The Need to Simplify Federal Pension Law, and Some Possible Means of Doing It

By Allen Buckley

The complexities of the pension laws are costing employers a lot of money. Much of the complexity comes from tax laws and regulations. Suggestions discussed in this article to simplify the laws and thereby reduce costs include elimination of top-heavy rules and IRC Section 4980F, reduction of the scope of IRC Section 409A and the definitions of compensation, simplification of the IRC Section 401(a)(9) minimum distribution, vesting, and relative value rules, use of a common safe harbor age, and establishment of an IRS prototype plan.

Recently, some of my fellow ERISA practitioners have talked about the "final generation of ERISA attorneys." Are they speaking of the institution of a national retail sales tax such as the "Fair Tax" to replace the income tax, thus rendering much of ERISA void? No, they are speaking of the unwillingness of most intelligent, rational-thinking people to enter a profession that is so complex that it takes a decade of work (following completion of law school and perhaps an LL.M. from a tax program) to be competent in the field.

Most ERISA practitioners have experienced the dismay of a client who receives a substantial bill related to a complex problem. Sometimes clients appreciate the complexity of the matter that was tackled; sometimes they do not. In many cases, there is little physical product to show for a tremendous amount of effort. Certainly, some clients question (at least in their minds) whether the value that they received was worth what they paid.

In Georgia, Florida, and Texas, a push is ongoing to replace the income tax with the "Fair Tax." The Fair Tax proposal [H.R. 25] calls for a national retail sales tax to replace the individual and corporate income tax, the FICA tax, and the estate and gift tax. The Fair Tax bill carries a 29.9 percent tax-exclusive rate (i.e., a good or service that costs $1 would bear a tax of 30¢). Both the Joint Committee on Taxation (an arm of Congress) and the President's Advisory Panel on Federal Tax Reform have said that the 29.9 percent rate is much too low to make up for the lost revenue of the current tax system. Fair Tax advocates disagree. Raising the rate substantially would hit middle class and most retiree taxpayers hard. With a Democratic Congress now in power, the Fair Tax is unlikely to see any traction in the near future.

In 1997, the Joint Committee on Taxation commissioned a study (the "Study") on the economic impacts of conversion to either:

1. A value-added tax (VAT) or a VAT in the general nature of retail sales tax system; or
2. A unified income tax with few deductions.

Nine economic teams issued reports on the matter. One of the nine teams (members Dale Jorgensen and Peter J. Wilcoxen) reported that conversion to a consumption tax or a flat-rate income tax would produce modest economic gains, and that the major gain from conversion would be reduced tax compliance costs. The Study, dated November 20, 1997, was titled "Joint Committee on Taxation Tax Modeling Project.
Substitution of flat rate consumption or income taxes for existing taxes would be the most drastic change in federal tax policy since the introduction of the income tax in 1913. Therefore, it is somewhat surprising that the economic impacts we have summarized would be so modest. In fact, in the case of the consumption tax it appears that the major gain from tax reform would be a reduction in the substantial compliance costs associated with the existing tax system, estimated to range from $100 to $500 billion per year. These benefits are large and are not captured by our model.

Why not simplify the tax laws and reduce compliance costs of companies, the IRS, and individuals? Perhaps simplification would help give rise to a new generation of ERISA attorneys. Interestingly, many of the members of Congress who are pro Fair Tax, such as H.R. 25 cosponsor John Linder, have voted for bills that have greatly enhanced complexity. For example, Mr. Linder voted in favor of the American Jobs Creation Act of 2004 (AJCA), the Act that created Internal Revenue Code (IRC) Section 409A.

Are some of these laws enacted to create work for attorneys, actuaries, and administrators? It is hard to say. Following are some suggestions for simplification of the tax provisions of the Code and ERISA that would have little impact on the “big picture.”

Eliminate the Top-Heavy Rules

Given: (1) the Section 401(a)(4) regulations and their protections for nonhighly compensated employees, including the cross-testing rules; and (2) the advent of the 401(k) plan, and the accompanying actual deferral percentage (ADP) and actual contribution percentage (ACP) tests or fully vested necessary contributions for a safe harbor plan (thus ensuring that nonhighly compensated employees receive a reasonable amount of benefits relative to those received by the highly compensated employees), the need for the top-heavy rules no longer exists.

Passing the ADP and ACP tests, or providing the safe harbor (fully vested) contributions provides the basic benefits for nonhighly compensated employees that the top-heavy rules were designed to provide for “nonkey employees.” Furthermore, for cross-tested plans or defined benefit/defined contribution combination plans, the “minimum gateway” contribution is virtually always greater than the top-heavy minimum benefit.

At a minimum, the term “key employee” should be replaced with “highly compensated employee” as defined under IRC Section 414(q). There is usually little difference between key and highly compensated employees, yet the difference can result in significant complexity for a cross-tested plan. Similarly, the definitions of “highly compensated employee” under IRC Sections 125(e) and 105(h) and the definition of “key employee” under IRC Section 125(b)(2) could (i.e., should) be changed to be the Section 414(q) definition.

Reduce the Scope of IRC Section 409A

The Enron debacle was a substantial part of the reasoning for enactment of IRC Section 409A. Enron’s stock was publicly traded. Enron maintained a non-qualified plan with a “haircut” provision, whereby an immediate in-service distribution could be taken at a discount. When Enron began its precipitous decline, many executives exercised their rights under the haircut provision, thereby receiving millions of dollars of benefits from Enron’s nonqualified plan shortly before Enron’s bankruptcy filing. At the same time, many of Enron’s regular employees incurred substantial losses on Enron stock in Enron’s tax-qualified plans. While members of top management were jumping into lifeboats, the ordinary employees were experiencing a complete loss of much of their retirement benefits. IRC Section 409A largely addresses this perceived problem.

IRC Section 409A also addresses issues with respect to which the IRS had fought with taxpayers for years. Under IRC Section 409A(a)(4), deferral elections generally must be made before the beginning of a calendar year, and significant restrictions exist on the ability to change the payment form just before payment(s) are scheduled to be made. This has been the IRS’s position for years, notwithstanding more liberal judicial interpretations of the law in many litigated cases. Under IRC Section 409A(b), utilization of a foreign trust triggers taxation and haircuts are prohibited. Although many of the Section 409A provisions are not unduly restrictive or complex, the problem lies in the expansion of the rules by the regulations to cover equity compensation and the complexity of the regulations in general. The regulations under IRC Section 409A (including the preamble, almost 400 pages) cover stock options and other equity arrangements, even though the Code makes no mention thereof, and the legislative history makes only a passing reference.
to options issued at fair market value (saying that they are not problematic).

Why not limit IRC Section 409A, or at least its most onerous provisions, to companies with publicly traded stock? A possible solution: Keep the haircut prohibition of IRC Section 409A(b)(2), the foreign trust prohibition of IRC Section 409A(b)(1) and the deferral election and change of time and form of payment provisions of IRC Section 409A(a)(4) for all companies, but eliminate the remainder of IRC Section 409A and its regulations that fall outside these areas for all privately held companies. For example, the stock options and other equity compensation provisions of the regulations would not apply to privately held companies.

For private companies, with the possible exception of an ESOP, there is ordinarily no company stock in a qualified retirement plan. Thus, with the haircut prohibition, the possibility of the Enron scenario does not exist. (Employees can sue for breach of fiduciary duty if fiduciaries act imprudently with respect to an ESOP.) Cutting back or eliminating IRC Section 409A for privately held companies would reduce the tax compliance burden to such companies and not hurt ordinary employees. A possible compromise would be to extend the six-month wait for distributions mandated by IRC Section 409A(a)(2)(B)(i) to all non-qualified plans but scale back IRC Section 409A for companies so that only haircut and foreign trust prohibitions and deferral timing and election form change rules remain.

**Simplify IRC Section 401(a)(9)**

IRC Section 401(a)(9) generally requires that, following attainment of age 70½, annual distributions be made from qualified plans and from IRAs. Absent IRC Section 401(a)(9), benefits could continue to grow tax-free until death, and spouses of deceased participants/IRA holders could then roll over the benefits and continue growth tax-free without taking any distributions, and without producing any revenue for the government. (Under the Pension Protection Act of 2006, nonspouses can now roll over benefits tax-free.) Thus, a need for a law that requires that distribution be taken at some time is understandable.

In 2002, final regulations were issued under IRC Section 401(a)(9). (They were amended in 2004.) Although complex, these regulations replaced a quagmire of regulations that existed for many years. Complexity equals cost to someone.

A possible means of greatly simplifying IRC Section 401(a)(9): Require that installment payments be made over a definite period of time, such as 25 years. The payout beginning point could be the 31st of December of the year following the earlier of the year in which the participant/account holder dies or the year in which the participant/account holder attains a specified age, such as 70. An exception could permit surviving spouses of participants who die before payments begin to make a tax-free rollover, with installment payments from the IRA beginning by the 31st day of December of the year following the year of the earlier of the date of death of the surviving spouse or the date of attainment of age 70 by the surviving spouse. Rollovers to nonspouses could be required to be paid over 25 years, with the first payment due in the year after the year of death. The installments would continue without interruption. Big picture: little revenue effect to the federal government, little economic benefit or detriment to individuals, and much greater simplicity—that is, a rule that virtually everyone could understand and administer.

**Use a Common Safe Harbor Age**

Concerning the age at which certain benefits become available without penalties or qualification issues, such as the age 59½ exception to the 10-percent penalty of IRC Section 72(t), the age 62 or greater in-service pension distributions allowance added by the Pension Protection Act of 2006, and the age 55 separation-from-service exception to the 10-percent penalty of IRC Section 72(t), one common age (e.g., 60) could be utilized.

**Reduce the Number of Definitions of Compensation**

Between IRC Sections 414(s) and 415 and the regulations issued thereunder, at least seven possible definitions of compensation can apply for qualified plan testing purposes. Most of these definitions are based on W-2 pay or income tax withholding pay. Some additional alternative definitions are available in performing testing. The system could be greatly simplified by defining compensation as either income tax withholding pay or W-2 pay plus cafeteria plan contributions, 401(k)/403(b)/457(b) contributions, and qualified transportation pay.

**Simplify the Vesting Rules**

The vesting rules are relatively complex. Instead of the current rules, that differentiate between an
existing accrued benefit and a future accrued benefit for a vested participant once five consecutive one-year breaks in service have been experienced, one rule could apply for all vesting service credit purposes, such as elimination of all prior service (i.e., start a new slate) once a period of unworked service, such as seven consecutive one-year breaks in service, has been experienced. In no event would the vesting percentage of any existing accrued benefit be reduced. The cash-out/buyback rule could be subjected to the time frame, so that any buy-back would need to occur within the time frame. Also, given the short vesting schedules that now exist, the vesting schedule change rule of ERISA Section 203(a)(1)(B) and IRC 411(a)(10)(B) that permits a participant with three or more years of service to elect the old schedule or the new schedule, could (i.e., should) be eliminated.

Eliminate IRC Section 4980F

Even though much case law holds plan sponsors and fiduciaries liable for inconsistencies between the summary plan description (SPD) and plan document, no monetary penalties exist for failure to issue an SPD. In contrast, a monetary penalty of $100 per day per participant potentially exists for failure to give advance notice of a significant reduction in the future rate of benefit accrual under a pension plan. How many employees will quit or change any course of action by receiving such a notice? Perhaps none. Note that a summary of material modifications (SMM) for a material benefit-reducing change to a health plan (e.g., elimination of coverage for heart surgery) need not be given prior to a change, but instead must be given within 60 days after the reduction. Under ERISA Section 204(h), [29 U.S.C. § 1054(h)] in the event of an egregious failure to provide notice of a reduction to the future rate of benefit accrual, participants are entitled to the greater of:

1. Their benefits computed with regard to the amendment; and  
2. Their benefits computed without regard to the amendment.

Talk about a lack of symmetry! A solution would be to eliminate IRC Section 4980F, and apply the 60-day SMM rule to a significant reduction in the rate of future benefit accrual under a pension plan. The same time period could possibly be applied to retirement plan and all other employee benefit plan SMMs, instead of the current rule that permits an SMM to be distributed as late as the last day of the seventh month after the end of the plan year.

Apply 402(g) Limit to IRAs

The individual 402(g) limit ($15,500 for 2007) could be extended to IRAs. Currently, the employee of an employer that maintains a 401(k) plan, a 403(b) plan, or a 457(b) plan can elect to reduce his pay by up to $15,500 ($20,500 if catch-up contributions are available) on an income tax-deductible basis. In contrast, an employee of an employer that does not maintain such a plan is subject to the IRA deduction limits. For 2007, the deductible contribution limit generally is $4,000 for people under age 50 and $5,000 for people age 50 or older. Why should the employee’s individual tax deferred retirement savings ability be tied to his employer’s decision about whether to maintain a plan? An employee can create a health savings account (HSA) for herself. Why should the employee be disadvantaged when it comes to retirement savings? Using the 402(g) limit would eliminate the deduction rules applicable to IRAs. Few employers that currently maintain a 401(k) plan would cease to do so if the IRA limit was increased.

Simplify the Relative Value Rules

ERISA was enacted in 1974. At that time, most pension money was deposited in the trusts of defined benefit plans. For at least 20 years, plan administration was undertaken with respect to pension plans without any guidance to retiring participants concerning the relative value of retirement payment options.

I recall attending an ALI-ABA (American Law Institute/American Bar Association) in the late 1990s, and hearing a high-ranking IRS employee (Alan Tawshuntsky, I believe) talk about how the proposed relative value regulations came to exist. He said that one participant complained to her Congressman that she was harmed because she was not told of the value of an early retirement benefit to her. The matter escalated such that, without any change in any statute, the relative value proposed regulations were issued. Ultimately, the final relative value regulations were issued. Good luck finding a basis for these regulations in the Code.

A simpler solution would be to require that the SPD state whether a subsidy exists for early retirement and, if so, to provide a description of the nature of that subsidy. For any annuity, to the participant, the value will depend on the period for which payments will actually be made. If no subsidy exists, an explanation
thereof along with a description of the life expectancy and interest rate utilized to calculate the lump sum (if applicable) should be provided in terms that an average person could understand.

Move the Roth 401(k) Plan Option Outside Qualified Plans

Although the Roth 401(k) option is appealing, it adds an entirely new layer of complexity to the area of qualified plans. With baby boomers and all of their voting power heading for retirement, it appears unlikely that significant changes will be made to reduce entitlements. Including amounts owed to the Social Security Administration, the US debts now total almost $9 trillion. The present value of the unfunded liabilities is much, much greater. Printing money will not solve the country’s problems. Thus, there is a good chance that taxes will be increased substantially in the next ten to 20 years. The main issue is whether a value-added tax (VAT) or a sales tax will be added to supplement the income tax or income taxes and tax rates will increase. Almost all industrialized countries have both an income tax and a VAT (or a sales tax).

For many employers that have granted the Roth 401(k) option, the utilization rate has been low. Procrastination rules! Perhaps a better solution would be to eliminate the Roth 401(k) option and instead allow people to place a certain amount aside per year (e.g., $5,000) outside of a retirement plan but in an account similar to an IRA, with tax-free growth until retirement and with taxation of any amount withdrawn prior to retirement, subject to exceptions for death, disability, or hardship. Alternatively, the 402(g) limit could be applied to pre-tax deferrals (whether through a 401(k) plan, a 403(b) plan, 457(b) plan, and/or an IRA) and to contributions to a Roth account which is outside the qualified plans arena, on a combined basis, with any withdrawals from the Roth account prior to retirement being subject to tax, except for distributions taken because of disability, death, or hardship.

Eliminate Permissible Interest Rates Limitation on Cash Balance Plans

Under Section 701 of the Pension Protection Act of 2006, cash balance plans are legal, provided certain requirements are met. One of the requirements is that the interest rate credits not exceed a "market rate of return." A cash balance plan is subject to the benefits limits of IRC Section 415, so why the interest credit rate must be limited is unclear. The legislative history of the Pension Protection Act of 2006 does not provide an answer. If the trust’s earnings are insufficient to pay cash balances, the employer is obligated to make up the shortfall. The market rate return requirements should be eliminated.

Establish an IRS Prototype Plan

Why can’t the IRS create and maintain its own tax-qualified prototype defined contribution plan? The IRS creates Listings of Required Modifications (LRMs) for taxpayers to use to draft their plans. Certainly, the IRS could create and maintain a basic 401(k)/profit sharing prototype plan for adoption by businesses. If it did, the need to make determination letter filings with IRS would be eliminated for employers that adopted the IRS’s prototype plan.

Now, small and medium-sized businesses often “sign up” with an insurance company or brokerage company that maintains a prototype plan as part of a bundled package. Often, utilization of the prototype is coupled with brokerage services (i.e., mutual funds) and administration. If the IRS issued a prototype plan, small businesses could adopt the IRS plan, and then separately choose mutual funds and administrative helpers.

The US Department of Labor could issue a model summary plan description to accompany the IRS prototype plan. It could also produce sample loan procedures, just as it has issued sample qualified domestic relations procedures.

Conclusion

Given the actuarial aspects of retirement plans and the desire of many companies to benefit their highly paid employees to a greater degree than their non-highly paid employees, ERISA will be complicated, whether or not the preceding changes are made. These changes would, however, have little impact on the “big picture,” while reducing complexity and costs to employers and employees.