were the people at IRS and Treasury working at the very highest levels. This dismal state of affairs was the result of overly complex, piecemeal legislation.[65] This was the result of legislation where one small change in one section of the Internal Revenue Code impacted ten other sections — though the impact on some of these sections was often not discovered until months after the legislation had been passed. An example of this can be found in the defined benefit plan

[63] TEFRA Hearing at 672.

[64] *Id.*

[65] *Id.* (citing TEFRA Hearing at 113).

area with respect to the requirement that defined benefit plans be funded on a quarterly basis. The law sets forth the corridors for funding this quarterly liability.[66] Unfortunately, these corridors often directly conflict with the maximum permissible deductible amount under the minimum funding rules applicable to defined benefit plans. When the interrelationship of these Code Sections and the problem of a forced overfunding and attendant 10% penalty became evident to the Service, it devised a lengthy and burdensome procedure by which plans could extricate themselves from this absurd situation. Unfortunately, the procedure itself was costly and considered overreaching by many actuaries. This situation was finally resolved by the Retirement Protection Act of 1994 (part of GATT).[67]

[5] Termination of Existing Plans and Dramatic Slowdown of New Plans

By the 1990's, statistics had become available which showed that retirement plan terminations had escalated rapidly in the mid-to-late 1980's while new plan adoptions in the same time period had declined dramatically. Internal Revenue Service data showed that determination letter requests for new retirement plan establishments declined from approximately 85,000 requests in 1982 to 29,000 in 1989.[68] Conversely, the number of plan termination requests increased markedly from 15,000 in 1982 to 29,000 in 1989.[69] This was the result of the (i) additional costs and complexity injected into the private retirement system during the 1980's and (ii) dramatic cutbacks in the retirement benefits that could be offered, also during the 1980's.[70] By the beginning of the 90's, it became

---

66 I.R.C. § 412(m)(3)(B) (CCH 1998).

67 Retirement Protection Act of 1994, Pub. L. 103—465, 108 Stat. 5026 (codified as amended in scattered sections of 26 U.S.C.).

68 EBRI, *Databook on Employee Benefits*, 3rd Edition (on file with authors).

69 *Id.*

70 Congress gave little credence to the remarks from employers explaining that unless constant changes in the rules stopped and simplicity was restored, they would have to terminate the plans. Many can recall staff members at this time stating that the change in the laws was not a "big deal" and that all business had to do was change their software to accommodate the changes required by the law. The all-knowing ivory-tower attitude implicit in these oft-repeated statements is stunning to contemplate. These often young staff members, generally lacking

evident to those who wanted to increase retirement plan coverage that it was imperative to return stability and clarity to the voluntary qualified retirement plan system. Costs for administration had to once again become reasonable. Once again companies would have to be able to rely on the assurances of their advisors so that they could take actions knowing what the results would be.

§ 2.04 THE BEGINNINGS OF CHANGE

Small business began to let its views be known at the 1985 White House Conference on Small Business. At this conference about 1800 delegates from all over the country hammered out the top 60 recommendations which they wanted Congress to consider. The 20th recommendation to emerge from this conference stated: To promote the retirement security of our nation's employees, Congress must support and promote the continued viability of the private retirement system in the small-business community. In support of this goal, there must be a five-year moratorium on further changes in our private retirement plan laws except for the following changes which we recommend: (a) promote parity between large and small plans and between private and public sector plans; (b) simplify filing requirements and paperwork; (c) increase contribution benefit limits, including those applicable to 401(k) plans and IRAs, to be at least as great as the pre-1986 tax reform act limits; and (d) in the multi-employer sector, reform Multi-Employer Pension Laws to curtail or eliminate withdrawal liability.[71]

---

experience in the business world, were able to summarily dismiss the millions of man hours these changes required. Businesses with qualified retirement plans were required to: (i) communicate all of the changes to employees; (ii) review and understand the changes; (iii) redesign the plan so that costs were kept in line and (iv) draft amendments to and restatements of the retirement plans, summary plan descriptions and other communications to employees. Business had to give millions of dollars to their advisors to keep these plans in compliance and assist with the above work. Unfortunately, these were millions of dollars that could have gone to plan participants. The small cadre of staff members who developed the retirement plan tax policy in the 80's also said quite frequently that the employers were "crying wolf." The data did not show that plans were being terminated. Unfortunately, it took a number of years for the data to be compiled and once it was, it showed only too clearly that the employers had been telling it straight.

[71] The White House Conference on Small Business (A Report to the President of the United States) (November 1986).

At the 1986 White House Conference on Small Business, small business owners expressed their concerns about the retirement plan law. Many delegates voiced concern over the impact of the faster vesting schedules. They believed faster vesting was causing employees to leave their jobs sooner than they otherwise would. They also felt that greater benefits were being paid to the transient employees instead of to the more loyal employees. Not surprisingly, the reduction in benefits as well as overly complex rules were the major complaints. Many delegates called for the repeal of the top-heavy rules.

The Association of Private Pension and Welfare Plans ("APPWP") issued an outstanding white paper entitled "Pension Gridlock."[72] This paper set forth in understandable language the problems that the qualified retirement system, including those encountered specifically by small business, was facing. It also set forth a number of suggested legislative changes that if enacted would restore health to the system. The Small Business Council of America ("SBCA"), independently, had come to many of the same solutions that APPWP had advanced in "Pension Gridlock." The SBCA educated and discussed these issues with many of the delegates to the White House Conference. "Pension Gridlock" combined with the recommendations to emerge from the White House Conferences on Small Business began the process of Congress rethinking its policy on retirement plans. A dawning that legislation would be required to bring back simplification and incentives began.

Shortly after the conference, the Office of Advocacy at the Small Business Administration began to award contracts to determine whether the top-heavy rules should be repealed and to ascertain the impact of governmental regulation on the small business retirement system. The Office of Advocacy began to actively assist small businesses in bringing the retirement system to a rational basis.

[72] The Ass'n of Private Pension and Welfare Plans, "Gridlock: Pension Law In Crises and the Road to Simplification."

§ 2.05 PERCEPTION BY THE OWNERS AND KEY EMPLOYEES THAT RETIREMENT PLAN MONEY IS LESS ATTRACTIVE THAN OTHER ASSETS

In order to fully promote retirement plans in the small business sector, there will need to be a change in how retirement plan money is perceived by small business owners, their key employees and their advisors. Small business owners are often told by their advisors, by the media or otherwise, that if they die with retirement plan money, only about 25% or less of this money will be left to their heirs. Retirement plan money gives rise to income in respect of a decedent (i.e., income tax is due on the retirement funds). At the same time, estate tax is also due on the retirement funds. Thus, if the federal and state income tax rate is approximately 40% and the estate tax is approximately 50%, one can see how most of this money is sent to the Federal Government. Prior to January 1, 1982, retirement assets were not taxed as part of a decedent's estate.[73] At that time, retirement plan assets were exempt from Federal estate tax (but were, of course, subject to income tax). Then in 1982, I.R.C. § 2039(c) was amended so that only the first $100,000 of retirement plan assets were exempt from estate tax.[74] By 1985, all retirement assets of plan participants who were not in pay status as of December 31, 1984, were fully subject to estate tax.[75] This problem had been further compounded by the so-called 15% excise tax on "excess" retirement accumulations that applied both to lifetime distributions and at death.[76] This chilling tax was repealed in 1997.[77]

[73] I.R.C. § 2039(c) (CCH 1998).

[74] I.R.C. § 2039(g) (CCH 1998).

[75] I.R.C. § 2039(c) & (g) repealed by The Deficit Reduction Act of 1984, Pub. L. No. 98—369, 98 Stat. 494 (codified as amended in scattered sections of 26, 28, 31, 40 and 42 U.S.C.).

[76] I.R.C. § 4980A (CCH 1998).

[77] Taxpayer Relief Act of 1997, Pub. L. No. 105—34, § 1037(a), 111 Stat. 788 (1997). Repeal was largely due to the efforts of Senator Gramm of Texas. The SBCA had discussed this issue in testimony before the House Small Business Committee on Pension Reform and Simplification on September 5, 1995. It also discussed this issue with the Office of Advocacy at the U.S. SBA, at the White House Conference on Small Business, particularly at the 1995 Conference and with members of the Ways and Means Committee and Finance Committee so that these Committees and the small business community were familiar with the issue.

Because so much retirement money can be lost to taxes at the participant's death,[78] it will be difficult to persuade some small business owners to make significant contributions to the plan. Worse, if the advisers tell the owner(s) that he, she or they have "too many" retirement plan assets, contributions are likely to decline in that particular plan. If the tax law on retirement plan assets were changed so that it no longer subjected these assets in whole or in part to estate tax, then it is likely that there would be greater contributions to the retirement plans which will benefit all small business employees. Income tax is due and payable when retirement plan assets are distributed from a retirement plan or an IRA. Thus, if all the retirement assets are paid out in a lump sum, then all of the retirement assets are subject to income tax.[79] If retirement plan assets are removed slowly, however, for example, by utilizing the required minimum distribution rules,[80] then the impact of the income tax is ameliorated. The problem, of course, arises when the small business owner passes away. Absent sophisticated estate planning, including most often significant amounts of life insurance purchased only to pay federal estate taxes, the estate will be hit with an estate tax equal to roughly 40 to 50% of the total value of the estate. This tax is due and payable nine months after death.[81] Often the only available liquid assets to pay the estate taxes are the retirement plan assets. As discussed, these are among the worst assets to use to pay estate taxes since the distribution triggers the income tax (via the income in respect of a decedent). Estate taxes often hit small business owners disproportionately hard. Many small

---

Other groups such as ASPA, APPWP, PSCA and the U.S. Chamber had also discussed this issue with members of Congress and their own members.

[78] If a participant leaves his/her surviving spouse the entire retirement plan balance, then federal estate taxes can be deferred to the surviving spouse's death because of the estate tax marital deduction. I.R.C. § 2056 (CCH 1998).

[79] Prior to 1986, if an individual took a lump sum payment ten-year income averaging was available. A grandfather provision was available for individuals who had attained the age of 50 by January 1, 1986. Ten-year income averaging was replaced with five-year income averaging in 1986 TRA 86 P.L. 99—514. Five-year income averaging was repealed by the SBJA effective January 1, 1999. SBJPA of 1996, Pub. L. 104—188, 110 Stat. 1755. Thus, income tax averaging is now only available to the grandfathered group.

[80] I.R.C. § 401(a)(9) (CCH 1998).

[81] I.R.C. § 6075(a) (CCH 1998).

business are owned by women or by minorities.[82] Only 30% of family businesses make it through to the second generation. Seventy percent do not. Only 13% make it through the third generation. Eighty-seven do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

§ 2.06 THE MUCH MALIGNED 5% OWNER AND THE PROFESSIONAL CORPORATION

For at least two decades, Congress has singled out the 5-percent owner for special discriminatory treatment under the Internal Revenue Code. Not surprisingly, these 5-percent-owner rules unfairly impact small business. These rules, on their face, would appear to have a neutral impact on businesses of all sizes. In reality, however, these rules generally only impact small and mid-size businesses. For retirement plan purposes, a 5-percent owner is defined as any person owning more than 5 percent of the outstanding stock of a corporation or more than 5 percent of the capital or profits interest in an employer.[83] Retirement plans sponsored by "big" business are unlikely to be affected by many of these rules because it is unlikely that any one individual would own more than 5 percent of a large company. These rules are particularly harsh because the 5-percent owner rules do not contain any compensation

[82] The Kennesaw State College study on the impact of the federal estate tax, prepared by Joseph Astrachan and Craig Aronoff, studied in detail the impact of the estate tax on members of the Associated Equipment Distributors (AED), an association composed of capital-intensive family-owned distribution businesses, and on newly emerging, minority-owned family enterprises selected from lists published by *Black Enterprise* magazine The study found that the minority-owned businesses suffered from the impact of estate taxes more than their non-minority counterparts. Perhaps one reason for this is that many small business owners are not even aware of estate taxes and it appears that the traditional avenue for bringing this to the attention of the owners, the life insurance professional, is not reaching out to these groups. Without a significant amount of estate planning which will often require the purchase of a lot of insurance, it is likely that the family will look to the retirement plan for liquidity to pay the estate taxes and/or the "fire" sale of the business. Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups" (1995).

[83] I.R.C. § 416(i)(1)(B)(i) (CCH 1998).

limitations. Therefore, a retirement plan which covers a 5-percent owner is subject to these rules regardless if the owner makes $65,000 a year or $650,000 a year. The 5-percent owner rules primarily impact two retirement plan areas: (i) the required distributions under I.R.C. § 401(a)(9); and (ii) the top-heavy rules under I.R.C. § 416. Generally, a participant is required to begin receiving distributions from a retirement plan account by age 70.[84] However, a participant can delay the start of distributions until retirement even if the participant has already reached age 70.[85] This change brought about by SBJPA, specifically did not apply to 5-percent owners.[86] There seems to be little rationale for requiring 5-percent owners to take their plan money out of the retirement plan prior to retirement.

For example, Sam and Dave are both computer programers at SmallNet. Inc. Both are age 70 and have no plans to retire in the near future. Sam owns 6% of the stock of SmallNet and earns about $75,000 a year while Dave is a regular employee who also earns around $75,000 a year. Therefore, Dave does not have to receive a distribution this year unless he wants to receive one while Sam *must* begin receiving a distribution. Sam and Dave both have a retirement plan balance of $475,000. Thus, the $38,000 earned by Dave's account can continue to grow tax free while Sam must receive a distribution of $25,650 from his account by April 1 (assuming a twenty-year distribution period based on his and his wife's joint life expectancy) and pay income taxes on this amount. The 5-percent-owner rules also impact the top-heavy rules. A plan is considered to be top-heavy when: (i) in the case of a defined benefit plan, "the cumulative accrued benefits under the plan for key employees exceeds 60% of the present value of the [total] cumulative accrued benefits; and (ii) in the case of a defined contribution plan, "the aggregate accounts of key employees under the plan for key employees exceeds 60% of the aggregate of the accounts of all employees under such plan."[87]

---

[84] I.R.C. § 401(a)(9)(A) (CCH 1998). *See*, Estate Tax discussion, *supra*, § 2.05.

[85] I.R.C. § 401(a)(9)(C)(i)(II) as amended by SBJPA, Pub. L. No. 104—188 Art. 1404(a) 110 Stat 1755.

[86] I.R.C. § 401(a)(9)(C)(ii)(I) as amended by SBJPA, Pub. L. No. 104—188 Art. Sec. 1404(a) 110 Stat 1755.

[87] I.R.C. § 416(g)(A) (CCH 1998). *See*, Top-Heavy discussion, *supra*, § 2.03[3][*a*].

This has a disparate impact on small business retirement plans as opposed to big business retirement plans in several subtle ways. First, an employee can be considered to be a key employee either because his/her compensation is in excess of certain limits or *the employee is a 5% owner.*[88] Thus, the pool of key employees is in reality far greater for small business than its larger counterparts.

Example: Ten computer programmers form a small business and each invests $100,000 and owns an equal interest in the business. Thus, each owns a 10-percent interest in the group and is considered a key employee for purposes of the top-heavy rules. This is true even if each programmer makes $25,0000 a year. However, if those ten programmers went to work for M, a publicly traded computer giant, and invested the same $100,000 in M, it is highly improbable that these programmers would meet the 5-percent-ownership rules with respect to M.

This is compounded by small business retirement plans having fewer non-key participants than large business retirement plans and thus, are more likely to get caught in the top-heavy trap. Congress has singled out the Service Organization for special discriminatory treatment. A Service Organization is defined in Treas. Reg. § 1.414(m)—2(f)(2) as an organization which is engaged in any of the following: (i) health; (ii) law; (iii) engineering; (iv) architecture; (v) accounting; (vi) actuarial; (vii) performing arts; (viii) consulting; and (ix) insurance. For whatever reasons, a Congressional policy emerged that such professionals as doctors, lawyers, accountants, engineers, and actuaries needed harsher rules to prevent them from abusing the tax system. These rules were codified in the affiliated service group rules.[89] Basically, these rules operate in such a manner that it is difficult for the same person to be an owner of two (or more) different enterprises without all of the enterprises being considered one entity for retirement plan purposes. These rules are extremely complicated and generally apply to small and mid-size entities.

Even though these "rich" professionals were maligned by Congress, their qualified retirement plans more often than not provided the largest contributions for non-highly compensated employees of

88 I.R.C. § 416(i)(1) (CCH 1998).

89 I.R.C. § 414(m) (CCH 1998).

virtually any plans offered by any size business. It was not unusual for a service organization to make contributions of 10-15% per year for all employees of the business.

Interestingly, these plans traditionally had relatively short vesting and provided total portability to other qualified retirement plans or to IRAs. Thus, the service organization, often held up as discriminatory, in reality often provided the highest, most portable benefits for the non-highly compensated employees.

§ 2.07 WHY IS THE SMALL BUSINESS DEFINED BENEFIT PLAN ON THE MOST ENDANGERED LIST?

As the 1980's drew to a close, the small business defined benefit plan had virtually been wiped out. The devastating legislation of the 1980's had caused its demise. As additional tests were imposed, the time spent by actuaries to make sure funding and design complied with the many layers of tax rules, multiplied about threefold. The actuarial fees to the small businesses similarly multiplied.

Annual benefits for owners and key employees decreased substantially at this time, from the lesser of $136,425 or 100% of the average for the highest three consecutive calendar years to the lesser of $90,000 or 100% of the average of the highest three years.[90] Additionally, the top-heavy rules imposed greater contribution requirements for non-key employees in the defined benefit plan than those required in the defined contribution arena. This is reflected in the top-heavy regulations which require that when a participant is covered by both a defined contribution plan and a defined benefit plan, either the 2-percent defined benefit minimum is required or a 5-percent defined contribution minimum is required.[91] If they were equal then logic dictates that the company should be able to meet the required top-heavy minimums in either plan. I.R.C. § 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current "termination liability."[92] This is misleading because termination liability is often less than the

[90] I.R.C. § 415(b)(3) (CCH 1998), TEFRA of 1982 P.L. 97—248.

[91] Treas. Reg. § 1.416—1 M—12 Q&A and M—14 Q&A.

[92] The Omnibus Budget Reconciliation Act of 1987 (Revenue Reconciliation Act of 1987), Pub. L. No. 100—203 § 9301(a), 101 Stat. 1330 (1987).

actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. In effect, current law inappropriately mortgages benefit promises by prohibiting the level funding that is the reasonable way for plans to fulfill benefit obligations, and instead requires plans to be funded with payments which escalate in later years. The full funding limitation should be based on ongoing (projected) liabilities, and not on termination liability. As negative as this rule is for most defined benefit plans, it hits small business especially hard. Small businesses need to able to fund their plans in a level fashion. A small business simply cannot tolerate being unable to budget for a major expense correctly. Many small businesses decided to terminate their defined benefit plans when they were told by actuaries that the proper funding for the first several years would be X dollars and then in the third or fourth year might be 3X dollars because of the operation of this law.

Moreover, it became clear that a small business could not freeze benefits for a time in the defined benefit plan without significant cost. Even though benefits were frozen, the 2% defined benefit required minimum contribution under the top-heavy rules still had to be accrued for the non-key employees. Thus, since they could not freeze them, small business by and large terminated the defined benefit

Finally, beginning late in 1989, the IRS singled out so-called "small defined benefit plans"[93] for unprecedented audits. This audit program attempted to apply new actuarial standards retroactively on a group of taxpayers that were perceived as "too small" to litigate. The Administration actually included this in its annual budget — it dictated to IRS how much it was to receive from a targeted audit group. In this case IRS was to collect $660 million in two years from small business defined benefit plans. This was, plain and simple, reprehensible. To go after a class of taxpayers because it was perceived that they did not have the deep pockets

[93] The IRS claimed it was not auditing *small business* defined benefit plans but rather only *small* defined benefit plans. The distinction was made to reflect that this was not an audit program aimed at small businesses who were less able to afford such an audit and even less able to pay for advisors needed to confront the IRS with their arguments. Whatever the IRS thought, it was clear to small business that small defined benefit plans were defined benefit plans sponsored by small businesses.

necessary to litigate should never have been tolerated. This program was unseemly — secret memos requiring agents to impose retroactive actuarial guidelines on small plans, key officials at IRS and Treasury publicly stating they were unaware of the program and forcing the public to obtain the data through Freedom of Information.

Interestingly, the IRS totally misjudged the situation. When it attacked mainstream actuarial assumptions, the actuaries decided they had to defend their science, so in effect the large number of small businesses involved did have a deep pocket and a determined advocate on their side. It is probably not an exaggeration to say that the actuaries were fighting for their very livelihood. If IRS had succeeded in this attempt, it would have been in a position to retroactively dictate to the actuaries what assumptions they were to use (i.e., what the IRS deemed reasonable), thereby ignoring the actuarial science. Even though justice ultimately prevailed in the courts,[94] this program not only hurt the small businesses involved and the actuarial community which was forced to defend prudent actions, but it seriously damaged the relationship which had long existed between the retirement plan advisor community and the IRS. Worst of all, word got out that small business should stay clear of the defined benefit plan — not only was it costly and impossible to fund in a level fashion because of the law, but the company was "buying" an audit.

§ 2.08 TYPES OF RETIREMENT PLANS AVAILABLE TO SMALL BUSINESS

In addition to the standard retirement plans — the profit-sharing plan, the 401(k) plan, the money-purchase pension plan, the target benefit plan and the defined benefit plan — small business has two other plans available to it: the SIMPLE plan and the SEP.

[1] SIMPLE Plans

Created by SBJPA of 1996,[95] Savings Incentive Match Plans for Employers (SIMPLE) IRAs and 401(k) Plans were created to

[94] See for example, *Wachtell, Lipton, Rosen & Katz v. Commissioner of Internal Revenue*, 291 F.3d 291 (2d Cir. 1994).

[95] Small Business Job Protection Act of 1996, Pub. L. No. 104—188, 110 Stat. 1755 (codified in scattered sections of 26 U.S.C.).

provide a low-cost and less complex retirement plan alternative for small businesses. It appears that many micro small businesses are beginning to sponsor the SIMPLE IRA plan. A survey performed by the Investment Company Institute indicates that 18,261 SIMPLE IRAs were established during the first six months of 1997, covering over 95,000 participants. Businesses with less than 25 employees accounted for 97% of these SIMPLE IRAs.[96]

[a] *Employer/Employee Contributions*

Under a SIMPLE IRA, an employee can choose to take a portion of his/her compensation and have it contributed into the SIMPLE IRA.[97] The employer must make either matching contributions or nonelective contributions.[98] Both the employee and employer contributions must be made to a special IRA called a SIMPLE IRA. Employee contributions to a SIMPLE IRA are limited to $6,000 annually. Employee contributions are excludible from taxable income but are subject to FICA and FUTA.[99] The employer may deduct any contributions made on behalf of an employee to a SIMPLE IRA on the tax return in the year made. Contributions must be made by the due date of the filing of the employer's tax return.[100] An employer who makes matching contributions to a SIMPLE IRA is generally required to match the employee's contributions on a dollar for dollar basis up to 3% of pay.[101] An employer may reduce its matching contribution if: (i) the limit is not below one percent; (ii) the limit is not reduced for more than two years out of the five year period that ends with (and includes) the year for which the election is effective; and (iii) employees are notified of the reduced limit within a reasonable time before the 60-day election period during which the employees can enter into salary reduction agreements.[102] Alternatively, an employer may make a nonelective contribution to a SIMPLE IRA. A nonelective contribution must be made for every employee who is eligible to participate in the

---

[96] Conte, *supra* note 4 at 20.

[97] I.R.C. § 408(p)(2) (CCH 1998).

[98] I.R.C. § 408(p)(2)(A)(ii)(a) (CCH 1998).

[99] I.R.S. Notice 98—4, 1998—2 I.R.B. 25 Q&A D—4 and Q&A D—6.

[100] *Id.* at Q&A I—1.

[101] *Id.* at Q&A D—4.

[102] *Id.* at Q&A D—5.

SIMPLE IRA and is equal to 2% of pay. A nonelective contribution is made on behalf of the employee regardless of whether the employee makes an elective deferral contribution to the SIMPLE IRA.[103]

[b] *Employee Eligibility*

The eligibility rules for a SIMPLE IRA are generally much less restrictive than for a qualified retirement plan.[104] To be eligible, an employee need only have received at least $5,000 in wages[105] during two preceding calendar years and be expected to receive at least $5,000 in wages during the current calendar year. The employer is free to reduce this wage limit if it wishes.[106] Thus, SIMPLE IRAs extend retirement plan coverage to many part-time employees.[107]

Example: To meet the 1,000-hour requirement an employee must work approximately 19.23 hours a week during a calendar year. However, to meet the $5,000 requirement that same employee has to work roughly 500 hours (or 9.6 hours/week) during the calendar year (assuming the employee earns at least $10.00 per hour).

[c] *SIMPLE 401(k) Plans*

Alternatively, an employer may establish a SIMPLE 401(k) plan. A SIMPLE 401(k) plan operates similarly to a SIMPLE IRA with

---

[103] *Id.* at Q&A D—6. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year.

[104] Many defined contribution or defined benefit plans impose a 1,000-hour requirement for employees to be eligible to participate in the retirement plan.

[105] For the purposes of SIMPLE IRA eligibility, wages or compensation is defined as those amounts described in I.R.C. § 6051(a)(3) and 6051(a)(8). I.R.S. Notice 98—4, 1998—2 I.R.B. 25 Q&A C—4.

[106] *Id.* at Q&A C—1.

[107] Certain employees are not eligible to participate in a SIMPLE IRA. Those employees include: (i) union employees who are covered under a collective bargaining plan; (ii) airline pilots; and (iii) nonresident aliens who received no United States source income. Additionally, in the event of a merger, an employer may exclude those employees during the year the merger occurs who would not have been eligible to participate. *Id.* at Q&A C—1.

a few differences. Employee contributions are subject to the annual contribution limitations of I.R.C. § 415(c)(1) and are therefore limited to the lesser of $6,000 or 25% of compensation. Additionally, if an employer elects to make a 3% matching contribution to a SIMPLE 401(k) plan, then this contribution may not be reduced.[108] Also I.R.C. § 401(a)(17) applies to the simple 401(k) Plan. The SIMPLE 401(k) is not a popular plan and little wonder—why should a small business get involved with all the extra burdens of a qualified retirement plan when it can get the same plan (perhaps an even better plan) at a much lower cost as an IRA?

[d] *Drawbacks of SIMPLE IRAs*

[i] *The 100-Employee Limitation*

However, despite their apparent simplicity, SIMPLE IRAs do have drawbacks. A simple IRA can only be adopted by an employer who has less than 100 employees. The 100-employee limit is a firm ceiling. All employees of the employer are included in the count regardless of whether the employee is eligible to participate in the SIMPLE IRA. As a result, the 100-employee limitation includes: (i) union employees; (ii) self-employed individuals; and (iii) employees who do not meet the $5,000/year compensation requirement.[109] Thus, a small business with 65 full-time employees and 36 employees earning less than $5,000/year could not establish a SIMPLE IRA. Additionally, a SIMPLE IRA cannot be adopted by an employer who maintains another qualified plan,[110] even if the qualified plan only covers a portion of the employees. However, an employer may adopt a SIMPLE 401(k) Plan to cover those employees who are not otherwise eligible to participate in the qualified plan.[111]

[ii] *Contribution Limitations*

Contributions to a SIMPLE IRA or SIMPLE 401(k) Plan are limited to $6,000 from the employee plus a 3% match from the employer.[112]

---

[108] I.R.C. § 401(k)(11)(B)(i)(II) (CCH 1998).

[109] I.R.S. Notice 98—4, 1998—2 I.R.B. 25 Q&A B—1.

[110] I.R.C. § 408(p)(2)(D) (CCH 1998).

[111] I.R.C. § 401(k)(11)(C) (CCH 1998).

[112] *See,* Employer/Employee Contributions discussion, *supra,* § 2.08[1][a].

Example: TEENY Inc. has two employees, John Smith and Mary Jones, both age 50. TEENY, Inc. established a SIMPLE IRA in 1998. TEENY offers a 3% matching contribution. John earns $60,000 a year and Mary earns $100,000 a year. Both have worked for TEENY since its inception and have had no access to a retirement plan prior to 1998. To make up for lost time, both John and Mary wish to maximize their contributions to the SIMPLE IRA. Therefore, John and Mary each contribute $6,000 of their own compensation and receive a 3-percent match from TEENY. John's total retirement contributions for 1998 would be $7,800 ($6,000 plus a 3-percent match of $1,800) and Mary's total retirement contributions for 1998 would be $9,000 ($6,000 plus a 3-percent match of 3,000). However, if TEENY offered a standard 401(k) plan with a 3% profit-sharing match, then Mary's total retirement contributions for 1998 could increase to $13,000 ($10,000 plus a 3% match) and John's could increase to $10,800 ($9,000 plus a 3% match).

[iii] *Creditor Protection*

A hallmark of ERISA is its anti-alienation and assignment provisions.[113] These provisions prevent a participant's retirement account from being attached by a participant's creditors. However, these provisions only extend to ERISA qualified retirement plans.[114] SIMPLE IRAs are established under I.R.C. Section 408(p) and are not subject to ERISA's anti-alienation provisions. Therefore, unless an exception exists under state or local law,[115] a creditor may be able to attach a participant's SIMPLE IRA.[116]

[113] "A trust shall not constitute a qualified plan under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated." I.R.C. § 401(a)(13)(A) (CCH 1998).

[114] An ERISA qualified plans are those plans created under I.R.C. § 401(a) which cover at least one non-owner employee.

[115] *Patterson v. Shumate*, 504 U.S. 753 (1992).

[116] For example, Maryland specifically exempts those retirement plans created under § 408A of the Code. "(1) In addition, to the exemptions provided in subsections (b) and (f) of this section and any other provisions of law, any money or other assets payable to a participant or beneficiary from, or any interest of any participant or beneficiary in, a retirement plan qualified under § 401(a), § 403(a), § 403(b), § 408, § 408A, § 414(d), or § 414(e) of the United States Internal Revenue Code of 1986, as amended, or § 409 (as in effect prior to January 1984)

[e] *SIMPLE Plans Exempt from the Top-Heavy Rules*

In a major departure from existing law with respect to small business retirement plans, the SIMPLE plan does not require any minimum contribution to be made on behalf of eligible employees. Thus, it is conceivable for a SIMPLE plan to have no employer contributions if none of the non-highly compensated employees contribute to the plan. Interestingly, this is in line with the rules governing non-top-heavy 401(k) plans.

[f] *SIMPLE IRA is an IRA, Not a Qualified Retirement Plan*

Because the SIMPLE (as well as the SEP) plan rests on an IRA framework, the sponsoring company has no reporting requirements or fiduciary responsibilities. This makes this type of plan very attractive to micro small businesses. Interestingly, some employees do not view contributions to an IRA on their behalf as a retirement plan, they look at it as a bonus plan. The employee can access the money at any time with either a 25% penalty (for the first two years) or a 10% penalty thereafter.[117]

[g] *From a Tax Policy Viewpoint, Which is Preferable — the SIMPLE, the SEP or a Qualified Retirement Plan?*

The forced savings feature of a "regular" qualified retirement plan, such as the 401(k) plan, should not be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Retirement plan money can be removed by written plan loan which cannot exceed the lesser of 50 percent of the account balance or $50,000.[118] Retirement plan money can also be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency. This is in contrast to funds inside an IRA, a SIMPLE IRA or a SEP (both of which

of the United States Internal Revenue Code of 1954, as amended, shall be exempt from any and all claims of the creditors of the beneficiary or participant, other than claims by the Department of Health and Mental Hygiene." MD. Code Ann., Cts. and Jud. Proc.11—504(h)(1) (1998). *But cf,* VA Code Ann.34 34 (Mitchie 1996).

[117] I.R.S. Notice 98—4, 1998—2 I.R.B. 25 Q&A I—2.

[118] I.R.C. § 72(p)(2)(A) (CCH 1998).

are employer-sponsored IRA programs) where the funds can be accessed at any time for any reason. True, funds removed will be subject to a 10% penalty if the employee has not reached age 59 (which is also the case for a hardship distribution from a 401(k) plan), but preliminary and totally unofficial data suggests that individuals freely access IRAs and SEPs and that the 10% penalty does not seem to represent a significant barrier. This is why the SIMPLE IRA starts off with a 25% penalty for the first two years an individual participates in hopes that if a participant can accumulate a little bit he or she will be tempted to leave it alone and watch it grow.[119] Nevertheless, there is a distinct difference between asking the employer for a loan or a hardship distribution and having to jump through some well-placed statutory hoops versus simply removing money at will from your own IRA.

It is exciting to see that the SIMPLE IRA is attracting so many small businesses. Hopefully, however, the SIMPLE IRA will be viewed only as a starter plan. It is important, therefore, that all businesses, including the very small, be given incentives to enter the qualified retirement plan system as quickly as possible. The SIMPLE IRA is an IRA program, as is the old SEP plan, and in the long run true retirement security for employees is better served by strengthening qualified retirement plans system rather than SIMPLE IRAs and SEPs. This is simply because, as mentioned above, employees have a far greater opportunity to remove the money from IRAs and SEPs and spend it — the forced savings feature of a qualified retirement plan is not present. Certainly, for start-up companies or micro businesses, a SIMPLE or the proposed salary reduction SIMPLE (discussed below) is the best first step into the retirement plan system. By making the SIMPLE rules "better" than the qualified retirement system rules, the reverse is achieved. Thus, we hope that the "gap" between the 401(k) limit ($10,000) and the SIMPLE limit ($6,000) and (if enacted) the salary reduction SIMPLE limit is carefully preserved so that the system does not tilt in the wrong direction.

[h] *Does Small Business Need any Other Plans?*

The so-called "Salary Reduction Only" SIMPLE deserves consideration. One of the major reasons why a small business does not

[119] I.R.S. Notice 98—4, 1998—2 I.R.B. 25 Q&A I—2.

adopt a retirement plan is lack of profitability. The proposed Salary Reduction Only SIMPLE plan is a plan that a small business will adopt regardless of its lack of profits because it costs the company almost nothing to sponsor. This plan rests on an IRA framework so the company has no reporting requirements or fiduciary responsibilities. Also the company is not required to make *any* contributions, to the plan — so profitability is irrelevant. The plan will give every eligible employee of the company a chance to contribute up to a designated amount (e.g. $5,000) for his or her own retirement security each year.

Other than the possible addition of the Salary Reduction Only SIMPLE, no further new plans are needed. Small business now has a very good mix of plans available to it — from those which are complex but provide needed flexibility and choice to very simple plans for the companies who want low administration costs.

[2] Simplified Employee Pensions

Simplified Employee Pensions (SEPs) are IRAs established for the benefit of employees and offer another viable alternative for the small business that wants to provide a retirement plan for its employees, but lacks the stability and profitability to sponsor a qualified retirement plan.

[a] *Employee Eligibility*

SEPs—similar to SIMPLE IRAs—also offer retirement plan coverage possibilities for part-time employees. If an employer sponsors a SEP, then every employee is eligible to participate in the SEP provided he/she has: (i) reached age 21; (ii) earned at least $400 in wages during the calendar year; and (iii) has worked for the employer for three out of the last five years.[120] Employers are allowed to reduce the requirement that an employee have worked for the employer for three out of the last five years.[121] An employer may exclude from participation in the SEP[122] employees who are

[120] I.R.C. § 408(k)(2) (CCH 1998). The wage requirement is indexed for inflation. "The Secretary shall adjust the $300 amount in paragraph (2)(C) at the same time and in the same manner as under section 415(d). . ." I.R.C. § 408(k)(8). For 1998, the wage requirement was increased to $400.

[121] I.R.C. § 408(k)(2) (CCH 1998).

[122] I.R.C. § 408(k)(2) (CCH 1998).

covered by a retirement plan which is part of a collective bargaining agreement and nonresident aliens.

[b] *Contributions*

Under a SEP retirement plan, an employer may make retirement plan contributions which are more generous than the contributions an employer can make under a SIMPLE IRA (or SIMPLE 401(k)). These contributions are flexible and are limited to the lesser of 15% of the employee's compensation (not to exceed $160,000 for plan years beginning in 1997) or $30,000.[123] In contrast, employer contributions to a SIMPLE IRA (or SIMPLE 401(k)) are limited to 3 percent of compensation.[124] This difference could be significant.

Employees may not make an elective salary deferral contribution to a SEP established after December 31, 1996. SEPs established prior to January 1, 1997 could provide for elective salary deferrals by employees.[125] However, these elective deferrals were limited. A SEP could allow elective salary deferrals if (i) 50% of the eligible employees elected a salary deferral; (ii) the deferral percentage for highly compensated employees did not exceed 125% of the deferral percentage of the non-highly compensated employees and (iii) no more than twenty-five employees were eligible to participate.[126]

[c] *Drawbacks of SEPs*

[i] *100% Participation*

Every employee who meets the eligibility requirements[127] is eligible to receive a SEP contribution from his/her employer. As a result, an employer who sponsors a SEP may end up making larger contributions to the SEP than an employer who sponsors a traditional profit-sharing plan.

Example: Small Business, Inc. ("SB") has 75 employees who have worked for SB for the last three years. Fifty employees work

---

[123] I.R.C. § 408(k)(3) (CCH 1998).

[124] *See* SIMPLE IRA discussion *supra* § 2.08 [1][*a*].

[125] I.R.C. § 408(k)(6) as amended by Small Business Job Protection Act of 1996, Pub. L. No. § 104—188, 110 Stat. 1755.

[126] I.R.C. § 408(k)(6)(A)(ii) and I.R.C. § 408(k)(6)(B).

[127] *See* Employee Eligibility discussion *supra*, § 2.08[2][a].

approximately 600 hours a year for SB and each earns roughly $10,000 per year. The remaining twenty-five employees work over 1,000 hours a year and each earns $100,000 per year. SB sponsors a SEP and decides to make a 5-percent contribution on behalf of its employees in 1999. SB's contribution for 1999 is $150,000. Alternatively, if SB sponsored a profit-sharing plan with a 1,000-hour requirement, then SB's contribution for 1999 would be $125,000 (assuming the same 5-percent contribution).

[ii] *100% Vesting*

Employees are fully vested in a contribution when made.[128] This removes the incentive for employees to continuing working with an employer in order to receive their full retirement contribution from the employer.[129]

[iii] *Tax Filing Requirements*

SEPs have fewer filing requirements than a regular retirement plan.[130] However, SEPs may still be expensive to administer. SEPs are subject to the discrimination rules of I.R.C. § 414(q)[131] and the top-heavy rules of I.R.C. § 416(c)(2).[132] Thus, a small business owner may still face significant fees from a plan administrator to ensure that his/her plan is in compliance with these rules.

[3] 401(k) Plans and the New Safe Harbor Provisions

The 401(k) plan is a tremendous success story. The excitement generated by this plan in the small business arena is amazing. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much the employer contributes. Employees meet with investment advisors to be guided as to which investments to select and have toll-free numbers to call to see how their investments are doing and to determine whether they want to change them. Employees discuss

---

128 I.R.C § 408(k)(4) (CCH 1998).

129 *See*, Top-Heavy Vesting discussion *supra* § 2.03[3][*c*][*i*].

130 SEPs are not required to file an annual Form 5500 with the IRA. Instead, SEPs are required to file an information report detailing the annual contributions and the fair market value of the SEP assets. Prop. Treas. Reg. § 1.408—5.

131 I.R.C. § 408(k)(3) (CCH 1998).

132 I.R.C. § 408(k)(1)(A) (CCH 1998).

among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown. There is no question that this is the best known and most popular retirement plan design today.

The SBJA added a safe harbor which may make 401(k) plans more attractive to small business.[133] Prior to 1999, 401(k) plans were subject to complicated discrimination plans which tied contributions that highly compensated employees could make to the contributions made by non-highly compensated employees.[134] These tests are expensive to administer. Additionally, if non-highly compensated employees did not optimize their participation, then highly compensated employees could not contribute as much as they wished.

It is now possible for 401(k) plans to eliminate the discrimination tests and allow every employee (including highly compensated employees) to contribute up to the maximum. Under current law, a 401(k) plan will be treated as meeting the discrimination tests if the employer: (i) makes a contribution for every eligible non-highly compensation employee equal to at least 3 percent of that employee's compensation; or (ii) makes a matching contribution for each eligible non-highly compensated employee equal to 100% of the first 3 percent of pay and at least 50% of the next two percent of pay ("basic matching formula").[135] Other match formulas are allowed under the safe harbors. The "enhanced matching formula" can also be used to satisfy the ADP safe harbor. This is where the rate of match cannot increase as an employee's rate of deferrals increases and in the aggregate, the match must be at least equal to the basic matching formula. Examples of the enhanced matching formula include: 100% match on the first 4% of compensation deferred, or a 150% match on the first 3% of compensation deferred, or a 125% match on the first 3% and 25% on the next 1% of compensation deferred.[136] In addition, these contributions must be

[133] I.R.C. § 401(k)(12) as amended by Small Business Job Protection Act of 1996, Pub. L. No. 104—188, 110 Stat. 1755.

[134] I.R.C. § 401(k)(3)(A) (CCH 1998).

[135] I.R.C. § 401(k)(12) (B) and (C) (CCH 1998).

[136] Additional discretionary matching contributions can be made without losing the safe harbor, but discretionary matches cannot be used for purposes of meeting the ADP safe harbor.

100% vested[137] and made to every employee even if he/she does not meet the 1,000-hour requirement or is not employed on the last day of the plan year. Normal eligibility requirements (age 21 and one year of service) are allowed for the safe harbor contributions.[138] The safe harbor contributions must be subject to the 401(k) withdrawal restrictions, but can not be available for hardship withdrawals. In addition the employer must provide written notice to employees apprising the employees of their rights and obligations under the plan. This notice must be comprehensive and be written in "plain" English.[139]

Many experts in the small business retirement plan area believe that the voluntary safe harbors will prove to be the easiest and most cost-effective way to make the 401(k) plan user friendly for small businesses. If a small business makes a 3-percent contribution for all non-highly compensated employees, or makes the required matching contributions, then the company no longer has to pay for the complex 401(k) discrimination testing (nor does it have to keep the records necessary in order to do the testing). Of course, many companies will choose to stay outside the safe harbor because the 3-percent employer contribution or required match is too high and because it is more cost effective to stay with their current system (including software and written communication material to employees).

Legislation is needed, however, to allow small business to use the match safe harbor without also having to satisfy the top-heavy required minimum contribution. Otherwise the match safe harbor designed in large part for small businesses may not be used by them.

Unfortunately, the notice requirement as interpreted by Notice 98—52, is very restrictive and will probably cause most small businesses not to be able to use the safe harbor this year. The IRS requires that a business electing either safe harbor, give notice (in the case of a calendar year plan) by March 1st.[140] Again, there are two safe harbors — one is a prescribed company match to employee 401(k) contributions, the other is a non-elective 3-percent contribution. A non-elective 3-percent contribution means that every eligible

---

137 I.R.S. Notice 98—52, 1998—46 I.R.B. 16.

138 *Id.*

139 I.R.C. § 401(k)(12)(D) (CCH 1998).

140 I.R.S. Notice 98—52, 1998—46 I.R.B. 16.

employee receives this contribution whether or not he or she makes 401(k) contributions. The rationale for advance notice in the context of the match safe harbor is self evident. An employee may very well change his or her behavior and contribute more knowing that a match is going to be made.

There appears to be no rationale for such advanced notice in the context of the non-elective 3-percent contribution — no employee is going to change any behavior merely because a contribution will be made for them at the end of the year. The problem is compounded when dealing in the small business world. Unless an outside advisor has informed a small business that it must give a fairly extensive notice by March 1st and the company complies, it will not be able to take advantage of the safe harbor for the entire year. It is likely that there will be countless small businesses this year who would have taken advantage of the 3-percent non-elective safe harbor but will not be able to do so because they had not been informed of the requirements of this restrictive notice requirement. Thus, they will not be able to rid themselves of the complex and costly 401(k) discrimination testing this year.[141] If the notice requirement was changed so that notice must be given within 30 days of the close of the plan year for those companies selecting the 3-percent non-elective contribution safe harbor then this would allow word to get out to small business about this option and give them time to comply with the notice requirement.

Additionally, the 3-percent non-elective contribution must be paid to each non-highly compensated employee regardless of whether the employee has completed 1000 hours of service or is employed on the last day of the plan year.[142] This is more restrictive than either the rule for normal plan contributions or the rule for the top-heavy minimum contributions. There seems to be no rationale for a safe harbor which is designed to help small business avoid complicated testing to be so restrictive. A better alternative might be that the 3-percent non-elective contribution be made to

---

[141] Based upon an informal discussion with Mark Iwry, Benefits Tax Counsel at United States Department of Treasury on March 23, 1999, it appears that there might be some relaxation with respect to the nine-month notice required for this year only for the 3% non-elective safe harbor. This would be welcome news for many small businesses just learning about the safe harbors and their requirements now.

[142] I.R.S. Notice 98—52, 1998—46 I.R.B. 16.

either all non-highly compensated employees who have worked 1,000 hours (the normal plan contribution rule) or to those employees who are employed on the last day of the plan year (the top-heavy minimum required contribution rule), but not both.

§ 2.09 THE 1995 WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Out of the 60 final recommendations to emerge from the 1995 White House Conference on Small Business, the Pension Simplification and Revitalization Recommendation received the seventh-highest ranking in terms of votes.[143] The Pension Simplification and Revitalization Recommendation[144] reads as follows: Congress should repeal current disincentives and burdensome regulations on qualified retirement plans and IRAs, and encourage adequate retirement savings and capital accumulation, including: (i) Adopt a pension simplification bill which contains the voluntary 401(k) safe harbors;[145] (ii) Raise compensation and benefit levels to 1992 limits and index for inflation; (iii) Provide an exclusion from estate tax for retirement plan and IRA assets to avoid double taxation (they are already subject to income tax); (iv) Eliminate the 15% excise tax of I.R.C. § 498—A;[146] (v) Repeal the family aggregation rules of I.R.C. § 416;[147] (vi) Reinstate deductible IRAs and expand to include non—employed spouses in full; (vii) Expand SARSEPs to employers with up to 100 employees;[148] (viii) Repeal the minimum

---

[143] It is important to note that H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act, just introduced on March 11,1999 incorporates many of the recommendations made by the delegates to the 1995 White House Conference on Small Business and certainly captures the essence of what the delegates wanted.

[144] The White House Conference on Small Business Commission, *Foundation for a New Century* (A report to the President and Congress) (September 1995) NCRA #91.

[145] The SBJA provided a voluntary 401(k) safe harbor. *See,* § 401(k) Voluntary Safe Harbor discussion, *supra,* § 2.08[3].

[146] The excise tax was repealed by the Taxpayer Relief Act of 1997, Pub. L. No. 105—34, § 1037(a), 111 Stat. 788 (1997).

[147] Repealed by Small Business Job Protection Act of 1996, Pub. L. No. 104—188, 110 Stat. 1755.

[148] SARSEPs are salary reduction SEPs. Prior to 1997, SARSEPs were available to businesses with less than 26 employers. Currently, an employer (of any size) cannot establish a SARSEP. *See,* SEP discussion, *supra,* § 2.08[2][b].

distribution rules for defined contribution plans of I.R.C. § 401(a)(26); (ix) Lower the Qualified Separate Line of Business exception to 15 employees; (x) Increase the exceptions to the affiliated service group rules[149] and include a minimum 20% ownership test for "A" organizations; (xi) Repeal all defined benefit plan rules enacted after 1985; and (xii) Amend Section 72(p) of the I.R.C. on plan loans[150] to (a) allow for plan loans by proprietorships and partnerships (b) increase the plan loan balance up to $100,000 and (c) balloon payments in lieu of quarterly payments if the loan is secured by the participant's account balance.

Why did the delegates consider this recommendation to be so important that it received the seventh-highest vote total? The reason is simple—small business owners want retirement to be a viable option for them. For small business, the qualified retirement plan is the best way to save for retirement. As mentioned above, due to the current tax law, most small businesses do not provide nonqualified pension benefits, stock options and other perks. Unfortunately, many small businesses perceive the qualified retirement plan area to be a quagmire of complex rules and burdens. It is perceived as a system which discriminates against small business owners and key employees. The Conference Delegates understood that if the retirement system became user friendly and provided sufficient benefits then they would want to use it. By doing so, they could provide for their own retirement security, while at the same time providing valuable retirement benefits for their employees.

§ 2.10 THE NATIONAL SUMMIT ON RETIREMENT SAVINGS — JUNE 1998

This summit was called for under the "Saver Bill."[151] By bringing together professionals and other individuals working in the fields of employee benefits and retirement savings and Members of Congress and officials in the executive branch, it was hoped that the public's knowledge and understanding of retirement savings would be advanced, that barriers which hinder workers from setting aside adequate savings for retirement and impede employers,

---

[149] I.R.C. § 414(m) (CCH 1998).

[150] I.R.C. § 72(p) (CCH 1998).

[151] Savings Are Vital to Everyone's Retirement Act of 1997, Pub. L. No. 105—92, 111 Stat. 2139 (codified 29 U.S.C. §§ 1001, 1146—47).

especially small employers, from assisting workers in accumulating retirement savings would be identified and specific recommendations for legislative, executive and private sector actions to promote retirement savings among American workers would be developed. There were a number of statutorily required participants — the Speaker and Minority Leader of the House and Senate, the Chairman and Ranking Member of the House Committee on Education and the Workforce in the House, of the Senate Committee on Labor and Human Resources, of the Senate Special Committee on Aging and of the Subcommittees on Labor, Health and Human Services and Education of the Senate and House (or their designees). There were to be no more than 200 other participants — 1) professionals and other individuals working in the fields of employee benefits and retirement savings; 2) representatives of State and local governments, 3) representatives of private sector institutions, including individual employers, and 4) representatives of the general public. One-half were appointed by the President in consultation with the elected leaders of the Democrats and one-half were appointed by the leaders of the Congress.

Even though small business retirement plan experts, administrators and owners were not well represented at the Summit, their ideas came through loud and clear in the break-out sessions. Calls for repeal of the top-heavy rules, increases in contribution limits, particularly the 401(k) limit, elimination of costly discrimination testing in the 401(k) area, and a return to the old compensation limits, were repeated across the break-out sessions. There were even individuals calling for support of a particular piece of legislation — the Portman-Cardin retirement plan bill (this was the 1998 bill). Of course, many ideas were discussed particularly in the educational area, but an impartial observer would have noticed that the small business representatives were very united in their message — increase benefits, decrease costs. In other words, when undertaking a cost/benefit analysis, small business currently perceives the costs too high compared to the benefits to be gained.

§ 2.11 SMALL BUSINESS JOBS PROTECTION ACT AND TAXPAYER RELIEF ACT OF 1997 HAVE BEGUN THE PROCESS OF SIMPLIFICATION AND INCREASED INCENTIVES

Although there is still a long way to go, the SBJPA[152] and the Tax Payer Relief Act of 1997[153] certainly appear to be steps in the right direction for pension reform. The reforms enacted by these Acts include: (i) the I.R.C. § 401(k) safe harbor; (ii) the repeal of family aggregation under I.R.C. § 401(a)(17) and I.R.C. § 414(q)(6); and (iii) the repeal of I.R.C. § 4890A excise tax. However, because many of these reforms are just now being implemented, the full impact of these reforms will not be known for several years.

[1] The I.R.C. § 401(k) Safe Harbor

The I.R.C. § 401(k) Safe Harbor[154] offers an opportunity to eliminate costly discrimination testing and at the same time maximize salary contributions for all employees (including highly compensated employees). This appears to be a change which would make the 401(k) plan more attractive to small business. However, the safe harbor was just implemented for plan years beginning January 1, 1999 and the impact of this safe harbor will not be known for several years.

[2] The Repeal of Family Aggregation

Prior to the repeal of family aggregation, an individual's annual compensation included not only his/her actual annual compensation but that of his/her spouse and other family members if he/she was a highly compensated employee. Now that family aggregation has been repealed, an individual's compensation will be only the compensation actually earned by the individual and not impacted by compensation earned by other family members.

---

[152] Small Business Job Protection Act of 1996. Pub. L. No. 104—188, 110 Stat. 1755.

[153] The Taxpayer Relief Act of 1997, Pub. L. No. 105—34 § 1037(a) 111 Stat. 788 (1997).

[154] *See*, I.R.C. § 401(k) discussion, *supra*, § 2.08[3].

[3] The Repeal of the I.R.C. § 4890A Excise Tax

The repeal of I.R.C. § 4890A excise tax certainly is a welcome change. No longer will an estate (or more accurately the participant's children) of a plan participant be punished by a 15% excise tax imposed solely because the participant accumulated too large a plan balance. Now, the nonspousal heirs will simply have to pay the estate taxes and the income taxes generated by the plan balance. Also the "chilling" effect this provision had on small business plans is gone. Because advisors told small business owners not to accumulate "too much" in the retirement plan, plans were often terminated prematurely or contributions cut back significantly. These terminations and cut backs adversely affected *all* small business employees.

§ 2.12 WHAT FURTHER REFORMS ARE NEEDED TO RESTORE FULL HEALTH TO THE SYSTEM?

[1] Increasing the § 415 Limits and the § 401(a)(17) Limit

Increasing the contribution limits (in reality reversing the limits) to where they stood in 1982 is extremely important in order to provide needed incentives for small business to enter (or reenter) the qualified retirement plan system. The defined contribution limit should be raised from $30,000 to $45,000 and the defined benefit limit should be raised from $130,000 to $180,000. There should be corresponding increases in the 401(k) limit and the SIMPLE limit. The current I.R.C. § 415 25-percent compensation limits should be repealed.[155] The 25% limitation today primarily operates to cause contributions for non-highly compensated employees to be cut back. Also, the I.R.C. § 401(a)(17) limitation (currently $160,000) on includable compensation should be increased.

A major reason why small businesses stay away from the retirement system is that the benefits that can be obtained by the owners and the key employees are perceived as too low for the cost and "hassles" involved. It is no secret that small business owners believe that the retirement plan system discriminates against them.

---

155 Currently, annual additions to a participant's defined contribution account are limited to "the lesser of (A) $30,000, or (B) 25 percent of the participant's compensation." I.R.C. § 415(c)(1).

Short vesting periods and quick eligibility have provided more benefits for the transient employees at the expense of the loyal employees. Cutbacks in contribution levels hurt key employees and owners (of course they hurt the non-highly compensated also, but it took a long time for Congress and others to understand there was a very real correlation between what the small business owners could put away for themselves and their key employees and what would be put in for the non-highly compensated employees).

It is interesting to examine where these limits would be today if the law in 1982 had not been enacted. *The defined contribution limit, which was $45,475 in 1982, assuming a constant 3% COLA would have been $75,163 in 1999. This is also where the 401(k) plan limit would have been also.* Only in 1987, was the amount an employee could save by annual 401(k) contributions limited to $7,000 and the "ADP" tests could further limit this amount for the highly compensated employees.[156] *The defined benefit limit, which was at $136,425 in 1982, assuming a constant 3% COLA, would be at $225,490 today. These numbers assume a constant COLA of 3%. The true COLA number during those years would be closer to an average of 4%—5%.* In 1974, the maximum defined benefit pension at age 65 was $75,000 a year. Today the maximum benefit is $130,000, even though average wages have more than quadrupled since 1974. Thus, pensions replace much less pre-retirement income now than they did in the past. In order for these ratios to return to prior levels, the maximum would have to be over $300,000 now.

Given how critical it is for people to start saving for their own retirement today, it seems most peculiar to have limits harsher than they were 17 years ago. Some people say that increasing limits will not operate as an incentive to small businesses to sponsor a plan and will only be used by the so-called "rich."[157] Not only will the increased limits serve as an incentive to small businesses to sponsor a retirement plan, but the higher limits will be enjoyed by employees

[156] I.R.C. § 402(g) (CCH 1998).

[157] The term "rich," as used here, is a subjective term. The Internal Revenue Code defines a "highly compensated" employee as an employee who: (i) is a 5% owner; or (ii) earned more than $80,000 (indexed for inflation) and was in the top paid group of employees for the preceding plan year. I.R.C. § 414(q)(1). *See,* 5% Owner discussion, *supra,* § 2.06. At times when listening to officials from Treasury, "rich" seems to mean any individual making more than $40,000 — $50,000.

who are not "rich." For instance, it is very common today for both spouses to be employed. Quite often, these couples decide that one of the spouse's income will be used as much as possible to make contributions to a 401(k) plan. Today, the most the couple can save is $10,000 (and if the partcipant-spouse makes more than $80,000 or makes less but is a 5% owner of a small business, then the couple might not even be able to put in $10,000).[158] Often, the couple would have been willing to save more. These couples might earn $40,000, $50,000 or more, but they are not "rich." It is only because both spouses are working that they are enjoying decent income levels. We should provide the means by which they can save in a tax-advantaged fashion while they can. This same principle applies particularly to women who enter and leave the workforce intermittently as the second family wage earner. They and their families stand to benefit the most from increased retirement plan limits because they will provide the flexibility that families require as their earnings vary over time, and as demands such as child rearing, housing costs and education affect their ability to save for retirement.

Many mid-size employers rely less on their existing defined benefit plans to provide benefits for their key employees and more on non-qualified deferred compensation plans. This is a direct result of the reduction in the defined benefit plan limit. Thus, pensions replace much less pre-retirement income now than they did in the past. In order for these ratios to return to prior levels, the maximum would have to be over $300,000 now. The lower limits have caused a dramatic increase in non-qualified pension plans, which provide benefits over the limits. They help only the top-paid employees. This has caused a lack of interest in the defined benefit plan because there is no incentive to increase benefits since the increases cannot benefit the highly compensated employees or key employees. This is unfortunate since increases affect all participants.[159]

---

[158] I.R.C. § 414(q)(1) (CCH 1998).

[159] Recently, there has been talk of the retirement plan tax expenditure in 1999 being approximately 100 billion dollars with 20% going to the top 1% of taxpayers, 75% going to the top 20% of taxpayers and less than 10% going to the bottom 60% of taxpayers. Office of Tax Analysis, U.S. Dep't of Treasury, "Distribution of Pension Benefits Under Current Law — Talking Points 1" (1999). According to EBRI, the total pension tax expenditure in the FY 1993 federal budget was $56.5 billion. Of this amount $27.9 billion (or 49.4%) was attributable to public

There should be a corresponding increase in the limit on includable compensation for similar reasons. There was no dollar limit on the amount of annual compensation taken into account for purposes of determining plan benefits and contributions under ERISA. TRA 86 required a qualified retirement plan to limit the annual compensation taken into account to $200,000, indexed. The $200,000 limit was adjusted upward through indexing to $235,843 for 1993. As part of the Omnibus Budget Reconciliation Act of 1993, the limit on includable compensation was further reduced down to $150,000 for years after 1994. The $150,000 compensation limit in 1974 (ERISA) dollars is now approximately equal to $46,500 in terms of today's dollars (assuming 5% average inflation rate). This is far below the $75,000 that represented the highest amount upon which a pension could be paid under then-new I.R.C. § 415 in 1974. At first, it was thought that this cutback had hurt

---

sector defined benefit pension plans. Private sector defined contribution plans followed at $19.3 billion (34.2%), followed by private sector defined benefit plans at $8.2 billion (14.5%) and public sector defined contribution plans at $1.1 billion (2%). Thus, the actual number we were dealing with in 1993 in connection with the *private* retirement system was $27.5 billion. Even assuming *arguendo* that the expenditure has grown from 1993 to 1999 by 43.5 billion dollars, the expenditure for the private retirement system would be roughly 48.7 billion dollars, not 100 billion dollars. The 100 billion dollar figure, if accurate, includes the expenditure for the public retirement system of 51.3 billion dollars. Also, it is likely that the expenditure for public sector defined contribution plans has increased since 1993.

EBRI found that in 1992, the value of the pension tax expenditure was allocated as follows:

Income Class	%
less than $10,000	0.0
10,000—19,999	1.4
20,000—29,999	7.1
30,000—49,999	28.1
50,000—99,999	42.8
100,000—199,999	13.4
200,000 and over	6.7

See EBRI Issue Brief (February 1993). Again, these numbers appear to be at variance with the numbers distributed by the Office of Tax Analysis of the Department of Treasury. The EBRI numbers are based on actual data. Further, with the proliferation of 401(k) plans and how much they are used by the non-highly compensated employees it would seem that the numbers today would be increased in the $20,000 and $30,000 groupings and further decreased in the top two income levels due to the continued growth in the non-qualified plan area.

several groups of employees — owners and other key employees of all-size businesses who made more than $150,000 and mid-range employees and managers (people in the $50,000-$70,000 range) who were in 401(k) plans and in defined benefit plans. It now appears that all employees were hurt. As small business owners determined that the benefits were too low compared to the costs and administrative burdens, they terminated plans. Non-qualified plans took over in the mid-to-large business context and the defined benefit plan, in particular, became static. Because benefits could not be increased for key employees, they were not increased at all.

Although indexed, adjustments are now being made in increments of $10,000 and adjusted downward. Since 1997, the indexed amount has been $160,000.[160] The limit on includable compensation should be restored to its 1988 level of $235,000 and be indexed in $1,000 increments in the future.[161]

[2] 401(k) Changes

[a] *Increase the I.R.C. § 401(k) Contribution Limit*

Increasing 401(k) contributions from $10,000 to $15,000 would be a significant change which would assist many employees, particularly those who are getting closer to retirement age and/or those employees who are reentering the workforce after long absences (e.g., a mother who took time off to raise young children).

---

[160] I.R.S. Notice 96—55, 1996—2 C.B. 222.

[161] The Department of Labor's ERISA Advisory Council on Employee Welfare and Benefit Plans recently released its "Report of the Working Group on Small Business: How to Enhance and Encourage The Establishment of Pension Plans" dated November 13, 1998. This report provides eight recommendations for solving the problems facing small businesses today in the retirement plan area. Interestingly, these recommendations mirror many of those that came out of the National Summit on Retirement Savings and mirror many of the provisions in H.R. 1102.

The Advisory Council report calls for a repeal of top-heavy rules, elimination of IRS user fees, an increase in the limits on benefits and contributions, an increase in the limits on includable compensation, the development of a National Retirement Policy, consider the development of coalitions, tax incentives and the development of a simplified defined benefit plan. This a comprehensive and well-reasoned report and should be read by anyone trying to determine how to encourage small businesses to enter the qualified retirement plan system.

[b] *Exempt Match Safe Harbor from Top-Heavy Rules*

Opening up the second 401(k) Safe Harbor—the "Match Safe Harbor"—to small businesses by exempting it from the Top-Heavy Rules would be a valuable change which would place small business on a *level playing field* with its larger counterparts.

[c] *The Qualified Plus Contribution is an Exciting Concept*

The Qualified Plus Contribution is an exciting concept which may prove to be sought after by employees contributing 401(k) contributions. The Qualified Plus 401(k) Contribution[162] extends the Roth IRA concept to the 401(k) plan. Basically, the 401(k) plan could allow each participant who makes a 401(k) contribution to designate a portion of the 401(k) contribution as a Roth 401(k) contribution (or a Qualified Plus Contribution). Similar to a regular Roth IRA contribution, the Qualified Plus Contribution is a *non-deductible* 401(k) contribution. This means that the amount of the 401(k) contribution elected by the participant to be a Qualified Plan Contribution would be included in the participant's taxable income for the current year. Because the Qualified Plus Contribution is treated like a Roth IRA contribution, however, the earnings on the Qualified Plus Contribution, while inside the 401(k) plan will not be subject to income tax nor will distributions from the Qualified Plus Contribution be subject to income tax when made (assuming the distribution qualifies for tax-free treatment.)[163] Also, this money could be rolled directly to a Roth IRA. This could be a valuable income tax savings option for 401(k) participants.

Example: Hardworker becomes a participant in her employer's 401(k) plan in 1999 and makes a $10,000 401(k) contribution for 20 years. Her 401(k) allows for a Qualified Plus Contribution. Hardworker elects to designate $2,000 a year as a Qualified Plus

---

[162] Comprehensive Retirement Security and Pension Reform Act. H.R. 1102, 106th Cong. § 109(a) (1999).

[163] Distributions from a Roth IRA are generally not subject to income tax if the distribution is made: (i) after the participant reaches age 59 (ii) after the death of the participant; (iii) on the account of the participant's disability; and (iv) as a qualified special purpose distribution (to purchase a first home). I.R.C. § 408(d)(2). Of course, because a Qualified Plus Contribution is not subject to income taxes when distributed, Qualified Plus Contributions would have to be kept in a separate account. This may increase administrative costs for 401(k) Plan.

Contribution which earns an average of 8% during the 20-year period. The contribution is made at the beginning of the year. If Hardworker retires after that 20-year period, then her Qualified Plus Contribution Account would be $98,846. All of which can be distributed to Hardworker income tax free!

[d] *Exclude 401(k) Contributions from the I.R.C. § 404 15% Deduction Limit*

Excluding 401(k) contributions made by the employees from the 15% deduction limit of I.R.C. § 404[164] would make these plans better for all employees. Today, employee 401(k) contributions are included as part of the I.R.C. § 404 limit. I.R.C. § 404 limits a company's deduction for profit-sharing contributions to 15% of eligible participants compensation.[165] This limit covers both employer contributions (e.g., matching or profit-sharing) and employee 401(k) contributions made to the 401(k) plan.[166] This limitation now operates against public policy; either employer contributions are cut back, which works to the detriment of the employees' retirement security, *or* employee pre-tax salary deferred contributions (e.g., 401(k) contributions) must be returned to the employee. Thus, employees lose an opportunity to save for their retirement in a tax-free environment. This is particularly inappropriate since the employee has already taken the initiative to save for his or her retirement, exactly the behavior Congress wants to encourage, not discourage.

[e] *Repeal of the Complicated "Multiple Use Test"*

The complicated "Multiple Use Test"[167] should be repealed. This test is nearly incomprehensible and forces small businesses (really their accountants or plan administrators) to apply different anti-discrimination tests to employer matching contributions than what may have been used for the regular 401(k) anti-discrimination tests. Quite often because of this test, small businesses stay away from matching contributions.

---

164 I.R.C. § 404(a)(3) (CCH 1998).

165 *Id.*

166 *Id.*

167 Treas. Reg. § 1.416—1 M—20 Q&A. Key employee contributions to a 401(k) plan are deemed employer contributions.

[f] *Employee-Pay-All 401(k) Plans for Small Business Should be Allowed*

Allowing employee-pay-all 401(k) plans for small business is fair. A key employee should be able to make a contribution to a 401(k) plan sponsored by a small business without triggering the top-heavy rules so that the small business is required to make the 3% required minimum contribution[168] for all non-key employees. Not only is the existing law a trap for the unwary since many small businesses, including their advisors, are unaware of this strange regulatory, not statutory, rule, but it is also unfair since a larger company would be able to sponsor an employee-pay-all 401(k) plan and not have to make any employer contributions to the plan. The regular 401(k) anti-discrimination tests are more than sufficient to ensure that the non-highly compensated employees are treated fairly vis a vis the highly compensated employees.

[g] *Catch-up Contributions*

The so-called "Catch-Up Contributions" for people approaching retirement would be very helpful for all employees but especially for small business employees (many of whom were not able to save while they were younger). Catch-up contributions will be particularly helpful if they are deemed to be a part of the 401(k) safe harbor or are exempt from ADP testing. If they are not, they will probably not be used by small business very much because the small business is then thrown back into complicated ADP testing.

[3] Increase I.R.C. § 404 Deduction Limit From 15% to 25%

Increasing the I.R.C. Section 404 15% deduction limit to 25% would be a major change which would appreciably assist small businesses. Section 404 limits a company's deduction for profit-sharing contributions to 15% of eligible participants' compensation. Because of this rule, today many companies, including small businesses, sponsor two plans because the 15% limit is too low for the contributions they are making for their employees. Most often a money-purchase pension plan is coupled with a profit-sharing plan to allow the company to go beyond the 15% deduction level. By

---

[168] *See*, Top-Heavy discussion, *supra*, § 2.03.

requiring companies to sponsor two plans where one would do, administration expenses and user fees are doubled. Each year the company is required to file two IRS 5500 forms instead of one. The company is required to have two summary plan descriptions instead of one. This change would truly simplify and reduce administration expenses.

[4] Top-Heavy Rules

The Top-Heavy rules[169] are now largely duplicative of many other qualification requirements which became law subsequent to the passage of these rules. They often operate as a "trap for the unwary," particularly for mid-size businesses which often do not check for top-heavy status and for micro small businesses which often do not have sophisticated pension advisors to help them. These rules have always been unfair impacting only small-to-mid-size businesses.[170]

The top-heavy rules have required extensive record keeping by small businesses on an ongoing five-year basis.They have also represented a significant hassle factor for small business — constant interpretative questions are raised on a number of top-heavy issues. Consequently, additional work is required to be done by a pension administrator when dealing with a top-heavy plan, particularly a top-heavy 401(k) plan.

Family attribution for key employees in a top-heavy plan should also be repealed. These rules require a husband and wife and children under the age of 19 who work in a family or small business together to be treated as one person for certain plan purposes. They discriminate unfairly against spouses and children employed in the same family or small business. Again, many small business owners believe these rules have already been repealed. They do not realize that family aggregation is different than family attribution. It is time for individual family members, particularly spouses, to be treated as individuals.

---

169 *See,* Top-Heavy discussion, *supra,* § 2.03[3].

170 The changes made in recently introduced H.R. 1102 will significantly simplify the retirement system with little to no detriment to any policy adopted by Congress during the last decade. Comprehensive Retirement Security and Pension Reform Act. H.R. 1102, 106th Cong. 109(a) (1999).

A simplified definition of a key employee, as well as only requiring the company to keep data for running top-heavy tests for the current year, rather than also having to keep it for the past four years, in addition to the current year, would simplify the system without adversely affecting any underlying policy.

[5] Required Minimum Distribution Rules

A certain minimum amount should be exempt from the complex required minimum distribution rules.[171] Further, the rule which delays receiving distributions for all employees other than 5-percent owners[172] until actual retirement, if later, should be extended to 5-percent owners. There seems to be no policy rationale for forcing 5-percent owners to receive retirement distributions while they are still working.

[6] Lineal Descendants Should Be Allowed to Roll-Over Inherited Plan Assets to an IRA

Direct lineal descendants of the participant, in addition to a spouse, should be able to rollover an inherited retirement plan balance to an IRA. Today, if a participant dies and names the spouse as beneficiary, the spouse can "rollover" the retirement plan assets into an IRA,[173] rather than receiving payments from the retirement plan. 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 will in most cases be forced to take the distribution in one lump sum. This triggers a difficult estate and income tax problem.[174]

[7] All (or a Portion) of Retirement Assets Should Be Exempt From Estate Taxes

There should be an exemption (either in full or part) for the retirement plan benefits from estate taxes. If the children are forced to take a lump sum distribution (and assuming they have no surviving parent), the entire retirement plan contribution is brought

[171] I.R.C § 401(a)(9)(A) (CCH 1998).

[172] I.R.C. § 401(a)(9)(C)(ii) (CCH 1998).

[173] I.R.C. § 401(a)(9)(B)(iv) (CCH 1998).

[174] *See*, Estate Tax Exemption discussion, *infra*, § 2.12[7].

into the estate of their parent who was a plan participant and is subject to immediate income tax.[175] This is the fact pattern where the plan distribution is reduced by up to 85% due to taxes — federal and state income taxes and federal and state estate taxes. This is why people often say they do not want to save "too much" in a retirement plan because if they die the government takes it all and their children and grandchildren receive way too little.

[8] Eliminate I.R.C. § 404(a)(7)

I.R.C. § 404(a)(7) is an additional deduction limitation imposed on companies that sponsor any combination of 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 deduction equal to 25% of the eligible participant's compensation.[176] The defined benefit plan is subject to a myriad of limitations on deductions and contributions. The defined contribution plan is likewise subject to its own limitations on deductions and contributions. This extra limitation often hurts the older employees who would otherwise receive a higher contribution in the defined benefit plan. Often companies simply choose not to sponsor both types of plan because of this limitation. This is unfortunate since the defined benefit plan is more valuable to the older, long-time employees while the defined contribution plan is more valuable to the younger, more transient employees.

[9] Allow Plan Loans for S Corporation (Sub-S) Owners, Partners and Sole Proprietors

The rules with respect to loans from retirement plans should be extended to Sub-S owners, partners and sole proprietors. This would place all small business entities on a level playing field.

[10] Repeal of 150% of Current Liability Funding Limit

This is a very technical issue, but basically, defined benefit plans are not allowed to fund in a level fashion. I.R.C. § 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current "termination liability." This is misleading because

---

[175] *See*, Lineal Descendants discussion, *supra*, § 2.12[6].

[176] I.R.C. § 404(a)(7) (CCH 1998).

termination liability is often less that the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. *This provision is particularly detrimental to small businesses which simply cannot adopt a plan that does not allow funding to be made in a level fashion.*[177]

[11] User Fees and Tax Credits

As discussed, small businesses face assorted and high administrative costs when deciding to implement a retirement plan. These costs also include the "user fees" charged by I.R.S. when a business applies for the I.R.S.'s "approval" on the implementation of its retirement plan. These fees generally run about $100-$125 but can go as high as $1,250.[178] These user fees serve as a determent to the formation of new plans and should be eliminated. A start-up tax credit for some or all of the start-up costs paid by an employer would promote new small business plans particularly if it covers costs for a two-or three-year period.[179]

§ 2.13 CONCLUSION

A small business will go through a cost-benefit analysis to determine whether to sponsor a qualified retirement plan. A number of factors are analyzed including the profitability and stability of the business, the cost of sponsoring the plan both administratively as well as required company contributions, whether the benefit will be appreciated by staff and by key employees and whether the benefits to the key employees and owners are significant enough to offset the additional costs and burdens which come with a retirement plan. Legislation such as H.R. 1102, S. 741 and S. 646 would dramatically improve the qualified retirement plan system.[180] By making the system more user friendly and increasing

[177] The changes made to this law by H.R. 1102 would increase small businesses access to defined benefit plans.

[178] I.R.S. Form 8717 (1997).

[179] H.R. 1102 would provide such a tax credit for businesses with less than 100 employees. The credit would be limited to: (i) $2,000 for the 1st year of the plan; and (ii) $500 for each of the next two plan years.

[180] H.R. 1102 represents a huge step forward. Indeed, if this legislation becomes the law only a few and relatively minor changes remain to fully restore the system to its former health prior to the onslaught of negative and complex changes of the 1980's while retaining the needed reforms introduced during that period.

benefits, more small businesses will sponsor retirement plans. Easing administrative burdens will reduce the costs of maintaining retirement plans. The changes would revitalize the retirement plan system for small business as it is perceived by small businesses as more fair to them. Finally, the positive changes made by Congress in the 1980's would be retained and the time-tested ERISA system would stay in place. Ultimately, it is essential for this country to do everything possible to encourage small business retirement plans so that individuals are not dependent upon the government for their retirement well-being.