The Honorable Max S. Baucus  
Chairman  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

The Honorable Dave Camp  
Chairman  
House Committee on Ways & Means  
1102 Longworth House Office Building  
Washington, DC 20515

The Honorable Orrin G. Hatch  
Ranking Member  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

The Honorable Sander Levin  
Ranking Member  
House Committee on Ways & Means  
1102 Longworth House Office Building  
Washington, DC 20515

Re: Options for Tax Reform Regarding Employee Benefits and Executive Compensation

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform regarding employee benefits and executive compensation. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Rudolph R. Ramelli  
Chair, Section of Taxation

Charles H. Egerton  
Former Chair, Section of Taxation

Enclosure

cc:  Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee  
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee  
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee  
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee  
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation  
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service  
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
OPTIONS FOR TAX REFORM AND SIMPLIFICATION
REGARDING EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

These options for tax reform and simplification (“Options”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, these Options should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer. These Options were prepared by individual members of the Employee Benefits Committee of the American Bar Association Section of Taxation. Principal responsibility for preparing these Options was exercised by Amy A. Null, and prior to August 1, 2011 by Victoria A. Judson.1 Substantive contributions were made by Joni L. Andrioff, Christopher E. Condeluci, Matthew J. Eickman, Thomas A. Jorgensen, Kathryn J. Kennedy, Vanessa Scott, Susan P. Serota, Stuart A. Sirkin, and Donald E. Wellington. The Options were reviewed by Joni L. Andrioff, former Committee Chair. The Comments were further reviewed by Bruce Pingree of the Section’s Committee on Government Submissions and by Thomas R. Hoecker, former Council Director, and Pamela Baker, Council Director, for the Employee Benefits Committee. The comments were also reviewed by Priscilla E. Ryan and James R. Raborn on behalf of the American Bar Association Section of Taxation’s Tax Reform Project Steering Committee.

Although the members of the Section of Taxation who participated in preparing these Options have clients who might be affected by the federal income tax principles addressed by these Options, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options, except that some members have sought to have specific excise taxes waived as part of corrections for particular matters under the Employee Plans Compliance Resolution System.

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Date:  October 3, 2012

1 Since August 1, 2011 Ms. Judson has been the Internal Revenue Service’s Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities).
EXECUTIVE SUMMARY

The Options set forth herein relate to provisions of the Internal Revenue Code of 1986, as amended, that govern retirement plans, executive compensation and employee benefits. These Options seek to:

1. simplify rules governing qualified plans, individual retirement accounts and individual retirement annuities ("IRAs"), and executive compensation;
2. eliminate requirements that are not achieving policy objectives;
3. simplify recordkeeping and compliance tasks that must be done by individuals, particularly those of modest means;
4. target tax expenditures more to retirement goals and less to estate planning objectives;
5. facilitate flexibility in using retirement assets for retirement needs; and
6. encourage new, and preserve existing, retirement savings.

To achieve these ends, the Options are intended to target tax provisions more closely to achieve retirement goals and encourage retirement savings by:

1. reforming the required minimum distribution ("RMD") rules; and
2. facilitating phased retirement.

In addition, the Options set forth below are intended to simplify plan and benefit operation and administration by:

1. simplifying and better targeting section 409A to its goals;
2. standardizing the definition of compensation;
3. allowing a simplified alternative for applying the "controlled group" rules under section 414(b) and (c);
4. liberalizing the rollover and trustee-to-trustee transfer rules and permitting certain corrections for impermissible rollovers and trustee-to-trustee transfers;
5. eliminating complicated recapture calculations and recordkeeping by individual taxpayers and undue compliance burdens on qualified plan and IRA recordkeeping systems;

2 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
6. simplifying survivor benefit rules under sections 401(a)(11) and 417;
7. simplifying the benefit restrictions under section 436;
8. eliminating “at-risk” liability under section 430(i); and
9. reforming qualified plan and IRA excise tax calculations and the Internal Revenue Service’s waiver authority.

A. Options Targeting Tax Provisions More Closely to Achieve Retirement Goals and Encourage Retirement Savings

1. Reform RMD rules

a. Present Law

The RMD rules of section 401(a)(9) require that participants in tax-favored retirement plans, including plans qualified under section 401(a), section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) programs for public schools and charitable organizations, eligible deferred compensation plans under section 457(b), simplified employee pensions (“SEPs”), SIMPLE plans and IRAs, begin receiving distributions by the “required beginning date,” which is generally April 1 of the year following the year the participant attains age 70½ or (except for IRAs and five percent owners) the year the participant retires, if later.3 Distributions before the death of the participant must be made over a period that does not exceed the life (or life expectancy) or the joint-life (or joint-life expectancies) of the participant and beneficiary.4 These distributions must be made in accordance with detailed rules, using prescribed tables that generally limit the ability to stretch out payments over the life or life expectancy of a beneficiary who is more than ten years younger than the participant, except if the beneficiary is the spouse.

Distributions after death are subject to different rules depending on whether the death is before or after the required beginning date and whether and when separate accounts are established for beneficiaries.5 For death before the required beginning date, the RMD rules may be satisfied by distributing the entire account balance within five years of the end of the year in which the participant dies.6 Alternatively, distributions generally must commence by the end of the year following the participant’s death and must be made over the life or life expectancy of the beneficiary, not recalculated.7 A beneficiary who is the deceased participant’s spouse may defer the commencement of distributions until the end of the year the participant would have attained age 70½, and life expectancy may be recalculated.8 When a participant dies on or after

3 Reg. § 1.401(a)(9)-2.
4 Id.
5 Reg. § 1.401(a)(9)-8, Q&A 2.
6 Reg. § 1.401(a)(9)-3.
7 Id.
8 Id.
the required beginning date and minimum distributions have commenced, the remaining portion of the participant’s interest must be distributed at least as rapidly as before his or her death. In the case of a defined contribution plan, the amount of the required minimum distribution is determined by taking into account the period which is the longer of (i) the remaining life expectancy of the participant and (ii) if there is a designated beneficiary, the remaining life expectancy of the beneficiary. Similar rules apply for defined benefit plans.

One hundred percent joint and survivor annuities satisfy the RMD rules if the annuity is for the life of the participant and his or her spouse. For an annuity with a non-spouse beneficiary more than ten years younger than the participant, RMD regulations limit the permitted applicable percentage of the survivor annuity based on age differentials. Regulations also limit the permissible annuity increases and mandate that annuity distributions begin by the required beginning date.

For a qualified plan, the plan administrator must make distributions in accordance with RMD requirements. For IRAs, regulations permit the RMD rules to be applied on an aggregate basis. The IRA trustee or custodian is required to provide a statement to each IRA owner if a RMD is required from the IRA. The statement must either (i) provide the amount of the RMD and the date by which the distribution must be made or (ii) inform the IRA owner that a minimum distribution is required, the date by which it is required to be distributed and state that the IRA trustee or custodian will calculate the RMD if requested by the IRA owner. However, the RMD rules do not apply to Roth IRAs during the life of the IRA owner, but generally do apply to distributions after the owner’s death.

An individual who fails to receive distributions in accordance with the RMD rules may be subject to an excise tax penalty of 50% of the amount that was not timely distributed, though this penalty may be waived by the Internal Revenue Service (the “Service”) if the shortfall is due to reasonable error and reasonable steps are taken to remedy the shortfall. In addition, a plan may be disqualified if there is a pattern or practice of not satisfying the RMD rules.

b. Reasons for Change

The RMD rules were intended to prevent taxpayers whose retirement savings receive tax-advantaged treatment from using those savings for estate planning purposes. Qualified retirement plans are not intended to be tax-planning vehicles to provide wealth for subsequent generations. By requiring that distributions from tax-favored retirement plans generally start no later than the participant’s attainment of age 70½, the RMD rules promote the use of these tax-favored benefits for retirement and limit the opportunity for excess accumulations. However, the RMD rules apply not only to those who have accumulated substantial tax-favored retirement

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9 Reg. § 1.401(a)(9)-2.
10 Reg. § 1.401(a)(9)-5, Q&A 5.
11 Reg § 1.401(a)(9)-6, Q&A 2(c).
12 Reg. § 1.401(a)(9)-6.
13 Reg. § 1.408A-6, Q&A 14.
14 I.R.C. § 4974.
benefits, but also to those individuals with modest retirement savings that are needed to support
those individuals in their retirement.

The RMD rules are overly complex, requiring annual calculations for defined
contribution plans using prior year account balances and life expectancy tables with various
adjustments that differ depending on the timing of the death of the participant and the ages and
types of beneficiaries. If there are multiple beneficiaries and it is desirable to use each of their
life expectancies for determining the payout period to each, there are rules for establishing a
separate account for each beneficiary. Inadvertent errors are common. Also, in the case of
IRAs, the burden of compliance falls on individual taxpayers.

The current rules also deprive those with modest means of useful flexibility in the timing
of their distributions. For example, under current rules, an individual who needs to withdraw
more than the RMD amount in one year for health care needs or for an assisted living facility
payment is not permitted to take credit for such withdrawals against the required minimum
amount to be distributed in later years. Requiring that distributions be made to an individual of
modest means in advance of when funds are needed further depletes his or her retirement assets
because taxes are due when the amount is distributed, thereby decreasing the amount of assets
that can build-up tax-free until distributed. Also, an individual generally is not permitted to skip
distributions for a year when assets have declined.15

In determining the best mechanisms for providing added flexibility for those with
moderate retirement savings, it is important to consider potential administrative and compliance
burdens. The Administration’s proposal to eliminate RMD rules for account or plan balances the
aggregate value of which is equal to or less than $50,00016 is an example of a well intentioned
proposal to reform the RMD rules that is too burdensome to implement and complex to
administer.17 Under the Administration’s proposal, if the total value of an individual’s IRA and
other tax-favored retirement plan assets does not exceed $50,000 at the beginning of the year in
which the individual attains age 70½ or, if earlier, the year in which the individual dies, then the
RMD rules would not apply. The proposal also generally states that the RMD rules would be
phased-in for individuals with aggregate retirement benefits between $50,000 and $60,000. The
aggregate value of the assets is re-measured if the plan or IRA receives additional contributions,
rollovers or transfers. This proposal, if adopted, would be burdensome on taxpayers, trustees and
custodians because there would be no easy way to distinguish between IRAs and plans that
would and would not be subject to the RMD rules. Plan administrators would not be able to
determine whether RMD rules applied to benefits under their plans, because the administrators
would not know the value of participants’ retirement benefits under other plans and IRAs.
Monitoring the IRAs and plans annually for additional benefits would be burdensome and

15 However, in response to general market declines, Congress passed a special waiver of application of the RMD
rules for 2009. See I.R.C. § 401(a)(9)(H). If this Option were adopted, such piecemeal, ad hoc action would be
unnecessary.

16 See General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals, at 83-84 (Department of
the Treasury, February 2011); see also http://agingandwork.bc.edu/documents/PhasedRetirement08-07.pdf.

17 Although Roth IRAs are not subject to the RMD rules before the account holder’s death, Roth IRAs would be
taken into account in determining whether the $50,000 threshold is exceeded. Benefits under qualified defined
contribution plans being paid in the form of an annuity, however, would not be taken into account.
mistakes would be likely because the monitoring would fall to participants. Administration and enforcement of such a rule would be challenging. The Administration’s proposal to reform the RMD rules could be simplified by raising the threshold amount substantially or doing away with the threshold altogether, relying on the post-death RMD rules to achieve the goal of the RMD rules.

c. **Options for Consideration**

The Option that we offer for your consideration is to simplify the RMD rules by allowing for flexibility during retirement years, eliminating the need for computations based on various tables, and limiting an individual’s ability to defer benefits substantially beyond his or her death and the death of the individual’s spouse. This could be achieved by eliminating the RMD rules during the lives of the individual and his or her spouse when the value of their vested interests in tax-qualified plans is less than or equal to $250,000 as of the end of the prior year and when account balances for all of their IRAs are less than or equal to $250,000 as of the end of the prior year. This Option provides separate thresholds for tax-qualified plans and for IRAs. For post-death distributions, we propose that Congress consider modifying the existing RMDs rules to require that an individual’s vested interests in all IRAs and plans currently subject to the RMD rules be distributed by the later of:

i. the end of the fifth calendar year following the calendar year of the death of the last to die of the individual and his or her spouse, and

ii. if the beneficiary is a child of the individual or his or her spouse, the end of the year in which the beneficiary attains age 26.

2. **Facilitate phased retirement**

a. **Present Law**

A qualified defined benefit plan (a “DB Plan”) may not make a distribution to a participant who has not separated from employment (an “in-service distribution”) until the participant has attained the plan’s normal retirement age\(^{18}\) or age 62.\(^{19}\) A similar rule applies for money purchase plans.\(^{20}\)

A qualified defined contribution plan (a “DC Plan”) may make in-service distributions in some circumstances. However, a DC Plan with a qualified cash or deferred arrangement (a “401(k) Plan”) generally may not permit a participant to take an in-service distribution before he or she attains age 59½ (there are certain exceptions, such as for hardship withdrawals).\(^{21}\)

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\(^{18}\) I.R.C. § 401(a)(36)

\(^{19}\) See I.R.C. § 411 (a)(8); Reg. § 1.401-1(b).

\(^{20}\) I.R.C. § 401(a)(36).

b. **Reasons for Change**

With millions of members of the “baby boom” generation -- people born between 1946 and 1964 -- at or approaching retirement age, DB Plan sponsors need a simple, reliable process that will allow older workers to receive a portion of their retirement benefits while gradually phasing out of the workforce. Studies have found that many workers approaching retirement would like to reduce hours or to “cycle” in and out of work before they retire. However, under existing rules, the only choices that may be available to employees who want to access their retirement funds before age 62 and the plan’s normal retirement age are to terminate their existing employment and either work for another employer or return to their former employer as an independent contractor, which can potentially lead to employment tax misclassification issues.

Treasury regulations proposed in 2004 (the “2004 Proposed Regulations”) would have allowed for partial distributions from a DB Plan or a qualified money purchase plan to an employee who, before his or her phased-retirement, was a full-time employee and attained age 59½ but had not reached the plan’s normal retirement age under an employer’s “bona-fide phased retirement program.” The 2004 Proposed Regulations defined a “bona-fide phased retirement program” as a written, employer-established program pursuant to which employees could work fewer hours and receive a portion of their vested pension benefits. The 2004 Proposed Regulations provided for a pro rata payment of a participant’s accrued benefit during the phased retirement period based on the number of the participant’s reduced work hours. An employee who could have participated in the program would have been required to work no more than 80% of his or her previously scheduled hours and would have been able to continue to accrue benefits under the employer’s pension plan as if the employee were still employed on a full-time basis.

The 2004 Proposed Regulations lacked the flexibility necessary to allow employers to structure effective, individualized phased retirement programs. After the Treasury proposed these regulations, Congress enacted the Pension Protection Act of 2006 ("PPA"), which added section 401(a)(36) to the Code. Section 401(a)(36) allows DB Plans to permit participants who have attained age 62 to receive benefits while the participant continues to work. It appears that because of the enactment of section 401(a)(36) and the criticism that the Treasury received regarding the 2004 Proposed Regulations, the Treasury did not finalize them.

Allowing employees to continue to work while receiving retirement benefits gives employers the ability to retain the skill and knowledge of an experienced workforce and to manage their costs in recruiting and training new employees. Furthermore, a reasonable argument could be made that allowing phased retirement accommodates life-style changes and incentivizes older workers to continue working on a part-time basis so that they can pass on to

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younger workers skills that might otherwise be lost in an employer’s workforce. In addition, a more flexible phased retirement policy would minimize the misclassification of workers as independent contractors.

c. **Option for Consideration**

The Option we offer for your consideration is to amend section 401(a)(36) by substituting age 55 for age 62. This amendment would expand an employer’s ability to retain older workers on a phased-retirement basis without adding the complexity of the 2004 Proposed Regulations. Under this Option, employers would be free to design a phased retirement program to achieve their business needs, establish and modify phased retirement eligibility rules as needed and establish minimum and maximum work hours for working retirees within reasonable parameters.

**B. Proposals to Simplify Plan and Benefit Operation and Administration**

1. **Simplify and better target section 409A to its goals**

   a. **Present Law**

   Section 409A provides that elections to defer compensation earned during a taxable year must generally be made no later than the close of the preceding year. The time and form of payment must be specified at the time of the initial election deferral, and any change to the time and form of payment is subject to strict limitations. Payments generally are limited to the following events: separation from service (subject to a six-month delay for “specified employees,” who are certain officers of publicly traded companies), death, a specified time (or a fixed series of payments), a change in control of a corporation, the occurrence of an unforeseeable emergency, or the disability of the service provider. Subject to certain exceptions, payments cannot be accelerated (i.e., made earlier than initially specified), including through changes in the form of payment.

   Much like the rules applicable to tax qualified plans, if section 409A applies, there are complex and detailed “form” and “operational” requirements. However, unlike tax-qualified plans, there is no advance determination letter process and no equivalent of the Employee Plans Compliance Resolution System (“EPCRS”)25, although there is a limited operational correction provision.26

   The consequences for noncompliance with section 409A are harsh: a 20% additional tax, as well as an acceleration of regular income tax and a special interest provision on amounts paid in violation of section 409A and its regulations. Under regulations, these consequences apply to all plans and arrangements of the same type, even if the other plans and arrangements comply with section 409A. While these taxes and interest are imposed on the service provider, the employer is liable for tax reporting and withholding taxes. The same consequences apply regardless of the magnitude or nature of noncompliance.

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b. Reasons for Change

While Congress enacted section 409A to deal with certain perceived abuses in the deferral of compensation by executives, the section 409A regulations subject a vast array of compensation arrangements to federal regulation. On the other hand, section 409A has had a positive effect in that the rules relating to deferred compensation are much more objective than in the past. Before the enactment of section 409A, when a statutory moratorium was in effect, the taxation of deferred compensation was governed primarily by sometimes ambiguous and inconsistent guidance from the Service and case law relating to constructive receipt.

Unfortunately, many companies (and their counsel) remain unaware of the scope of section 409A in preparing employment agreements and other “non-traditional” deferred compensation arrangements with service providers. Even for experienced practitioners, the manner in which section 409A applies (or even whether it applies) often is counter-intuitive. In many cases, section 409A noncompliance occurs as a result of the parties’ lack of familiarity with section 409A and its complex regulations, or when a seemingly unrelated event occurs that has an impact on how section 409A applies to a particular deferred compensation arrangement.

The broad scope of section 409A unduly burdens service providers who are not officers or controlling parties. We believe the 20% additional tax associated with noncompliance often falls on those least responsible for the noncompliant arrangements -- non-executive employees, but it is the employer that has control over the documentation and operation of the deferred compensation arrangement. Although the Service has taken a number of steps to ameliorate the punitive effects of section 409A, they are still overly harsh and are difficult to calculate.

c. Options for Consideration

There are a number of Options we offer for your consideration that would improve the application of section 409A. One Option that would better target the scope of section 409A is for Congress to modify section 409A to apply the 20% additional tax and special interest provision only to the five highest-paid employees and those employees with income in excess of a certain threshold amount, e.g., the section 401(a)(17) limit ($250,000 for 2012). This Option retains the immediate income inclusion for all employees in the event of section 409A noncompliance. This Option is based upon the view that the 20% additional tax and special interest provision are unduly harsh for employees who have little control over the terms of their deferred compensation arrangements.

Another Option for consideration is for Congress to exempt violations of section 409A involving immaterial amounts and technical violations where no payment (or further deferral) of the deferred compensation rule has been made. Yet another Option is to provide that the plan aggregation rule applies only in the case of willful violations. Finally, another Option for Congress to consider is to direct the Service to develop a correction program for violations of section 409A similar to the Employee Plans Compliance Resolution System (“EPCRS”) that is available for sponsors of tax-qualified plans.

2. **Standardize the definition of compensation**

   a. **Present Law**

      The term “compensation” is defined in, or used in, many statutory and regulations governing the operation of tax-favored retirement and benefit plans, including non-discrimination testing provisions under sections 401(a)(4), 401(k), and 125; limits under sections 401(a)(17) and 415; minimum contribution mandates for certain cross-tested plans under Treasury regulations promulgated under section 401(a)(4); the determination of the highly compensated employee group under section 414(q); and the top heavy plan provisions under section 416. The average percentage of total compensation included under the alternative definition for an employer’s highly compensated employees as a group may not exceed by more than a de minimis amount the average percentage of total compensation for the employer’s nonhighly compensated employees as a group.\(^{28}\) Separate provisions of the Code or regulations often allow employers to choose among certain “safe harbor” definitions of compensation.

      Despite the statutory and regulatory definitions of compensation, a plan is generally free to define “compensation” for purposes of computing contributions or benefits in any nondiscriminatory manner (for example, contributions can be made on the basis of only base salary).\(^{29}\) The definition of compensation selected for purposes of determining the amount of contributions or benefits, however, must be reasonable. Prototype plans typically provide a choice among several “standard” definitions of “compensation,” which may be used both to determine contributions or benefits and to perform nondiscrimination testing.

   b. **Reasons for Change**

      The varying definitions of compensation create complexity, resulting in significant compliance challenges and costs. For example, section 415 requires distinctions between compensation paid to an individual while he or she is an employee and compensation paid to the individual thereafter. This provision is extremely difficult and costly to administer as it does not relate to the tax reporting and payroll systems that employers have in place. Finally, many employers, particularly those that utilize prototype plans, fail to administer correctly the definitions of compensation set forth in their plans and instead administer their plans using Form W-2 compensation.

   c. **Option for Consideration**

      The Option we offer for your consideration is to provide a standard definition of compensation to be used in Code (and regulatory) provisions applicable to tax-favored retirement plans (sections 401(a), 403(b) and 457(b)) and other benefit plans subject to non-discrimination requirements (such as section 125 plans and 129 plans), *i.e.*, Form W-2 Box 1 wages plus pre-tax elective deferrals and amounts excluded from income pursuant to participant elections under section 125 and similar provisions. While this Option limits the flexibility under current law to elect alternative definitions of compensation for nondiscrimination testing purposes, we believe

\(^{28}\) Reg. § 1.414(s)-1(d).

\(^{29}\) Reg. § 1.414(s)-1(b).
that the gains in simplification and compliance would be significant and that the existing flexibility in the law does not serve to enhance the delivery of benefits to rank-and-file employees.

The standardized definition would apply so long as the individual was an employee at some time during the year, and no special rules would apply in connection with the first or last year of employment. For example, severance or bonus payments made to an individual during the calendar year in which he or she terminated employment would be includible in compensation, regardless of whether paid before or after termination of employment. While this simplification will result in an expansion of the compensation included in the final year of employment, we believe that other Code provisions, such as section 401(a)(17), minimize the potential for abuse.

We do not recommend that the standardized definition be required for determining contributions or benefits. For example, a plan would continue to be able to determine elective deferral percentage or matching contributions, or both, on cash compensation only, or some subset such as base pay and bonus. Nonetheless, the adoption of this Option would encourage the use of the standardized Form W-2-based definition as the plan’s definition for contribution and benefits purposes, because use of the Form W-2-based definition will in most cases result in automatic satisfaction of nondiscrimination and other requirements.

3. **Allow simplified alternative for applying controlled group rules**

   a. **Present Law**

      Under section 414(b) and (c) and related Treasury regulations, two or more entities in the same controlled group or under common control are required to be treated as a single employer for purposes of applying sections 401, 408(k), 408(p), 410, 411, 415, and 416 and certain provisions of Title IV of ERISA. Section 414(b) provides that members of a controlled group are determined pursuant to section 1563, which employs an 80% vote or value test. Section 414(c) extends the principles of section 414(b), including the 80% relationship, to non-corporate businesses. Under the parent-subsidiary rules, “control” is generally defined as ownership of at least 80% of the vote or value of the second organization. Under the brother-sister rules, trades or businesses are under common control if the same five-or-fewer individuals have controlling interests in each organization. Pursuant to regulations, under certain conditions, (i) attribution rules apply to treat stock owned indirectly or stock owned by family members as owned by a person, and (ii) the ownership of interests by certain other parties related to a person are treated as not outstanding. Other statutory and regulatory provisions, such as the definition of employer under section 409A, apply a 50% test for determining control.\(^{30}\)

   b. **Reasons for Change**

      The existing controlled group rules are complex. In many circumstances, it is difficult and costly for an employer to determine membership in a controlled group. In our experience, businesses with changing ownership levels are required frequently to monitor the intricacies of

\(^{30}\) See Reg. § 1.409A-1(h)(3).
the existing tests, including the effect of the attribution rules. In addition, significantly related entities, with material overlapping ownership and uniform benefits programs, which may be related for other purposes under the Code, are prevented from applying the nondiscrimination tests on a single-employer basis, which complicates the testing process by requiring multiple non-discrimination tests, all at increased expense. Finally, businesses with majority-owned, but not 80%-owned, subsidiaries may be ineligible to maintain a single prototype plan, increasing complexity and cost to the plan sponsor.

c. **Options for Consideration**

We propose that Congress consider allowing two or more entities that are in a parent-subsidiary relationship to elect into controlled group status if there is at least a 50% relationship interest among them. The election would apply for all retirement plan provisions, including Title IV of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The 50% test is material enough to ensure that a significant business relationship exists among the parties and that loosely related entities do not restructure in order to take advantage of the benefits of controlled group status. Under this Option, controlled group status would continue to be mandatory if 80% threshold were present.

In considering the adoption of a voluntary 50% controlled group election, Congress might also consider simplifying the determination of whether 50% controlling interest is present by disregarding the attribution rules. The Treasury could be directed to establish a simplified test without regard to certain provisions of the current regulations that are designed to prevent the ability of parties to avoid controlled group status through the utilization of family members or employees. The specific election procedures would be determined by the Treasury, together with the Pension Benefit Guaranty Corporation and the Department of Labor. Once made, an election could be required to apply for a period of time, such as three to five years, absent a significant change in ownership.

4. **Liberalize rollover and trustee-to-trustee transfer rules and permit certain corrections for impermissible rollovers and trustee-to-trustee transfers**

a. **Present Law**

Generally, assets can be moved from tax-favored employer retirement plans and IRAs to other eligible retirement plans without adverse tax consequences (there are restrictions on the ability to roll over Roth accounts to non-Roth accounts). An “eligible retirement plan” for rollover purposes means a traditional IRA, an individual retirement annuity, a section 401(a) tax-qualified plan, a section 403(a) annuity plan, a section 457(b) eligible deferred compensation plan or a section 403(b) annuity contract.\[^{31}\] Notably, SIMPLE IRAs are not eligible retirement plans. A plan participant or IRA owner may move assets from one eligible retirement plan to another by means of a direct rollover, a 60-day rollover, or a direct trustee-to-trustee transfer that is not a distribution (a “transfer”).\[^{32}\] Rollovers and transfers from a SIMPLE IRA to another

\[^{31}\text{I.R.C. § 402(c)(8)(B).}\]

\[^{32}\text{I.R.C. §§ 401(a)(31); 402(c) and 408; Rev. Rul. 78-406, 1978-2 C.B. 157; Rev. Rul. 67-213, 1967-2 C.B. 149.}\]
SIMPLE IRA can be made at any time, and rollovers and transfers may be made from SIMPLE IRAs to eligible retirement plans after two years.\textsuperscript{33}

Rollovers and transfers have been restricted in certain contexts because of the basis allocation rules (e.g., accounting for pre-tax and after-tax contributions differently) or conflicting distribution rules. For example, rollovers of after-tax contributions from one eligible retirement plan to another may be accomplished only through a direct rollover (not a 60-day rollover) and only if the recipient plan provides for separate accounting of after-tax contributions and earnings.\textsuperscript{34} Similarly, moving assets from IRAs to Roth IRAs results in income taxation and thus is restricted.

The rollover rules limit the ability of a non-spouse beneficiary to move assets from one eligible retirement plan to another. If a participant in a tax-qualified plan dies before receiving all of his or her benefit under the plan and has designated a non-spouse beneficiary, the beneficiary may move the remaining benefit only to an inherited IRA\textsuperscript{35} by means of a direct rollover (not a 60-day rollover). If the owner of an IRA dies before receiving all of the IRA assets and has designated a non-spouse beneficiary, then the beneficiary may transfer the remaining IRA assets only to an inherited IRA by means of a transfer – not by a direct rollover or 60-day rollover.\textsuperscript{36}

b. **Reasons for Change**

Rollover rules have been liberalized over the years. For example, Congress included major changes to increase portability through rollovers and transfers in the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).\textsuperscript{37} The liberalized rollover rules enhance portability and allow individuals to consolidate retirement assets for better investment management, to achieve economies of scale, and to promote greater diversification of assets. Additional liberalization of the rollover rules could be adopted to extend these benefits to a broader group of tax-favored retirement arrangements.

In other contexts, rollovers and transfers have been restricted because of basis allocation rules (e.g., accounting of pre-tax and after-tax savings differently) or conflicting distribution rules. Nonetheless, erroneous rollovers or transfers are made, and distributions are made to individuals who intended to make a 60-day rollover in situations in which such a rollover is not permitted. Current law provides no mechanism for correcting many of these errors, although limited correction may be possible under EPCRS.

\textsuperscript{33} I.R.C. §§ 408(d)(3)(G), 72(t)(6); Notice 98-4, Q&A I-4, 1998-1 C.B. 269.

\textsuperscript{34} I.R.C. § 402(c)(2).

\textsuperscript{35} I.R.C. § 402(c)(11); Notice 2007-7, 2007-1 C.B. 345, Section V. A direct trustee-to-trustee transfer is treated as a direct rollover.

\textsuperscript{36} See I.R.C. § 408(d)(3)(C).

A surviving non-spouse beneficiary of a deceased participant’s qualified plan benefit may move the benefit to only an inherited IRA and only by means of a direct rollover.\textsuperscript{38} In contrast, a spousal beneficiary also has the option of moving his or her deceased spouse’s qualified plan benefit to an IRA by means of a 60-day rollover and the IRA can be treated either as an inherited IRA or the surviving spouse’s own IRA. However, a non-spouse beneficiary may be unaware of this difference and may attempt to transfer the qualified plan benefit to an inherited IRA through a 60-day rollover or to transfer the assets to his or her own IRA rather than to an inherited IRA.\textsuperscript{39}

c. Options for Consideration

We propose that Congress consider modifying the rollover rules to permit rollovers from eligible retirement plans to SIMPLE IRAs, subject to the existing rule that a tax-free rollover from a SIMPLE IRA can be made only to another SIMPLE IRA during the two-year period beginning on the first day on which contributions are made by the individual’s employer to the SIMPLE IRA.\textsuperscript{40} Applying this two-year restriction to the total SIMPLE IRA account would be easier to administer than a rule that would require sourcing of SIMPLE contributions to those subject to the two-year rule and those not subject to such rule. With this change, rollovers would be freely permitted between all types of tax-favored plans, except for nongovernmental section 457(b) plans.

We also propose that Congress consider modifying the law to permit corrective rollovers or transfers back to an eligible retirement plan following a rollover or transfer that is prohibited under present law, provided that: (i) the related earnings are also transferred and (ii) the individual comply with any related reporting requirements imposed by the Service. This approach would retain the rules that restrict rollovers and transfers in order to comply with basis allocation rules or conflicting distribution rules, but permit a taxpayer to correct an error.

In the context of a non-spouse beneficiary under an eligible retirement plan who erroneously believed that a 60-day rollover could be made to an inherited IRA, we recommend that Congress consider allowing the non-spouse beneficiary to return the assets to the eligible retirement plan. Alternatively, Congress could consider permitting a non-spouse beneficiary to roll-over the distribution to an inherited IRA by means of a 60-day rollover, provided that the beneficiary substantiate to the IRA custodian the date of birth and date of death of the deceased participant or deceased IRA owner. This alternate proposal would remove the current rule that prohibits a 60-day rollover of such assets. Also, Congress could consider giving the Service the authority to require reporting of the non-spouse beneficiary’s 60-day rollover.

\textsuperscript{38} I.R.C. § 402(c)(11).

\textsuperscript{39} The Administration has proposed permitting non-spouse beneficiaries to move inherited qualified plan assets or IRA assets to an inherited IRA by means of a 60-day rollover. See General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals, at 85-86 (Department of the Treasury, February 2011).

\textsuperscript{40} I.R.C. § 408(d)(3)(G); Notice 98-4, Q&A I-4, 1998-1 C.B. 269.
5. **Avoid adoption of proposals that require complicated recapture calculations and recordkeeping by individual taxpayers and undue compliance burdens on qualified plan and IRA recordkeeping systems**

   a. **Present Law**

   There are laws that allow taxpayers to include an item of income over multiple years or that impose different taxation regimes for funds not held in accounts for minimum periods of time. In order to prevent circumvention of these rules, recapture, acceleration of income inclusion, and additional taxes may be imposed. For example, section 408A(d)(3)(A)(iii) provides that Roth conversions made in 2010 would be taxable half in 2011 and half in 2012 unless the taxpayer elected to include the conversion in income in 2010. Section 408A(d)(3)(E) provides for acceleration of income inclusion where converted amounts are distributed. Section 408A(d)(3)(F) requires that conversion amounts distributed within five taxable years of the year of conversion be treated as includible in income for purposes of the 72(t) premature distribution tax. Similar rules applied to the four-year spread that was included in section 512(b) of the Tax Increase Prevention and Reconciliation Act of 2005.41

   b. **Reason for Change**

   Rules for acceleration, recapture, and increased taxes based on tracking of periods in which amounts have been in accounts may significantly increase the administrative costs of tax-qualified plans and IRAs. Systems need to be developed to track this information for all accounts, even though the provisions apply only to a small number of individuals. Often these rules are adopted without sufficient effective date lead time to accommodate development of adequate reporting systems. Furthermore, because some rules depend on knowledge of individual taxpayer’s adjusted gross income or past elections with respect to income inclusion, individual taxpayers bear the burden of complex recordkeeping requirements.

   c. **Option for Consideration**

   We propose that Congress consider the complexity and recordkeeping burdens imposed by recapture of income, acceleration rules, and imposition of additional taxes that are based on the number of years amounts are held in tax-favored accounts. When Congress determines that such burdens are necessary, we recommend that the burdens be borne by plan recordkeepers or IRA trustees or custodians whenever possible.

6. **Simplify survivor benefit rules under sections 401(a)(11) and 417**

   a. **Present Law**

   Tax-qualified defined benefit plans and certain other plans must provide that the automatic form of distribution is a qualified joint and survivor annuity (“QJSA”). Participants may elect other forms offered by the plan if they obtain spousal consent.42 If a plan wishes to

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42 I.R.C. §§ 401(a)(11), 417.
offer a participant who separates from service at any age an alternative form, such as a lump sum payment, the plan must provide the QJSA -- commencing immediately -- as the automatic form. The participant may then elect the lump sum with spousal consent. Offering a deferred annuity starting at a later date does not satisfy the immediate annuity requirement.\(^{44}\)

Spousal consent waiving the QJSA may only be provided within 180 days before the annuity starting date.\(^{45}\) As a result, a participant and his or her spouse may not consent to a deferred annuity (\textit{e.g.}, an annuity that will start at age 65 or age 85).

Defined benefit plans must provide a qualified preretirement survivor annuity (“QPSA”) equal to the survivor portion of the QJSA if they charge for QPSA coverage.\(^{46}\) Participants may waive QPSA coverage before the participant is age 35 only if the plan provides the participant another election at age 35.\(^{47}\)

Regulations prohibit use of pre-nuptial agreements to meet consent requirements.\(^{48}\) In addition, the 180-day rule would prevent most pre-nuptial agreements from being effective.

\textbf{b. Reasons for Change}

While a deferred annuity option advances the policy that tax-favored plans are intended to provide retirement benefits, an immediate annuity does not. Moreover, participants under age 55 typically do not take an immediate annuity rather than a lump sum.

A participant and his or her current spouse may find it desirable to elect an alternative benefit form that locks in part or all of the plan benefit as a deferred annuity, including a longevity annuity.

The age 35 QPSA rule adds unnecessary complexity. It requires an employer to set up records, which are used for no other business or regulatory purpose, to avoid failing to meet the deadline. Experience has shown that this requirement is mostly unknown and therefore compliance is low. The rule was included in the Retirement Equity Act of 1984\(^ {49}\) so that participants do not waive QPSA coverage when they are young. Nowhere else in the law are individuals as old as 34 treated as incapable of making informed decisions. The requirement of spousal consent provides enough protection and education to accomplish the same objective while eliminating complexity.

\begin{itemize}
  \item I.R.C. §§ 401(a)(11), 417.
  \item I.R.C. §§ 401(a)(11), 417.
  \item I.R.C. § 417(a)(6).
  \item I.R.C. § 417(c).
  \item I.R.C. § 417(a).
  \item Reg. § 1.401(a)-20, Q&A 28.
\end{itemize}
We believe the principal objection to allowing pre-nuptial agreements to govern the distribution of plan benefits was timeliness and complexity of plan administration. However, plans have adopted systems to administer QDROs and a similar structure could be created for pre-nuptial agreements.

c. **Option for Consideration**

We propose that Congress consider: (i) eliminating the requirement that a plan offer an immediate QJSA for lump sum distributions before a certain age (e.g., age 50 or 55); (ii) allowing a participant and his or her current spouse to lock into a deferred annuity upon a distributable event (e.g., separation from service) or as part of a qualified domestic relations order (“QDRO”); (iii) eliminating the age 35 QPSA rule; and (iv) allowing pre-nuptial agreements to be filed with the plan and honored as timely spousal consent.

7. **Simplify the benefit restrictions under section 436**

a. **Present Law**

A tax-qualified defined benefit plan must impose certain benefit restrictions if the plan’s adjusted funding target attainment percentage (“AFTAP”) for the year is below 80%, and additional restrictions if the AFTAP is below 60%. Generally, the AFTAP for the year is calculated retroactively as of the first day of the plan year. Until the plan’s actuary certifies the plan’s AFTAP for the current year, whether benefit restrictions apply for the current year depends on whether restrictions were in place for the prior year, the type of benefit restriction that may apply, a series of presumptions, the amount of funding standard carryover balance and prefunding balance, and whether additional contributions may be or are made.

An employer with calendar tax and plan years may continue to make contributions that are deductible for the year and include these contributions in the funding calculation for the year until September 15th of the following year (similar rules apply to plans that have non-calendar plan years). For calendar year plans, the Form 5500 is generally not due until October 15th of that following year. Schedule SB to such Form 5500 reports the final AFTAP for the plan year, as certified by the plan’s actuary.

If the AFTAP is less than 60%, the plan may not make accelerated payments (e.g., lump sum payments and Social Security leveling options) to participants or beneficiaries whose annuity starting date occurs when the plan’s AFTAP is less than 60%. If the AFTAP is 60% or greater but less than 80%, the plan may pay only 50% of a participant’s benefit in an accelerated form (not to exceed the present value of the Pension Benefit Guaranty Corporation’s maximum guaranteed benefit for the participant’s age at the time of distribution) and may pay the remainder only as an annuity (the “limited acceleration rule”).

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50 See, generally, I.R.C. § 436.
b. **Reasons for Change**

While using the current year’s AFTAP more timely links funding restrictions to the plan’s current funding status, not knowing the plan’s AFTAP before the start of the plan year substantially increases complexity. Many of the more complicated section 436 regulatory rules would not be necessary if the new AFTAP applied only after the information for a plan year was complete. Plan administration could be significantly simplified by applying the new AFTAP only after the Schedule SB filing date (a “look-back approach”).

A look-back approach sacrifices some immediacy for a great deal of simplicity. A look-back approach would eliminate the need for presumptions, the need to calculate adjusted and interim AFTAPs, and the need for the complex ordering rules governing use of funding standard carryover balances and prefunding balances.

The most complex benefit restriction is the limited acceleration rule. This rule was intended as a compromise to allow participants to receive some of their benefit in a lump sum if the plan’s underfunding was serious but not critical. However, the complexity created by the rule outweighs its benefit in our view.

A Social Security leveling option allows a participant to receive more of his or her accrued benefit before the participant is eligible for Social Security, thereby leveling the gross monthly amount a participant would receive from a combination of Social Security and the plan over the participant’s retirement years. However, the current rules treat payments under this option as accelerated payments.

c. **Options for Consideration**

We propose that Congress consider amending section 436 (and the parallel ERISA provision)\(^5\) to determine a plan’s AFTAP on a look-back basis from the Form 5500 Schedule SB due date and make conforming changes in the laws (such as eliminating the presumptions). For a calendar year plan, the new AFTAP would apply for the period beginning on October 16\(^{th}\) of the year the Schedule SB is filed through October 15\(^{th}\) of the following year. For example, the AFTAP that would apply from October 16, 2012 to October 15, 2013 would be determined based on the funding information as of the end of the 2011 plan year (December 31, 2011), but would include any retroactive contributions. This approach would also have the advantage of allowing an employer additional time to make contributions to avoid the restrictions on distributions.

We further propose that Congress consider eliminating the limited acceleration rule. Finally, we propose that Congress consider enacting a law providing that Social Security leveling options are not considered accelerated payments for purposes of the AFTAP benefit restrictions. Plan assets will not be “drained” by the relatively small increase in up-front monthly payments under a Social Security leveling option.

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\(^5\) ERISA § 206(g).
8. Eliminate “at-risk” liability under section 430(i)

a. Present Law

If a plan’s funding target attainment percentage (“FTAP”) is below 80% for the prior year ignoring at-risk liability, or below 70% considering at-risk liability, a plan is considered at-risk for the year. The consequence of being at-risk for a year is that the plan’s funding target and target normal cost for the year increase by a transition percentage of the increased liability. The transition percentage is 20% per year for the number of consecutive years (not to exceed five) that the plan has been at-risk. The increased liability subject to the transition percentage is determined using a special set of retirement assumptions (and is increased by a “load” representing the cost of purchasing annuities if the plan had been in at-risk status two of the prior four years).

b. Reasons for Change

As originally proposed, the at-risk rules were intended to take into consideration the health of the plan sponsor in addition to the health of the plan. Finding an acceptable way to consider the financial health of the sponsor proved very difficult. As a result, the at-risk liability rules enacted in section 101 of the PPA simply add another layer of contributions based on plan funding levels. These new rules add layers of additional complex calculations with very little increase in the amount of minimum funding. On balance, the complexity heavily outweighs any improvement in funding.

c. Option for Consideration

We propose that Congress consider eliminating the at-risk rules from section 430(i) (and the parallel ERISA provision).

9. Reform excise tax calculation and waiver authority

a. Present Law

Qualified plans and IRAs are subject to numerous excise taxes for noncompliance with the tax laws. Some of these taxes include explicit waiver provisions. As part of EPCRS, some of these excise taxes may be waived. In other cases, the Service will not pursue excise taxes with respect to corrected errors. One of the more common instances in which excise taxes apply

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52 I.R.C. § 430(i)(4).
53 I.R.C. § 430(i)(5).
54 Reg. § 1.430(i)-(c)(3)(ii).
55 Reg. § 1.430(i)-(c)(2)(ii), -(e)(4).
57 ERISA § 303(i).
58 See I.R.C. §§ 4971-4980F.
involves the late deposit of employee contributions to a qualified plan.\textsuperscript{59} Section 1101(a) of the Pension Protection Act of 2006\textsuperscript{60} authorizes the Secretary of the Treasury to implement plan correction programs and to waive excise or other taxes in certain circumstances.

b. **Reason for Change**

In many circumstances, the cost of calculating, reporting, and filing to pay the excise taxes significantly exceeds the amount of the penalty and results in undue plan administrative costs for relatively insignificant errors. This is particularly true in the case of the 15% excise tax under section 4975 in the case of unintentional late deposits of employee contributions. For example, if an employer pays employer contributions into a qualified plan one week later than they are due, this arguably results in a prohibited transaction and an excise tax of 15% of the interest attributable to the late contribution would be due. Also, interest would also be due each year on the accrued interest until it was repaid. This could require multiple year filings when small amounts were due based on late discovery of a late payment.

In these circumstances, it would be more cost-effective to impose a modest flat fee, rather than require complicated calculations of a pyramiding excise tax. This would also be the case when significant excise taxes would be due for innocent errors, or when excess amounts erroneously rolled from a tax-qualified plan could be transferred back into the plan to which the excess amounts were initially contributed.

Excise taxes serve as “sticks” to discourage certain behavior. However, if there is no mechanism for waiving or reducing excise taxes in these situations, there is little incentive for employers and service providers to fix systemic errors when they discover individual errors. In those situations, excise taxes reduce the effectiveness of “carrots” offered in the form of voluntary correction programs. When mechanisms, like EPCRS, are available to correct errors without imposition of excise taxes disproportionate to the nature, extent, and severity of errors, then service providers and employers are more likely to correct and improve their systems, and compliance with qualified plan and IRA rules is improved.

c. **Options for Consideration**

We propose that Congress consider giving employers the choice of paying a flat fee or using the current method of calculating the excise taxes and interest due. The flat fee could be graduated based upon Congress’ evaluation of the amount of the fee in comparison to the excise tax that would otherwise be due.

We also propose that Congress consider eliminating excise taxes and interest when they are triggered because ineligible amounts were rolled over from a tax-qualified plan if such amounts could be transferred back to the plan. This is consistent with the Service’s practice under EPCRS. Congress could further simplify the administration of these excise taxes by amending section 4973 to provide that the excise tax does not apply in certain limited circumstances, similar to the circumstances in which the Service has waived the excise tax under


\textsuperscript{60} Pub. L. No. 109-280, 120 Stat. 780.
EPCRS. Such an approach would relieve employers from the cost and administrative burden of preparing and filing an EPCRS application.

Finally, we propose that Congress consider reviewing all excise taxes that apply to tax-qualified plans with an eye toward identifying similar simplification measures. In this regard, Congress might consider authorization of a commission to review these excise taxes and to propose simplification measures. This commission would assist the Service in developing the correction policies and reforming excise tax enforcement policies and procedures consistent with Congress’ authorization of such policies in section 1101(a) of the PPA.