PRESENT LAW AND BACKGROUND RELATING TO TAX-FAVORED RETIREMENT SAVING AND CERTAIN RELATED LEGISLATIVE PROPOSALS

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on January 28, 2016

Prepared by the Staff
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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on January 28, 2016, on Helping Americans Prepare for Retirement: Increasing Access, Participation and Coverage in Retirement Savings Plans. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law, economic issues and data, as well as descriptions of certain legislative proposals, relating to tax-favored retirement saving.

Present Law

Tax-favored Employer-Sponsored Retirement Plans

Overview

Whether to offer a tax-favored retirement plan is a voluntary choice by an employer, with various factors entering into the decision. The Code provides for multiple types of tax-favored employer-sponsored retirement plans, including qualified retirement plans and annuities (secs. 401(a) and 403(a)), tax-deferred annuities (sec. 403(b)), governmental eligible deferred compensation plans (sec. 457(b)), SIMPLE (savings incentive match plan for employees) IRAs (sec. 408(p)), and simplified employee pensions ("SEPs") (sec. 408(k)). These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to the requirements applicable to each type of plan under the Code and, in some cases, under the Employee Retirement Income Security Act of 1974 ("ERISA").

Qualified retirement plans and annuities

Qualified retirement plans (and other tax-favored employer-sponsored retirement plans) are accorded special tax treatment under present law. Most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Additionally, many distributions can be rolled over to another plan for further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within certain limits) for contributions even though the contributions are not currently included in an employee's income. Contributions and earnings are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses. Defined benefit plans generally are subject to minimum funding requirements and benefits are guaranteed, within limits, by the Pension Benefit Guaranty Corporation ("PBGC"). Some

[1] This document may be cited as follows: *Joint Committee on Taxation, Present Law and Background Relating to Tax-Favored Retirement Saving and Certain Related Legislative Proposals* (JCX-3-16), January 26, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan; for example, cash balance plans are defined benefit plans, but plan benefits are defined by reference to a hypothetical account balance.

Qualified retirement plans are subject to various requirements to receive tax-favored treatment. Some of these requirements define participant rights and provide participant protections, such as minimum participation, vesting, exclusive benefit and minimum funding requirements. These requirements generally have parallels under ERISA. Some qualified plan requirements limit tax benefits, such as the limit on compensation taken into account under a plan and limits on contributions and benefits. Minimum coverage and nondiscrimination requirements and top-heavy requirements are intended to ensure that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees.

The Code generally prohibits certain transactions between qualified retirement plans and a disqualified person, including a fiduciary. The Code requirements apply also to individual retirement arrangements ("IRAs") and certain other tax-favored savings arrangements. Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Violation of the Code requirements may result in the imposition of an excise tax.

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor. Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar. ERISA also contains general fiduciary duty standards that apply to all fiduciary actions,

Enforcement of the qualified retirement plan requirements depends on the source of the requirements. Failure to meet a qualification requirement may mean the loss of tax-favored status; however, in practice, the IRS rarely disqualifies a plan. Certain Code requirements are enforced through an excise tax rather than through disqualification of the plan. ERISA requirements are generally enforced through administrative actions or lawsuits by the Department of Labor, lawsuits brought by plan participants or beneficiaries or plan fiduciaries, or, in some cases, the imposition of a civil penalty.

Qualified annuity plans are similar to qualified retirement plans in treatment, but plan assets are invested in annuity contracts rather than held in a trust or custodial account.

<u>Special types of plans for governmental and tax-exempt employers</u>

Tax-exempt charitable organizations (sec. 501(c)(3)) and educational institutions of State or local governments may offer their employees a section 403(b) plan. State and local government employers may offer their employees a section 457(b) plan. Section 403(b) plans and governmental section 457(b) plans are similar to section 401(k) plans.

<u>Taxation of distributions</u>

Distributions from tax-favored employer-sponsored plans are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the employee's basis (if any). Subject to certain limitations, distributions from a plan may generally be rolled over to another tax-free retirement plan with a deferral of income inclusion. A distribution may be rolled over directly to another plan or may be paid to the participant who may roll it over to another plan within 60 days. A distribution that is eligible for rollover is subject to income tax withholding at a 20-percent rate unless rolled over directly to another plan.

Defined Contribution Plans

In general

Defined contribution plans may provide for nonelective contributions and matching contributions by employers and pretax (that is, contributions are either excluded from income or deductible) or after-tax contributions by employees. Total contributions made to an employee's account for a year cannot exceed the lesser of $53,000 (for 2016) or the employee's compensation. The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation. A participant must at all times be fully vested in his or her own contributions to a defined contribution plan and must vest in employer contributions under three-year cliff vesting or two-to-six-year graduated vesting.

Defined contribution plans often provide for loans to participants and generally provide for distributions on severance from employment and, depending on the type of plan, may provide for in-service distributions. Defined contribution plans may provide for distributions to be made in a lump sum or installments; defined contribution plans may offer annuity distributions, but most are not required to offer annuities.

General types of defined contribution plans

Defined contribution plans may themselves be of different types, specifically, profit-sharing plans, stock bonus plans, or money purchase plans, and may include special features, such as a qualified cash or deferred arrangement (sec. 401(k)) or an employee stock ownership plan ("ESOP"). Rules requiring annuity benefits for surviving spouses and spousal consent to certain distributions apply to money purchase plans and, in some cases, other defined contribution plans offering annuities. However, most defined contribution plans are exempt from these requirements as long as they provide that a participant's account balance will be paid to the participant's surviving spouse (unless the spouse consents to a different beneficiary).

Section 401(k) plans

Under a section 401(k) plan, an employee may elect to have contributions (elective deferrals) made to the plan, rather than receive the same amount in cash. For 2016, elective deferrals of up to $18,000 may be made, plus, for employees aged 50 or older, up to $6,000 in catch-up contributions. Elective deferrals generally cannot be distributed from the plan before the employee's severance from employment, death, disability or attainment of age 59½ or in the case of hardship or plan termination.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan may include a qualified Roth contribution program under which elective deferrals are made on an after-tax basis (designated Roth contributions), and certain distributions ("qualified distributions") are excluded from income. Many section 401(k) plans provide for matching contributions and may also provide for employer nonelective contributions and after-tax employee contributions.

Section 401(k) plans may be designed so that elective deferrals are made only if the employee affirmatively elects them. However, a section 401(k) plan may provide for "automatic enrollment," under which elective deferrals are made at a specified rate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate. Various rules have been developed to provide favorable treatment for plans that provide for automatic enrollment, subject to certain notice requirements.

Elective deferrals under a section 401(k) plan are subject to a special nondiscrimination test, called the actual deferral percentage test or "ADP" test, which compares the average deferral rates for highly compensated employees and nonhighly compensated employees. A similar test, the actual contribution percentage test or "ACP" test, applies to employer matching contributions and after-tax employee contributions. Designed-based safe harbors are also available for satisfying the special nondiscrimination requirements.

ESOPs

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in employer stock. An ESOP can be an entire plan or it can be a portion of a defined contribution plan.

ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock, including a requirement that certain participants must be permitted to diversify a portion of their accounts. However, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans, including an exception to the prohibited transaction rules for certain loans and, in the case of a C corporation, higher deduction limits. ESOPs maintained by S corporations are subject to special rules, including some restrictions on the grant of stock options (or the provision of other "synthetic equity") by the S corporation.

Plan loans and hardship distributions

A defined contribution plan may provide for loans to participants, subject to certain conditions on the amount of the loan and repayment terms. A loan that does not meet these conditions is a deemed distribution. If a loan meets the required conditions, but the participant's account balance is later reduced (offset) to repay the loan, a distribution occurs in the amount of the plan loan offset.

Despite general restrictions on in-service distributions of elective deferrals, defined contribution plans and section 403(b) plans may offer hardship distributions. Section 457 plans may provide for distributions in the case of an unforeseeable emergency, a similar, but narrower, concept than hardship.

Lifetime income under defined contribution plans

Although pension plans are required to offer annuity forms of distribution, most defined contribution plans are not required to offer annuities. Instead, a participant's benefit consists of an account balance, which can be depleted during the participant's lifetime. The increase in the number of employees who are covered only by defined contribution plans has increased concern that participants will outlive their account balances. Similar concerns arise with respect to IRA owners.

These concerns have been a focus of an initiative by the Department of the Treasury and the IRS in collaboration with DOL to expand the availability of lifetime income options under defined contribution plans and IRAs. This initiative has led to the issuance of new IRS and DOL guidance relating to lifetime income options.

Individual Retirement Arrangements

There are two basic types of IRAs: traditional IRAs, to which deductible or nondeductible contributions can be made, and Roth IRAs, contributions to which are not deductible. The total contributions made to all IRAs for a year cannot exceed $5,500 (for 2016), plus an additional $1,000 (not indexed) in catch-up contributions for individuals age 50 or older. Certain individuals are not permitted to make deductible contributions to a traditional IRA or to make contributions to a Roth IRA, depending on their income.

Distributions from traditional IRAs are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the individual's basis (if any). Qualified distributions from a Roth IRA are excluded from income; other distributions from a Roth IRA are includible in income to the extent of earnings. IRA distributions generally can be rolled over to another IRA or qualified retirement plan; however, a distribution from a Roth IRA generally can be rolled over only to another Roth IRA or a designated Roth account.

SIMPLE IRAs and SEPs are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Deemed IRAs are permitted to be provided in conjunction with a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan. An employer may also establish a payroll deduction IRA program, under which employees can elect to have amounts withheld from their pay and contributed to an IRA opened by the employee. The Treasury Department has recently established the myRA program, under which individuals, particularly those without access to an employer-sponsored plan, can open and contribute to a Roth IRA.

Early Distributions and Required Minimum Distributions

Distributions before age 59½ that are includible in income are also subject to an additional 10-percent early distribution tax unless an exception applies.

Under the minimum distribution requirements, distributions from a qualified retirement plan are required to begin within a certain period after a participant attains age 70½ or, in certain circumstances, after a participant retires, if later, and distributions must be taken over the life or life expectancy of the participant (or the participant and a beneficiary). Minimum distribution requirements also apply after a participant's death. An excise tax may apply if required minimum distributions are not made.

Economic Issues Relating to Retirement Plans

Qualified retirement plans, IRAs, and other tax-favored forms of saving modify the tax treatment of saving that would apply in a pure income tax. By permitting taxpayers to defer income tax on income that is saved indirectly, this system achieves substantially similar economic effects as a cash-flow consumption tax.

From a practical standpoint, economists disagree whether these tax-favored saving vehicles increase the level of national saving; empirical investigations of this question often yield conflicting results, partially due to underlying assumptions about behavioral responses to such policies.

Data Relating to Retirement Savings

Data show that, in 2015, 66 percent of private-sector workers had access to a qualified retirement plan and 49 percent of those with access participated. Over the period 1975-2013, the number of participants in private single-employer defined contribution plans has steadily increased while participation in private single-employer defined benefit plans and multiemployer defined contribution and defined benefit plans has remained steady. Among private defined benefit plan participants, a steadily decreasing portion consists of active participants and a steadily increasing portion consists of inactives. Within the private sector, rates of access to and participation in qualified retirement plans vary between full-time and part-time workers and between union and non-union workers. Rates of access to and participation in qualified retirement plans also vary between workers in the private sector and in State and local government.

Data show that married households are more likely to have savings in tax-favored retirement arrangements than single households. Older households are more likely than younger households to have defined benefit plan pensions and younger households are more likely than older to have defined contribution plan accounts.

In 2013, assets in private defined benefit plans totaled about $3.1 trillion; assets in private defined contribution plans totaled about $4.9 trillion; and assets in IRAs totaled about $6.5 trillion. The investment composition of total assets held in private defined benefit plans, private defined contribution plans and IRAs varies among the types of arrangements.

Selected Legislative Proposals relating to Tax-Favored Retirement Savings

In connection with the work last year of the bipartisan Finance Committee Tax Working Groups, the report issued by the Savings & Investment Working Group discusses various legislative proposals relating to three key goals for policy makers, described herein.

Increasing Access to Plans

- Open multiple-employer plans (MEPs)
- Expand start-up credit
- Expand safe harbor and provide a matching credit

Increasing Participation and Contribution Levels

- Allow part-time workers to enroll in plans
- Saver's credit
- Nonrecognition of gain on sale of employer securities to an S Corporation ESOP

Preserving Savings and Making Them Last through Retirement

- Lifetime income portability
- Extend rollover period for plan loan amounts
- Allow 401(k) participants to continue to make contributions during six months following a hardship withdrawal

I. PRESENT LAW

A. Tax-Favored Employer-Sponsored Retirement Plans

1. Overview of employer-sponsored tax-favored retirement plans

Whether to offer a tax-favored retirement plan to employees is a voluntary choice by an employer. As with other components of a compensation package, an employer may have a variety of motivations in deciding whether to offer a retirement plan. The motivations to offer a plan may be different for a large public company that is broadly owned by its stockholders than for an owner-operated company where the plan is providing retirement benefits for both the owners and their employees. For a large public company that is competing for employees with other employers that offer retirement plans, the motivation may be primarily recruitment and retention of employees. For an owner-operated company, providing for the owner's retirement may play a larger role, with providing benefits also to employees as a further consideration. For some employers, the decision to offer a plan may be subject to collective bargaining negotiations.

A key element in an employer's decision is the value that employees place on being provided benefits under a retirement plan versus receiving current compensation. A basic reason for employees to value being provided benefits under an employer-sponsored retirement plan as a portion of their total compensation is the tax deferral and savings opportunity inherent in these plans. For example, the amount of elective deferrals an employee can make to an employer-sponsored retirement plan is greater than the contributions an individual can make to an IRA. In addition, the employer may separately make nonelective or matching contributions.

For employers that decide to offer a tax-favored retirement plan, the Code provides rules as to the amount of benefits, the timing of benefit distributions, and the deductibility of contributions. The Code also imposes protections for employees to ensure that they receive the benefits promised under the plan, for example, by requiring defined benefit plans to be adequately funded and protecting the integrity of individual accounts under defined contribution plans by making sure account assets are not misused or diverted; parallel rules generally apply under ERISA. However, subject to these rules, an employer has a great deal of flexibility in deciding the structure of its retirement plan and the level of benefits, as permitted under the various types of plans available.

One element in a plan's structure is whether the employer offers retirement benefits as a unilateral benefit that the employee accepts implicitly by accepting employment with, or remaining employed by, the employer. Alternatively, within limits, the employer may allow a year-by-year choice by the employee whether to accept current compensation or make contributions to the plan. Employers may structure a retirement plan in part as a retention tool so that only employees who work for a certain number of years become vested in the benefits accrued under the plan (within limits as discussed below).

The most common type of tax-favored plan is a qualified retirement plan,[2] which may be a defined benefit plan or a defined contribution plan. A defined contribution plan may include a qualified cash or deferred arrangement (commonly called a "section 401(k) plan"),[3] which offers an employer great flexibility in designing a retirement program for its employees. Another option is a qualified annuity plan,[4] which is similar to and subject to requirements similar to those applicable to qualified retirement plans.

Additional options are available to certain tax-exempt or governmental employers, including tax-deferred annuities[5] and eligible deferred compensation plans,[6] which are sometimes offered in lieu of a section 401(k) plan. Certain small employers have the option of maintaining a SIMPLE IRA plan[7] or a simplified employee pension ("SEP"),[8] both of which are funded through direct contributions by the employer to an IRA established for each employee.

Tax credits are available to small employers that start new retirement plans and to lower-income individuals who contribute to a retirement plan (or an IRA).

2. Qualified retirement plans and annuities

In general

A plan of deferred compensation that meets the qualification requirements under the Code (a "qualified retirement plan") is accorded special tax treatment. Employees do not include employer contributions, earnings on contributions, or benefits in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Certain distributions (such as lump sums) can be rolled over to another tax-favored plan with further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within limits) for contributions even though the contributions are not currently included in an employee's income.[9] Contributions to a qualified retirement plan (other than elective deferrals and after-tax contributions) are exempt from FICA tax, as are plan distributions. Pretax contributions are exempt from income tax withholding, and special withholding rules apply to distributions. Contributions to a qualified retirement plan, and

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[2] Sec. 401(a).

[3] Sec. 401(k).

[4] Sec. 403(a).

[5] Sec. 403(b).

[6] Sec. 457(b).

[7] Sec. 408(p).

[8] Sec. 408(k).

[9] Sec. 404. Under section 4972, an excise tax may apply if contributions in excess of the deduction limits are made.

earnings thereon, are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Defined benefit and defined contribution plans

Qualified retirement plans are broadly classified into two categories, defined contribution plans and defined benefit plans, based on the nature of the benefits provided.[10] Although both types of plans are subject to the qualification requirements, the requirements differ somewhat for the two types of plans.

Under a defined contribution plan, a separate account is maintained for each participant, to which contributions are allocated and investment earnings (and losses) are credited, and a participant's benefits are based solely on the participant's account balance.[11] Defined contribution plans commonly allow participants to direct the investment of their accounts. Because the account balance, and thus the participant's benefits, depends on the rate of return on the account, the risk of investment loss (and reward of investment gain) under a defined contribution plan lies with the participant rather than the employer.

Under a defined benefit plan, benefits are determined under a plan formula.[12] Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan, which are invested by plan fiduciaries in accordance with plan terms; individual accounts are not maintained for employees participating in the plan. Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.[13] The amount of required annual contributions depends on the type of plan and is determined under certain actuarial methods taking into account this valuation. This structure generally results in the risk of investment gain or loss under a defined benefit plan being born by the employer through increases or decreases in required contributions to fund the promised plan benefits. An employer is subject to an excise tax for a failure to make required contributions, unless the employer obtains a funding waiver.[14] Benefits under defined benefit

[10] Under the Code as in effect since before ERISA, retirement plans fall into three general types - pension plans, profit-sharing plans, and stock bonus plans, defined respectively at Treas. Reg. sec. 1.401-1(b)(1)(i), (ii), and (iii). Defined benefit plans and money purchase pension plans (a type of defined contribution plan) are pension plans under the Code; other defined contribution plans are either profit-sharing plans or stock bonus plans. The application of some Code requirements depends on whether the plan is a pension plan, a profit-sharing plan, or a stock bonus plan. Under ERISA, the term "pension plan," defined at ERISA section 3(2)(A), includes both defined benefit plans and defined contribution plans.

[11] Defined contribution plan is defined at section 414(i) and ERISA section 3(34). Under ERISA, a defined contribution plan is also referred to as an individual account plan.

[12] As defined in section 414(j) and ERISA section 3(35), a defined benefit plan is any plan that is not a defined contribution plan. For a more detailed discussion of defined benefit plans, see Joint Committee on Taxation, *Present Law and Background Relating to Defined Benefit Plans* (JCX-99-14), September 15, 2014. This document is available at www.jct.gov.

[13] Sec. 412.

[14] Sec. 4971.

plans are generally guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC").[15]

Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. However, legally, the plan is either a defined contribution plan or a defined benefit plan.[16]

Qualified retirement plan requirements

Present law imposes a number of requirements on qualified retirement plans that must be satisfied for favorable tax treatment to apply.[17] Some of these requirements define the rights of plan participants and beneficiaries, such as the minimum participation and vesting requirements. In addition, assets of the plan must be held in a trust or custodial account for the exclusive benefit of plan participants, and prohibited transaction rules (that is, rules prohibiting self-dealing by employers and plan fiduciaries) apply to plan assets.[18] Defined benefit plans and money purchase pension plans (a type of defined contribution plan) are also subject to minimum funding requirements.

Under the minimum participation rules, a plan generally cannot delay an employee's participation in the plan beyond the later of completion of one year of service (*i.e.*, a 12-month period with at least 1,000 hours of service) or attainment of age 21.[19] In addition, a plan cannot exclude an employee from participation on the basis of attainment of a specified age. Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

Under the vesting rules, a participant's right to the benefits he or she has accrued under a plan ("accrued benefit") generally must become nonforfeitable after a specified period of service or, if earlier, at attainment of normal retirement age under the plan.[20] Benefits under either a

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[15] To the extent benefits are not guaranteed by the PBGC, participants in an underfunded defined benefit plan bear the risk of losing benefits in the case of a distress termination of a single-employer defined benefit plan or insolvency of a multiemployer defined benefit plan.

[16] Under section 414(k) and ERISA section 3(35), a defined benefit plan that provides a benefit based partly on the balance of a separate account for a participant is treated as a defined contribution plan for certain purposes.

[17] In general, for purposes of these requirements, members of controlled groups under section 414(b) or (c) and affiliated service groups under section 414(m) or (o) are treated as a single employer.

[18] Secs. 401(a)(2) and 4975. Under this exclusive benefit requirement, prior to satisfaction of all liabilities under the plan with respect to employees and their beneficiaries, assets are not allowed to be used for or diverted to purposes, other than the exclusive benefit of employee or their beneficiaries.

[19] Sec. 410(a).

[20] Sec. 411. A plan may specify the plan's normal retirement age but may not specify a normal retirement age later than age 65 or, if later, the fifth anniversary of the time the participant commenced plan participation.

defined benefit plan or a defined contribution plan that are attributable to employee contributions (including elective deferrals) must be fully vested at all times. The period of service after which benefits attributable to employer contributions must be vested depends on the type of plan (defined benefit or defined contribution). A plan may provide for vesting earlier than when required, but not later.

The vesting rules also generally prohibit amendments that reduce previously accrued benefits or eliminate optional forms of benefit with respect to previously accrued benefits. Reductions in an employee's rate of accrual under a defined benefit plan, or rate of allocation under a defined contribution plan, due to increasing age generally are also prohibited.

The vesting rules also prohibit distribution of an employee's accrued benefit without consent (an "involuntary" distribution) before the later of the time the participant has attained normal retirement age under the plan or attained age 62. An exception generally allows an involuntary distribution if the present value of the employee's accrued benefit at the time of the distribution is not more than $5,000 ("mandatory cash-out").[21]

Some qualified retirement plan requirements provide limits on the tax benefits for qualified retirement plans, such as the limit on compensation that may be taken into account for qualified retirement plan purposes ($265,000 for 2016) and limits on contributions, benefits and deductions.[22] The limits on contributions, benefits and deductions apply separately to defined benefit and defined contribution plans.

Minimum coverage, nondiscrimination and top-heavy requirements

In general

A qualified retirement plan is prohibited from discriminating in favor of highly compensated employees, referred to as the nondiscrimination requirements. These requirements are intended to ensure that a qualified retirement plan provides meaningful benefits to an employer's rank-and-file employees as well as highly compensated employees, so that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.[23] For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the

[21] In determining present value for this purpose, benefits attributable to a rollover to the plan may be disregarded.

[22] Secs. 401(a)(16) and (17), 404 and 415.

[23] Sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in section 401(a)(5). Detailed regulations implement the statutory requirements. In addition to the minimum coverage and general nondiscrimination requirements, under section 401(a)(26), the group employees who accrue benefits under a defined benefit plan for a year must consist of at least 50 employees, or, if less, 40 percent of the workforce, subject to a minimum of two employees accruing benefits. Governmental plans are not subject to these requirements.

employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $120,000 (for 2016).[24]

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by a single employer. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement are generally disregarded.[25] If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be aggregated with another plan, and the two plans tested together as a single plan.

Minimum coverage requirement

Under the minimum coverage requirement, the plan's coverage of employees must be nondiscriminatory. This is determined by calculating the plan's ratio percentage, that is, the ratio of the percentage of nonhighly compensated employees (of all nonhighly compensated employees in the workforce) covered under the plan over the percentage of highly compensated employees covered. If the plan's ratio percentage is 70 percent or greater, the plan satisfies the minimum coverage requirement. If the plan's ratio percentage is less than 70 percent, a multi-part test applies. First, the plan must cover a group (or "classification") of employees that is reasonable and established under objective business criteria, such as hourly or salaried employees (referred to as a reasonable classification), and the plan's ratio percentage must be at or above a specific level specified in the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of contributions or benefit accruals for all nonhighly compensated employees in the workforce (taking into account all plans of the employer) must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.

General nondiscrimination requirements

Under a general nondiscrimination requirement, a qualified retirement plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits. The general nondiscrimination requirements are met if (1) the amount of contributions or benefits provided under the plan are nondiscriminatory, (2) each benefit, right or feature under the plan is available to a nondiscriminatory group of employees, and (3) the timing of plan

[24] Sec. 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee.

[25] A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements.

amendments does not have the effect of discriminating significantly in favor of highly compensated employees.[26]

In some circumstances, two or more plans may be aggregated and tested as a single plan for purposes the nondiscrimination requirements. In addition, the regulations implementing the general nondiscrimination requirements, allow a plan to be segmented into multiple plans, referred to as component plans, with each component plan tested separately. For example, a defined benefit plan may cover different divisions, with different benefit formulas for the employees of each division. For purposes of applying the general nondiscrimination requirements, the plan could be segmented into components, based on the portions of the plan covering employees of each division, and the requirements applied separately with respect to each component.

Nondiscrimination in the amount of contributions or benefits

There are three general approaches to testing the amount of contributions benefits under a qualified retirement plan: (1) design-based safe harbors under which the benefit formula under a defined benefit plan, or the formula for allocating employer nonelective contributions under a defined contribution plan to participants' accounts, satisfies certain uniformity standards;[27] (2) a general test; and (3) cross-testing of equivalent accruals or allocations.[28] A plan is not discriminatory merely because benefit accruals or allocations for highly compensated and nonhighly compensated employees are provided as a percentage of compensation (up to $265,000 for 2016).[29] Thus, the various testing approaches are generally applied to the amount of contributions or benefits provided as a percentage of compensation.

The general test is generally satisfied by measuring the allocation rate (under a defined contribution plan) or accrual rate (under a defined benefit plan) of each highly compensated employee to determine if the group of employees with the same or higher rate of accrual or allocation (referred to as a rate group) is a nondiscriminatory group.[30] This test generally is

[26] Treas. Reg. sec. 1.401(a)(4)-1. With respect to the amount of contributions, employee elective deferrals under a section 401(k) plan and employer matching contributions and after-tax employee contributions to a defined contribution plan are subject to special testing rules, rather than being included in applying the general nondiscrimination requirements. In addition, the amount of employer contributions to an ESOP is tested separately from other employer contributions. Rules applicable to benefits, rights and features and the timing of plan amendments are provided in Treas. Reg. secs. 1. 401(a)(4)-4 and -5 respectively.

[27] Sections 401(a)(5)(C)-(D) and 401 (l) and Treas. Reg. secs. 1.401(l)-1 through -6 provide rules under which the benefit or allocation formula may take into account the employer-paid portion of social security taxes or benefits, referred to as permitted disparity.

[28] These approaches are explained in Treas. Reg. secs. 1.401(a)(4)-2, -3 and -8. As discussed below, special nondiscrimination tests apply to elective deferrals under a section 401(k) plan and to employer matching contributions and after-tax employee contributions.

[29] Sec. 401(a)(5)(B).

[30] An employee's allocation rate generally is the amount of employer contribution allocated to an employee's account for the plan year, expressed as a percentage of the employee's compensation for the plan year.

satisfied if the ratio percentage of the rate group (that is, the percentage of nonhighly employees in the rate group, compared with the percentage of highly compensated employees) satisfies the minimum coverage requirement. For this purpose, if the ratio percentage of the rate group is less than 70 percent, a simplified standard applies, which disregards the reasonable classification requirement and instead applies a minimum ratio percentage for the rate group (and still requires satisfaction of the average benefit percentage test). The minimum ratio percentage under this simplified standard depends on the percentage of the employer's workforce that consists of nonhighly compensated employees (the nonhighly compensated employee percentage) and ranges from (1) a minimum ratio percentage of 45 percent if the nonhighly compensated employee percentage is 60 percent (or less) to (2) a minimum ratio percentage 20.375 percent if the nonhighly compensated employee percentage is 99 percent.

Cross-testing involves the conversion of allocations or accruals to actuarially equivalent accruals or allocations, with the resulting equivalencies tested under the general test.

Top heavy requirements

Top-heavy requirements apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.[31] Whereas the general nondiscrimination requirements are designed to test annual contributions or benefits for highly compensated employees, compared to those of nonhighly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits for nonkey employees and, in some cases, faster vesting is required.

For this purpose, a key employee is an officer with annual compensation greater than $170,000 (for 2016), a five-percent owner, or a one-percent owner with compensation in excess of $150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

An employee's accrual rate generally is the amount of the annual payments under the employee's accrued benefit payable at normal retirement age in the form of a straight life annuity divided by the employee's years of service and expressed as a percentage of average annual compensation. Under the permitted disparity rules of section 401(l), allocation and accrual rates are then permitted to be increased by a factor to reflect the employer paid portion of social security taxes or benefits. If a defined benefit plan provides subsidized optional forms of benefit, the accrual rate for the actuarially most valuable benefit under the plan available to each employee is also calculated and tested.

[31] Secs. 401(a)(10)(B) and 416.

Prohibited transactions

The Code prohibits certain transactions between qualified retirement plans and a disqualified person.[32] If a prohibited transaction occurs, the disqualified person is subject to a two-tier excise tax.[33] The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Amount involved generally means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.[34]

Prohibited transactions include certain direct or indirect transactions between a plan and a disqualified person: (1) the sale, exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, services or facilities. Prohibited transactions also include any direct or indirect: (1) transfer to, or use by or for the benefit of a disqualified person of the income or assets of the plan; (2) in the case of a fiduciary, an act that deals with the plan's income or assets for the fiduciary's own interest or account; and (3) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

In general, "disqualified person" means: (1) a fiduciary; (2) a person providing services to the plan; (3) an employer any of whose employees are covered by the plan; (4) an employee organization any of whose members are covered by the plan; (5) a direct or indirect owner of a specified interest in such an employer or employee organization; (6) a member of the family of an individual which meets certain definitions of a disqualified person; (7) a corporation, partnership, or trust or estate of which (or in which) a specified interest is owned by certain other disqualified persons; (8) offers and directors (or individuals having powers or responsibilities similar to those of officers or directors), 10-percent or more shareholders, or highly compensated employees (earning 10 percent or more of the yearly wages of the employer) of certain other disqualified persons; or (9) a 10-percent or more (in capital or profits) partner or joint venturer of certain other disqualified persons. Disqualified persons also include corporations of which 50 percent or more of: (1) the combined voting power of all classes of stock entitled to vote; or (2) the total value of shares of all classes of stock of such corporation, is owned directly or indirectly, or held by certain other disqualified persons.

A fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other

[32] Sec. 4975. The prohibited transaction rules under the Code also apply to IRAs, health savings accounts (sec. 223), medical savings accounts (sec. 220), and Coverdell education savings accounts (sec. 530). The prohibited transaction rules do not apply to governmental plans or church plans. However, under section 503, a governmental or church plan that engages in a prohibited transaction as defined under that section may lose its tax-exempt status.

[33] Sec. 4975(a)-(b).

[34] Sec. 4975(f)(4).

compensation with respect to any plan moneys or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.

The Code exempts certain transactions that meet specified conditions from the definition of prohibited transaction. Examples of exempt transactions are plan loans to participants, the acquisition of qualifying employer securities or employer real property, and loans to a leveraged ESOP. [35]

ERISA

Qualified retirement plans are also subject to regulation under ERISA, which generally is under the jurisdiction of the Department of Labor ("DOL").[36] The ERISA rules generally relate to the rights of plan participants and beneficiaries, reporting and disclosure, and the obligations of plan fiduciaries. Some of the provisions of the Code and ERISA that apply to qualified retirement plans are identical or very similar.[37] For example, ERISA includes minimum participation and vesting requirements and prohibited transaction rules that parallel those under the Code.

ERISA contains general fiduciary duty standards that apply to all fiduciary actions, including investment decisions.[38] ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. With respect to plan assets, ERISA requires a fiduciary to diversify the investments of the plan so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets.[39] A plan fiduciary may be liable also for a breach of responsibility by another

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[35] Sec. 4975(c)(2), (d), and (f).

[36] Governmental plans and church plans are generally exempt from ERISA and from the Code requirements that correspond to ERISA requirements. The PBGC has jurisdiction over the defined benefit plan insurance program under Title IV of ERISA.

[37] Reorganization No. 4, Pub. L. No. 99-524, divides interpretive jurisdiction between Treasury and the Department of Labor with respect to these provisions so that generally only one agency has interpretative jurisdiction with respect to each provision that is in both the Code and ERISA.

[38] ERISA sec. 404(a).

[39] ERISA sec. 409. Under ERISA section 502(a)(2), an action for a breach of fiduciary responsibility may be brought by DOL, a plan participant or beneficiary, or another fiduciary.

fiduciary (a "co-fiduciary") in certain circumstances, for example, if the fiduciary's failure to fulfill its own fiduciary duties enabled the co-fiduciary to commit the breach.[40]

Enforcement of requirements

Enforcement of a qualified retirement plan requirement depends on the source of the requirement. The qualification requirements under the Code are enforced by the Internal Revenue Service ("IRS"). If a plan fails to meet the qualification requirements, the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income inclusion. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer (or other plan sponsor) to correct any violation of the qualification rules.[41]

Certain Code requirements for qualified plans, such as the prohibited transaction rules, are enforced through an excise tax rather than through disqualification. Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Code.

ERISA's requirements generally may be enforced through administrative actions by DOL or by lawsuits brought by DOL, plan participants or beneficiaries, or plan fiduciaries. Certain violations of ERISA may result in the imposition of a civil penalty.

Qualified annuity plans

A qualified annuity plan is a type of retirement plan that is subject to the same requirements as qualified retirement plans and receives comparable tax-favored treatment, but plan assets consist of annuity contracts, rather than investments held in a trust or custodial account.[42]

3. Special types of plans for governmental and tax-exempt employers

Tax-sheltered annuities (section 403(b) plans)

Section 403(b) plans are another form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. Section 403(b) plans may be maintained only by (1) charitable organizations tax-exempt under section 501(c)(3), and (2) educational institutions of State or local governments (*i.e.*, public schools, including colleges and universities). Many of the rules that apply to section 403(b) plans are similar to the rules applicable to qualified retirement plans, including section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan

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[40] ERISA sec. 405.

[41] See Part IV.B.1 for a discussion of the Employee Plans Compliance Resolution System, a formal program under which an employer (or other plan sponsor) may correct violations and avoid plan disqualification.

[42] Secs. 403(a) and 404(a)(2). Except when otherwise indicated, references herein to a qualified retirement plan include a qualified annuity plan.

may provide for employees to make elective deferrals, designated Roth contributions or other after-tax contributions.

Contributions to a section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the special limits for elective deferrals ($18,000 for 2016) and catch-up contributions ($6,000 for 2016) under a section 401(k) plan, or, if less, the employee's compensation. If elective deferral and catch-up contributions are made to both a qualified defined contribution plan and a section 403(b) plan for the same employee, a single limit applies to the elective deferrals under both plans. Special contribution limits apply to certain employees under a section 403(b) plan maintained by a church. In addition, under a special catch-up rule, an increased elective deferral limit applies under a plan maintained by an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches in the case of employees who have completed 15 years of service. In this case, the limit is increased by the least of (1) $3,000, (2) $15,000, reduced by the employee's total elective deferrals in prior years, and (3) $5,000 times the employee's years of service, reduced by the employee's total elective deferrals in prior years.[43]

Section 403(b) plans are generally subject to the minimum coverage and nondiscrimination rules that apply to qualified defined contribution plans.[44] However, pretax contributions and designated Roth contributions made by an employee under a salary reduction agreement (*i.e.*, elective deferrals) are not subject to nondiscrimination rules similar to those applicable to elective deferrals under section 401(k) plans. Instead, all employees of the employer generally must be eligible to make salary reduction contributions. Certain employees may be disregarded for purposes of this rule.

Governmental section 457(b) plans

Special rules with respect to deferred compensation arrangements of State and local government and tax-exempt employers.[45] Amounts deferred under an eligible deferred compensation plan, *i.e.*, a section 457(b) plan, are not currently included in income. In the case of a State or local government employer, a section 457(b) plan is generally limited to elective deferrals and provides tax benefits similar to a section 401(k) or 403(b) plan in that deferrals are

[43] Because contributions to a defined contribution plan cannot exceed an employee's compensation, contributions for an employee are generally not permitted after termination of employment. However, under a special rule, a former employee may be deemed to receive compensation for up to five years after termination of employment for purposes of receiving employer nonelective contributions under a section 403(b) plan.

[44] As in the case of a qualified retirement plan, a governmental section 403(b) plan is not subject to these nondiscrimination rules.

[45] Sec. 457.

contributed to a trust or custodial account for the exclusive benefit of participants, but are not included in income until distributed (and may be rolled over to another tax-favored plan).[46]

Deferrals under a governmental section 457(b) plan are subject to the same limits as elective deferrals ($18,000 for 2016) and catch-up contributions ($6,000 for 2016) under a section 401(k) plan or a section 403(b) plan, or, if less, the employee's compensation. However, the section 457(b) plan limits apply separately from the combined limit applicable to section 401(k) and 403(b) plan contributions, so that an employee covered by a governmental section 457(b) plan and a section 401(k) or 403(b) plan can contribute the full amount to each plan. In addition, under a special catch-up rule, for one or more of the participant's last three years before normal retirement age, the otherwise applicable limit is increased to the lesser of (1) two times the normal annual limit ($36,000 for 2016) or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

A governmental section 457(b) plan may include a qualified Roth contribution program, allowing a participant to elect to have all or a portion of the participant's deferrals under the plan treated as designated Roth contributions.

4. Taxation of distributions

<u>In general</u>

Distributions from qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans (other than distributions from designated Roth accounts, discussed below) are generally includible in gross income (to the extent the distribution exceeds basis) as ordinary income in the year in which distributed.[47] The part of any distribution that represents the participant's investment in the contract (*i.e.*, basis) is not includible in gross income. A participant generally has basis under the plan to the extent that the participant has made after-tax contributions to the plan that have not been recovered. The basis recovery rules differ depending on whether or not the distribution is received as an annuity payment.

As discussed below, an additional 10-percent tax applies to distributions before age 59½ from qualified retirement plans and annuities and section 403(b) plans unless an exception applies. In addition, participants in qualified retirement plans and annuities, section 403(b) plans, and governmental section 457(b) plans are required to begin receiving distributions at the later of age 70½ or retirement.

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[46] In the case of a tax-exempt employer, section 457(b) and 457(f) limit the amount of unfunded nonqualified deferred compensation that can be provided on a tax-deferred basis.

[47] Secs. 72, 402(a)(1), 403(a)(1), 403(b)(1) and 457(a).

Rollovers

A distribution from a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan that is an eligible rollover distribution may be rolled over to another such plan or an IRA. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over are usually not included in gross income. Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.[48]

Any distribution to a beneficiary other than the participant's surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.[49]

Qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.[50] If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20 percent income tax withholding.[51] Participants who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20-percent withheld will remain taxable unless the participant substitutes funds within the 60 day period.[52] The direct rollover and 20-percent withholding rules are designed to encourage tax-free rollovers, and thereby, to keep retirement funds in eligible retirement plans.

Distributions from qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans may be rolled into a Roth IRA. Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account (discussed below) must be included in gross income.

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[48] Section 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k).

[49] Sec. 402(c)(11).

[50] Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cash-out of more than $1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

[51] Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

[52] For example, if Adam receives an eligible rollover distribution of $10,000 and elects to have the entire amount paid directly to him, he will receive $8,000 since $2,000 would have been withheld as income tax. If within 60 days of receiving the distribution Adam decides to roll over the distribution into an IRA he will need to contribute an additional $2,000 to the IRA in order to defer taxes on the entire distributed amount.

B. Defined Contribution Plans

1. General description and rules

As discussed above, benefits under a defined contribution plan are based solely on the contributions, earnings, and losses credited to the separate accounts maintained for plan participants. For defined contribution plans, a participant's accrued benefit is the participant's account balance. Accordingly, the participant benefits from investment gains and bears the risk of investment losses on the account.

A defined contribution plan may provide for various types of contributions by employees or the employer. In the case of a section 401(k) plan, employees may elect to have pretax contributions made to the plan, referred to as elective deferrals, rather than receive the same amount as current compensation. A section 401(k) plan may also allow employees to designate some or all of their elective deferrals as after-tax Roth contributions. A defined contribution plan may also allow employees to make other after-tax contributions. Possible employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes pretax or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes contributions and can relate to pretax elective deferrals, designated Roth contributions, or other after-tax contributions.

The total contributions made to an employee's account for a year cannot exceed the lesser of $53,000 (for 2016) or the employee's compensation.[53] Contributions made to more than one plan for an employee are aggregated for purposes of this limit, and employee contributions to a defined benefit plan, if any, are taken into account in applying the limit. However, catch-up contributions (discussed below) are not taken into account in applying the limit.

A defined contribution plan can use one of two alternative minimum vesting schedules with respect to the portion of a participant's account balance that is attributable to employer contributions, including investment returns on employer contributions. Under the first vesting schedule, the account balance attributable to employer contributions must be 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's account balance attributable to employer contributions must become vested at a rate of no less than 20 percent, 40 percent, 60 percent, 80 percent, and 100 percent, respectively, over the period from two to six years of service.

Defined contribution plans often provide for loans to participants, subject to certain conditions. Defined contribution plans generally provide for distributions on severance from employment and, depending on the type of plan, may provide for distributions before severance from employment ("in-service" distributions). Defined contribution plans may provide for distributions to be made in a lump sum or installments. Defined contribution plans may also

[53] Sec. 415(c).

provide for distributions in the form of a life annuity (through the purchase of an annuity contract), but generally are not required to provide annuity distributions.

The deduction for employer contributions to a defined contribution plan for a year is generally limited to 25 percent of the participants' compensation.[54] For this purpose, a participant's compensation in excess of $265,000 (for 2016) is not taken into account. Elective deferrals (including designated Roth contributions) and employee contributions are not counted in applying the 25 percent limit. Special deduction rules apply to an ESOP (discussed below), or if an employer maintains both a defined contribution plan and a defined benefit plan. An excise tax may apply if contributions in excess of the deduction limits are made.[55]

2. General types of defined contribution plans

Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. The type of plan must be specified in the plan document. Within the three general types of defined contribution plans are plan designs that contain special features, such as a section 401(k) plan or an ESOP.

Profit-sharing plans were originally intended as a means of enabling employees to share in the profits of the employer's business. However, under present law, contributions to a profit-sharing plan are permitted regardless of whether the business has profits. A profit-sharing plan may provide for regular employer contributions each year or may provide that contributions are made each year at the discretion of the employer (called a "discretionary" profit-sharing plan). A profit-sharing plan must provide a definite formula under which contributions are allocated to participant accounts and must specify the events upon which distributions will be made to participants, such as severance from employment.

A stock bonus plan is similar to a profit-sharing plan except that benefits are distributable in stock of the employer. The plan may provide for cash distributions, but must also allow participants to take distributions in the form of employer stock. In the case of employer stock that is not publicly traded, participants generally must be given the right to require the employer to repurchase the stock under a fair valuation formula.

A money purchase pension plan must provide for a set level of required employer contributions, generally as a specified percentage of participants' compensation. A money purchase pension plan is subject to the minimum funding requirements, and the employer is generally subject to an excise tax if it fails to make the contributions required under the plan. A money purchase pension plan may not provide for in-service distributions except at normal retirement age (or age 62, if earlier) or in the case of plan termination.

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[54] Sec. 404.

[55] Sec. 4972.

Certain spousal protections apply to qualified retirement plans.[56] In the case of a pension plan (that is, a money purchase pension plan or a defined benefit plan), these protections generally require that benefits be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant elects a different form of distribution and the participant's spouse consents in writing to the election. A QJSA is generally a life annuity for the participant with an annuity of at least 50 percent of the participant's annuity amount payable to the surviving spouse after the participant's death.[57] If a married participant dies before benefits begin, the plan must offer a survivor benefit for the spouse in the form of a qualified preretirement survivor annuity ("QPSA"), which is a survivor annuity for the spouse that is at least 50 percent of the employee's accrued benefit.

Profit-sharing plans and stock bonus plans are generally not subject to these spousal protection requirements unless the participant elects an annuity form of distribution. However, a profit-sharing or stock bonus plan must provide that a participant's entire vested account balance under the plan will be paid to the participant's surviving spouse unless the spouse consents in writing to a different beneficiary.

3. Section 401(k) plans

<u>In general</u>

A section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement.[58] Thus, such arrangements are subject to the rules generally applicable to qualified defined contribution plans. In addition, special rules apply to such arrangements.

An employee may make elective deferrals to a section 401(k) plan. The maximum annual amount of elective deferrals that can be made by an employee for a year is $18,000 (for 2016) or, if less, the employee's compensation.[59] An employee who will attain age 50 by the end of the year may also make catch-up contributions to a section 401(k) plan.[60] As a result, the dollar limit on elective deferrals is increased by $6,000 (for 2016) for an individual who has attained age 50. An employee's elective deferrals must be fully vested.

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[56] Sec. 401(a)(11); ERISA sec. 205.

[57] A married participant must also be offered a qualified optional survivor annuity ("QOSA"), which is also a life annuity for the participant with an annuity payable to the surviving spouse as a percentage of the participant's annuity, with the required percentage depending on the QJSA percentage.

[58] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. In addition, certain small employers may adopt a SIMPLE section 401(k) plan similar to a SIMPLE IRA plan discussed in Part I.C.3. Except for certain grandfathered plans, a State or local governmental employer may not maintain a section 401(k) plan.

[59] Sec. 402(g).

[60] Sec. 414(v).

Elective deferrals, and attributable earnings, generally cannot be distributed from the plan before the earliest of the employee's severance from employment, death, disability or attainment of age 59½ or termination of the plan. Subject to certain conditions, elective deferrals, but not associated earnings, can be distributed in the case of hardship.

Elective deferrals are generally made on a pretax basis. However, a section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are elective deferrals that the participant designates as not excludable from the participant's gross income. The annual dollar limit on a participant's designated Roth contributions is the same as the limit on elective deferrals, reduced by the participant's elective deferrals that are not designated Roth contributions. Designated Roth contributions are generally treated the same as any other elective deferral for certain purposes, including the restrictions on distributions.

Qualified distributions from a designated Roth account are excluded from income, even though they include earnings not previously taxed. A qualified distribution is a distribution made after the end of a specified period (generally five years after the participant's first designated Roth contribution) and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

A section 401(k) plan that includes a designated Roth program may permit participants to transfer amounts from a nonRoth account under the plan to a designated Roth account, whether or not the amounts in the nonRoth account are permitted to be distributed from the plan at the time of the transfer.[61] In effect, this transfer is a Roth conversion (discussed below), with related income recognition, for any nonRoth amounts within the plan.

Section 401(k) plans are not required to provide for matching contributions, but often do. Many employers provide matching contributions because doing so encourages lower-paid employees to make elective deferrals, which makes it easier for the plan to satisfy the applicable nondiscrimination rules. A section 401(k) plan may also provide for employer nonelective contributions.

Automatic enrollment

Section 401(k) plans may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (*i.e.*, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

[61] Prior to 2013, transfers of nonRoth amounts to a designated Roth account were permitted only for amounts that were available for distribution from the plan at the time of the transfer.

Under a section 401(k) plan, an employee must have an effective opportunity to elect to receive cash in lieu of contributions. Whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[62]

Automatic enrollment was originally authorized by IRS guidance[63] and has been furthered by subsequent statutory changes providing special rules for automatic enrollment.[64] These rules include a nondiscrimination safe harbor for a section 401(k) plan that includes a qualified automatic contribution arrangement. In addition, if a section 401(k) plan includes an eligible automatic contribution arrangement, elective deferrals that were automatically contributed to the plan (*i.e.*, without an affirmative deferral election by an employee) may be distributed to the employee in accordance with an election by the employee within 90 days after the first automatic contribution.[65] Such a distribution is permitted, despite the general restriction on in-service distributions of elective deferrals, and the amount distributed is not subject to the 10-percent early distribution tax.

Use of these special rules is generally predicated on automatic contributions at a uniform rate (as a percentage of compensation) for all participants. In addition, a notice must be provided to participants explaining the choice between making or not making contributions and identifying the default contribution rate and investment, and each participant must be given a reasonable period of time after receipt of the notice to make an affirmative election with respect to contributions and investments.

Special nondiscrimination tests for section 401(k) plans

General rule

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to elective deferrals under a section 401(k) plan.[66] The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within

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[62] Treas. Reg. sec. 1.401(k)-1(e)(2). Similar rules apply to elective deferrals under section 403(b) plans and section 457(b) plans.

[63] Rev. Rul. 2000-8, 2000-7 I.R.B. 617; Rev. Rul. 2000-33, 2000-31 I.R.B. 142; Rev. Rul. 2000-35, 2000-31 I.R.B. 138; and Treas. Reg. sec. 1.401(k)-1(a)(3)(ii).

[64] The Pension Protection Act of 2006 ("PPA"), Pub. L. No. 109-280, added a number of special rules to the Code and ERISA with respect to automatic enrollment in section 401(k) plans. The Code rules generally apply also to section 403(b) plans and governmental section 457(b) plans.

[65] Sec. 414(w).

[66] Sec. 401(k)(3).

limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for nonhighly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for nonhighly compensated employees or, if less, twice the average deferral rate for nonhighly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or "ACP test") which compares the average rate of matching and after-tax contributions to the plan of the two groups.[67]

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for nonhighly compensated employees (and certain other corrections) or to distribute deferrals of highly compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

Design-based safe harbor nondiscrimination tests

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests. These safe harbors are based on the premise that, for a 401(k) plan with certain design features with respect to contributions (elective, matching, and nonelective) and enrollment, satisfaction of the minimum coverage requirement is a sufficient test of the amount of whether the amount elective deferrals and matching contributions are nondiscriminatory.[68] Under one safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement.[69] A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan. The matching contribution requirement under the safe harbor is 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution must be

[67] Sec. 401(m)(2).

[68] The safe harbors that only require certain matching contributions potentially allow satisfaction of the nondiscrimination requirement with respect to elective and matching contributions under a 401(k) plan for a year even though no contributions are ultimately provided to nonhighly compensated employees under the plan for the year due to a lack of voluntary participation.

[69] Sec. 401(k)(12). The plan satisfies the notice requirement if, within a reasonable time before the beginning of the plan year, the plan provides written notice to each eligible employee of the employee's rights and obligations under the plan.

immediately nonforfeitable (*i.e.*, 100 percent vested) when made. Other requirements also apply, including requirements for satisfying the ACP test on a safe harbor basis.[70]

Another safe harbor applies for section 401(k) plans that include a qualified automatic contribution arrangement.[71] Under a qualified automatic contribution arrangement, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 10 percent and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter.[72] Under the safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent (for a total matching contribution of up to 3.5 percent of compensation). The rate of the safe harbor nonelective contribution is three percent, as under the regular safe harbor. However, under a qualified automatic contribution arrangement, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

4. ESOPs

<u>In general</u>

An ESOP is a stock bonus plan that is designated as an ESOP and is designed to invest primarily in stock of the employer, referred to as "qualifying employer securities."[73] An ESOP can be maintained by either a C corporation or an S corporation.[74] For purposes of ESOP investments, a "qualifying employer security" is generally defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock

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[70] Sec. 401(m)(11).

[71] Secs. 401(k)(13) and (m)(12).

[72] These automatic increases in default contribution rates are required for plans using the safe harbor. Rev. Rul. 2009–30, 2009-39 I.R.B. 391, provides guidance for including automatic increases in other plans using automatic enrollment, including under a plan that includes an eligible automatic contribution arrangement.

[73] Sec. 4975(e)(7). Participant accounts in other types of defined contribution plans can also be invested in employer stock.

[74] A C corporation is so named because its tax treatment is governed by subchapter C of the Code. An S corporation is so named because its tax treatment is governed by subchapter S of the Code. An S corporation is a passthrough entity for income tax purposes. That is, income tax does not apply at the S corporation level. Rather, items of income, gain, or loss are taken into account for tax purposes by the S corporation shareholders on their own tax returns.

described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be an entire plan or it can be a portion of a defined contribution plan. An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a section 401(k) feature that permits employees to make elective deferrals. ESOPs are subject to additional requirements that do not apply to other plans that hold employer stock. For example, voting rights must generally be passed through to ESOP participants and employees must generally have the right to receive benefits in the form of stock.

Diversification requirements for ESOPs

ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.[75] The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (*i.e.*, age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three alternative investment options and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[76]

Special ESOP rules

Certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer stock. Under an exception to the prohibited transaction rules, an employer maintaining an ESOP may lend money to the ESOP, or the employer may

[75] Sec. 401(a)(28). Under sec. 401(a)(35) and ERISA sec. 204(j), diversification rights with respect to amounts invested in employer securities under an applicable defined contribution plan, generally defined as a defined contribution plan holding securities issued by the employer or a member of the employer's controlled group of corporations that are publicly traded, that is, readily tradable on an established securities market. An ESOP generally is not an applicable defined contribution plan unless it holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests applicable to section 401(k) plans. An ESOP that is an applicable defined contribution plan and subject to the related diversification requirements is excepted from the specific ESOP diversification requirements.

[76] Notice 88-56, 1988-1 C.B. 540, Q&A-16.

guarantee a loan made by a third-party lender to the ESOP, to finance the ESOP's purchase of employer securities.[77] An ESOP that borrows funds to acquire employer securities is generally called a leveraged ESOP.

In the case of an ESOP maintained by a C corporation, payments of principal on the ESOP loan are deductible to the extent permitted under the general deduction limits for contributions to qualified retirement plans (which generally limit the deduction for contribution to a defined contribution plan for a year to 25 percent of the participants' compensation), and interest payments are deductible without regard to the limitation.[78] In addition, a C corporation may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participants' election.[79] This deduction is also allowed without regard to the general deduction limits on contributions to qualified plans. Moreover, subject to certain requirements, a taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by a C corporation.[80]

ESOPs maintained by S corporations are subject to special rules. Generally, if a tax-exempt entity, including a trust holding qualified retirement plan assets, holds S corporation stock, it is treated as holding an interest in an unrelated trade or business and is subject to unrelated business income tax ("UBIT").[81] However, an ESOP holding employer securities issued by an S corporation is exempt from UBIT.

In part to prevent interests in income attributable to employer stock of an S corporation held by an ESOP (and thus not subject to current taxation) from being concentrated in a small group of persons, a number of adverse tax consequences may apply if a "nonallocation year" occurs with respect to an ESOP maintained by an S corporation. If any "disqualified person" has an interest in the S corporation in the form of "synthetic equity"[82] during a nonallocation year, an

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[77] Sec. 4975(d)(3). To qualify for the loan exemption, the loan must be primarily for the benefit of participants and beneficiaries of the plan, the interest on the loan must be at a reasonable rate, and any collateral given to a disqualified person by the plan must consist only of qualifying employer securities.

[78] Sec. 404(a)(9).

[79] Sec. 404(k). If a dividend is paid with respect to stock allocated to a participant's account and is used to make a payment on an ESOP loan, the plan must allocate employer securities with a fair market value of not less than the amount of such dividend to the participant's account for the year in which such dividend would have been allocated to such participant. Distributions with respect to S corporation stock held in an ESOP may also be used to repay an ESOP loan under similar conditions, but the distribution is not deductible by the S corporation.

[80] Sec. 1042. See Part IV.C.3 for a further discussion of this provision.

[81] Sec. 512(e). Section 511 imposes UBIT on a tax-exempt entity's income from an unrelated trade or business.

[82] Pursuant to Sec. 409(p)(5) and (6)(C), and Treas. Reg. sec. 1.409(p)-1(f),"synthetic equity" is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future; a stock appreciation right, phantom stock unit, or similar

excise tax is imposed on the S corporation equal to 50 percent of the amount of such synthetic equity. If there are "prohibited allocations"[83] for the benefit of disqualified persons during a nonallocation year, the amount of the prohibited allocations is treated as distributed to the disqualified persons; an excise tax equal to 50 percent of the amount of the prohibited allocation applies to the S corporation; the qualified plan ceases to be an ESOP; and there is a potential for disqualification of the plan.

A "nonallocation year" is a plan year of an ESOP maintained by an S corporation in which disqualified persons own (directly or indirectly) at least 50 percent of the S corporation shares. For this purpose, a person's interest in the S corporation in the form of synthetic equity is treated as ownership of S corporation shares and is taken into account, but only if taking it into account causes a plan year to be a nonallocation year or a person to be a disqualified person.[84] Thus, both determinations are done with and without synthetic equity. "Disqualified persons" generally are persons who have at least a 10-percent interest (or who are a member of a family group having at least a 20-percent interest) in the portion of the S corporation shares held by the ESOP, either by having shares of S corporation employer stock allocated to the person's account under the ESOP (or being treated as having a portion of unallocated shares), or by having an interest in the S corporation in the form of synthetic equity.

5. Plan loans and hardship distributions

In general

The rules for tax-favored retirement savings include provisions aimed at limiting or discouraging withdrawals before retirement (referred to as "leakage"), which deplete the assets available to provide retirement income. Such provisions include the 10-percent early distribution tax, discussed in Part I.D.1, and restrictions on distributions before termination of employment

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right to a future cash payment based on the value of such stock or appreciation in such value; and rights to nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. A person can be a disqualified person, and a nonallocation year can occur based solely on interests in the S Corporation in the form of synthetic equity, even if the person is not a participant in the ESOP. Synthetic equity is an interest in income attributable to employer stock held by an ESOP, and reduces the ESOP's economic ownership of the S corporation. On the other hand, it is possible in certain circumstances to grant options or warrants for S corporation stock (or other synthetic equity) to a single person that, when combined with the outstanding shares of the S corporation, are options for up to 49 percent of the S corporation stock without causing a nonallocation year.

[83] Generally a "prohibited allocation" for the benefit of a disqualified person occurs during a nonallocation year to the extent that S corporation employer stock owned by the ESOP (and any assets attributable to such stock) is held for the benefit of a disqualified person during the nonallocation year (whether the stock is allocated to the person's account under the ESOP during the nonallocation year or an earlier year).

[84] An ESOP maintained by an S corporation may be able prevent a nonallocation year (or a prohibited allocation during a nonallocation year) by transferring S corporation employer stock allocated to the account of disqualified persons (or persons expected to become disqualified persons) to a separate portion of the qualified plan (or another qualified retirement plan of the S corporation) that is not designated as an ESOP and allocate it to the accounts of those persons under the separate portion (or other plan). In that case, the qualified retirement plan is subject to UBIT with respect to those transferred shares of S corporation stock.

(referred to as "in-service" distributions), discussed in Part IV.D.1. However, restrictions on access to tax-favored savings before retirement may discourage individuals from making contributions out of concern that funds will not be available in the case of financial need. This concern is addressed by allowing plan loans and exceptions to the restrictions on in-service distributions, including in the case of hardship, as well as exceptions to the 10-percent early distribution tax.

Plan loans

Defined contribution plans, section 403(b) plans, and governmental section 457(b) plans generally are permitted, but are not required, to offer plan loans to participants. Plan loans must comply with certain conditions so that the loan is not treated as a taxable distribution to the participant.[85] Generally, a loan that does not satisfy all of the requirements will be treated as a deemed distribution, resulting in current income taxation and, for participants younger than 59½, a 10-percent early distribution tax. The requirements both limit the amount of the loan and the repayment terms. If the actual repayment of the loan does not satisfy the required repayment terms during the period the loan is outstanding, a deemed distribution of the loan outstanding occurs at that time.

In order not to be treated as a deemed distribution, a plan loan may not exceed the lesser of (1) $50,000 reduced by the excess of the highest outstanding loan balance from the plan during the one-year period ending on the day before the date on which the loan is made over the outstanding loan balance on the date on which the loan is made, or (2) the greater of (a) 50 percent of the present value of the vested accrued benefit of the participant or (b) $10,000. Generally, a plan loan is treated as a deemed distribution unless it provides for repayment within five years of the loan date[86] and for substantially equal payments of both principal and interest no less frequently than quarterly over the term of the loan. Repayment on an accelerated schedule is permitted, and plan terms may require full repayment on termination of employment.

Deemed distributions, resulting from a failure to comply with the loan requirements, are treated as actual distributions for tax purposes. They are not, however, treated as actual distributions for purposes of plan qualification or rollovers requirements.

Distribution of a plan loan offset amount occurs when, pursuant to plan terms, the accrued benefit of a participant or beneficiary is reduced in order to repay a loan. For example, it is common for plans to provide that, if a participant requests a plan distribution while a loan is outstanding, the loan must be repaid immediately or treated as in default. In the event of a loan offset, the amount of the account balance that is offset against the loan is an actual, not a deemed, distribution. In contrast to a deemed distribution, a loan offset amount can be an

[85] Sec. 72(p). Generally, if a participant or beneficiary assigns or pledges any portion of his or her interest in a qualified plan as security for a loan, the assigned or pledged portion is treated as a loan from the plan to the participant for purposes of section 72(p).

[86] An exception to the five-year rule applies in the case of a loan used to purchase the participant's principal residence. Rules also allow the suspension of repayment of a loan while the participant is performing services in the uniformed services of the United States. Treas. Reg. sec. 1.72(p)-1, Q&A-9(b) and (c).

eligible rollover distribution. A plan is not, however, required to offer a direct rollover with respect to the loan offset amount and the amount is generally not subject to mandatory 20-percent withholding.

Hardship distributions

Hardship distributions are an exception to the general prohibition on in-service distributions before age 59½ of amounts in a section 401(k) plan or 403(b) plan that are attributable to elective deferrals.[87] Section 401(k) and 403(b) plans are permitted, but are not required, to permit participants to take hardship withdrawals, provided two conditions are met. First, the distribution must be made on account of an immediate and heavy financial need of the employee. Second, the distribution must be necessary to satisfy that financial need. Determinations regarding whether an immediate and heavy financial need exists, and whether a distribution is necessary to meet that need, must be made in accordance with nondiscriminatory and objective standards set forth in the plan.[88] There are, however, regulatory safe harbors whereby the requirements may be deemed to have been met, such as for the purchase of a home or the payment of education expenses.[89] Hardship distributions must generally be limited to the amount of the employee's total elective deferrals as of the date of the distribution, reduced by the amount of any previous hardship distributions.

Section 457(b) plans may provide for distributions in the case of an unforeseeable emergency.[90] The concept of unforeseeable emergency is narrower than the concept of hardship under the section 401(k) and 403(b) rules and the regulatory safe harbors do not apply.

6. Lifetime income under defined contribution plans

Pension plans (defined benefit and money purchase pension plans) are required to provide participants with life annuity forms of benefit, including forms that provide life annuity benefits for surviving spouses. Pension plans are viewed as furthering retirement income security in that a participant (or surviving spouse) receiving benefits in life annuity form cannot "outlive" his or her benefits under the plan. However, profit-sharing and stock bonus plans are not required to offer annuity forms of distribution; instead, a participant's (or surviving spouse's) benefit consists of an account balance, which can be depleted during the participant's (or surviving spouse's) lifetime.[91] The increase in the number of employees who are covered only by a profit-sharing plan or stock bonus plan (including section 401(k) plans, which are usually

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[87] Sec. 401(k)(2)(B)(i)(IV). This exception does not apply to other contributions subject to the limitations on in-service distributions under section 401(k)(2)(B), such as safe harbor nonelective or matching contributions.

[88] Treas. Reg. sec. 1.401(k)-1(d)(3)(i).

[89] Treas. Reg. secs. 1.401(k)-1(d)(3) and 1.403(b)-6(d)(2).

[90] Sec. 457(d)(1)(iii).

[91] Although defined benefit plans are required to offer annuities, they may also offer lump sums, and many participants elect to receive a lump sum (perhaps rolling it over to an IRA), rather than an annuity.

profit-sharing plans) has increased concern that participants (and surviving spouses) will outlive their account balances. Similar concerns arise with respect to IRA owners.[92]

Discussion in recent years has focused on distribution options that enable a participant or surviving spouse to receive retirement savings in a form that is more likely to last over his or her lifetime ("lifetime income"), such as installment payments over an individual's lifetime, as well as investments in annuities and other lifetime income products. The appropriateness of a lifetime income product for individuals may vary with circumstances. For example, as a result of the formula used to calculate Social Security benefits, including the annual limit on wages taken into account for benefit purposes, the portion of an employee's earnings replaced by Social Security benefits is higher for lower-paid employees than for higher-paid employees.[93] Thus, for some employees, Social Security benefits may provide sufficient lifetime retirement income. Moreover, for individuals with modest retirement accounts, the need for access to those funds to cover occasional, large expenses may be greater than the need for additional lifetime income. However, for many, lifetime income products are a possible source of annuity income to supplement Social Security benefits.

Lifetime income concerns have also been a focus of an initiative by the Department of the Treasury and the IRS in collaboration with DOL to expand the availability of options that enable a participant or surviving spouse to take distributions in a form that is more likely to last over his or her lifetime ("lifetime income").[94] These agencies have sought public input on changes that would encourage employers to include lifetime income options in defined contribution plans and to encourage defined contribution plan participants and IRA owners to elect such options, at least with respect to part of their account balances.[95]

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[92] Much of the savings in IRAs results from rollovers from qualified retirement plans. In addition, profit-sharing (and stock bonus) plans often offer lump sums as the only form of distribution. In that case, a participant wishing to take installment distributions has to roll his or her account balance over to an IRA and take installments from the IRA.

[93] See, for example, Congressional Budget Office, "CBO's 2014 Long-Term Projections for Social Security: Additional Information," December 2014, Exhibit 9, available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/49795-Social_Security_Update.pdf. The portion of retirement income provided by Social Security benefits also varies among individuals. See, for example, Social Security Administration, "Income of the Aged Chartbook, 2012," April 2014, pp. 8, 16-18, available at http://www.ssa.gov/policy/docs/chartbooks/income_aged/2012/iac12.pdf. See also, AARP Public Policy Institute, "Sources of Income for Older Americans, 2012," December 2013, Figure 1, available at http://www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2013/sources-of-income-for-older-americans-2012-fs-AARP-ppi-econ-sec.pdf.

[94] An annuity by definition provides lifetime income, but lifetime income options also include, for example, installment payments over an individual's lifetime.

[95] Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 75 Fed. Reg. 5253 (February 2, 2010).

In response to comments, the following guidance has been provided:[96]

- Treatment of a series of target date funds ("TDFs") with investments in unallocated deferred annuity contracts as qualified default investment alternatives ("QDIAs") under ERISA;[97]
- Special rules for applying the Code nondiscrimination requirements to a series of TDFs that include deferred annuities among their assets and are offered as investment options under a defined contribution plan, even if some of the TDFs within the series are available only to older participants;[98]
- Regulations relating to minimum required distributions under the Code (discussed further below), providing special rules for annuity contracts under which payments may begin at age 85;[99]
- ERISA regulatory changes under consideration with respect to periodic benefit statements provided to defined contribution plan participants, under which a participant's account balance would be expressed also as an estimated lifetime stream of payments;[100]
- Clarification of the application of the spousal consent and QJSA and QPSA requirements when a deferred annuity contract is offered as an investment option under a profit-sharing plan.[101]

[96] As part of the same lifetime income project, the IRS issued guidance to increase annuity distributions from defined benefit plans. Proposed changes to Treasury regulations under section 417(e), relating to the calculation of minimum lump sums, address the situation in which a participant's accrued benefit under a defined benefit plan is bifurcated and the bifurcated portions paid in separate forms, such as an annuity and a lump sum. Prop. Treas. Reg. sec. 1.417(e)-(d), 77 Fed. Reg. 5454 (February 2, 2012). In addition, Rev. Rul. 2012-4, 2012-8 I.R.B. 386, provides guidance on transferring a participant's account balance under a defined contribution plan to a defined benefit plan in order to provide an increased annuity under the defined benefit plan.

[97] Letter dated October 23, 2014, from Phyllis C. Borzi to J. Mark Iwry, available at http://www.dol.gov/ebsa/regs/ILs/il102314.html.

[98] Notice 2014-66, 2014-46 I.R.B. 820.

[99] Treasury Decision 9673, 79 F.R. 37633 (July, 2, 2014) and Treas. Reg. secs. 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-12. Because the annuity is scheduled to begin at a time when an individual's life expectancy has declined, such an annuity contract generally costs much less than a contract providing an annuity with an earlier start date. Because the individual's retirement account balances are likely to have been at least partially depleted by the time the annuity is scheduled to begin, such an annuity is sometimes referred to as a longevity annuity or longevity insurance.

[100] 78 Fed. Reg. 26727 (May 8, 2013), issued under ERISA section 105.

[101] Rev. Rul. 2012-3, 2012-8 I.R.B. 383.

C. Individual Retirement Arrangements

1. Traditional and Roth individual retirement arrangements

In general

There are two basic types of IRAs under present law: traditional IRAs,[102] to which both deductible and nondeductible contributions may be made,[103] and Roth IRAs, to which only nondeductible contributions may be made.[104] The principal difference between these two types of IRAs is the timing of income tax inclusion. For a traditional IRA, an eligible contributor may deduct the contributions made for the year, but distributions are includible in gross income to the extent attributable to earnings on the account and the deductible contributions. For a Roth IRA, all contributions are after-tax (that is, no deduction is allowed) but, if certain requirements are satisfied, distributions are not includible in gross income.

Contribution and AGI limits

Annual contribution limit

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2016) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount.

An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the aggregate dollar limit is increased by $1,000. Thus, for example, if an individual over age 50 contributes $6,500 to a Roth IRA for 2016 ($5,500 plus $1,000 catch-up), the individual will not be permitted to make any contributions to a traditional IRA for that year. In addition, deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs generally are subject to AGI limits. IRA contributions generally must be made in cash.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels. In the case

[102] Sec. 408.

[103] Sec. 219.

[104] Sec. 408A.

of an individual who is an active participant in an employer-sponsored plan, the AGI phase-out ranges for 2016 are: (1) for single taxpayers, $61,000 to $71,000; (2) for married taxpayers filing joint returns, $98,000 to $118,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with AGI for 2016 between $184,000 and $194,000.

To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels. The AGI phase-out ranges for 2016 are: (1) for single taxpayers, $117,000 to $132,000; (2) for married taxpayers filing joint returns, $184,000 to $194,000; and (3) for married taxpayers filing separate returns, $0 to $10,000. Contributions to a Roth IRA may be made even after the account owner has attained age 70½.

Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert a traditional IRA into a Roth IRA through a distribution from a traditional IRA and rollover to a Roth IRA as discussed below. The amount converted is includible in the taxpayer's income as if a withdrawal had been made, except that the early distribution tax (discussed below) does not apply. However, the early distribution tax is imposed if the taxpayer withdraws the amount within five years of the conversion.

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize (in a trustee-to-trustee transfer) the amount of that contribution as a contribution to the other type of IRA (traditional or Roth) before the due date for the individual's income tax return for that year.[105] In the case of a recharacterization, the contribution will be treated as having been made to the transferee plan (and not the transferor plan). The amount transferred must be accompanied by any net income allocable to the contribution and no deduction is allowed with respect to the contribution to the transferor plan.

[105] Sec. 408A(d)(6).

Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA. However, Treasury regulations limit the number of times a contribution for a taxable year may be recharacterized.[106]

Excise tax on excess contributions

To the extent that contributions to an IRA exceed the contribution limits, the individual is subject to an excise tax equal to six percent of the excess amount.[107] This excise tax generally applies each year until the excess amount is distributed. Any amount contributed for a taxable year that is distributed with allocable income by the due date for the taxpayer's return for the year will be treated as though not contributed for the year.[108] To receive this treatment, the taxpayer must not have claimed a deduction for the amount of the distributed contribution.

2. Taxation of distributions from IRAs

Traditional IRAs

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent that the withdrawal is a return of the individual's basis.[109] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs. The portion of the individual's basis that is recovered with any distribution is the ratio of the amount of the aggregate basis in all the individual's traditional IRAs to the amount of the aggregate account balances in all the individual's traditional IRAs.

Roth IRAs

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions. To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions (including contributions rolled

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[106] Treas. Reg. sec. 1.408A-6.

[107] Secs. 4973(b) and (f).

[108] Sec. 408(d)(4).

[109] Basis results from after-tax contributions to the IRA or a rollover to the IRA of after-tax amounts from another eligible retirement plan.

over from other Roth IRAs); (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion. Thus, nonqualified distributions from all Roth IRAs are excludable from gross income until all amounts attributable to contributions have been distributed.

Rollovers

Distributions from IRAs are permitted to be rolled over tax-free to another IRA or any other eligible retirement plan. The general 60-day rollover rule (discussed above) applies to IRA rollovers as well as rollovers from qualified retirement plans, section 403(b) annuities, and governmental section 457(b) plans. There is no provision for direct rollovers from an IRA, but direct payment to another eligible retirement plan generally satisfies the requirements. Distributions from an inherited IRA (except in the case of an IRA acquired by the surviving spouse by reason of the IRA owner's death) and required minimum distributions are not permitted to be rolled over.[110] The portion of any distribution from an IRA that is not includible in gross income is only permitted to be rolled over to another IRA. Generally, distributions from a traditional IRA may only be rolled over tax-free to another IRA and distributions from a Roth IRA may only be rolled over tax-free to another Roth IRA. However, a distribution from a traditional IRA may be rolled over to a Roth IRA as a Roth conversion with the required income inclusion (as discussed above).

3. Employer retirement plans using IRAs

SIMPLE IRA plan

A small employer that employs no more than 100 employees who earned $5,000 or more during the prior calendar year can establish a simplified tax-favored retirement plan, which is called the SIMPLE retirement plan. A SIMPLE IRA plan is generally a plan under which contributions are made to an IRA for each employee (a "SIMPLE IRA"). A SIMPLE IRA plan allows employees to make elective deferrals to a SIMPLE IRA, subject to a limit of $12,500 (for 2016). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions under a SIMPLE IRA plan up to a limit of $3,000 (for 2016).

In the case of a SIMPLE IRA plan, the group of eligible employees generally must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. A SIMPLE IRA plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans.

[110] A trustee-to-trustee transfer between IRAs is not treated as a distribution and rollover. Thus, nonspouse beneficiaries of IRAs can move funds to another inherited IRA established as a beneficiary of the decedent IRA owner. In contrast, a surviving spouse is permitted to roll over a distribution to his or her own IRA.

Employer contributions to a SIMPLE IRA must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. The employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation); however, a lower percentage cannot be elected for more than two years out of any five year period. Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

The employer must provide each employee eligible to make elective deferrals under a SIMPLE IRA plan a 60-day election period before the beginning of the calendar year and a notice at the beginning of the 60-day period explaining the employee's choices under the plan.[111]

No contributions other than employee elective contributions, required employer matching contributions, or employer nonelective contributions can be made to a SIMPLE IRA plan, and the employer may not maintain any other qualified retirement plan.

Simplified employee pensions

A simplified employee pension ("SEP") is an IRA to which the employer may make contributions for an employee up to the lesser of 25 percent of the employee's compensation or the dollar limit applicable to contributions to a qualified defined contribution plan ($53,000 for 2016).[112] All contributions must be fully vested. Any employee must be eligible to participate in the SEP if the employee has (1) attained age 21, (2) performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $600 (for 2016) in compensation from the employer for the year. Contributions to a SEP generally must bear a uniform relationship to compensation.

Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the enactment of the SIMPLE IRA plan rules. However, contributions may continue to be made to SARSEPs that were established before 1997. Salary reduction contributions to a SARSEP are subject to the same limit that applies to elective deferrals under a section 401(k) plan ($18,000 for 2016). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a SARSEP up to a limit of $6,000 (for 2016).

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[111] Notice 98-4, 1998-1 C.B. 269.

[112] Sec. 408(k).

Deemed IRAs

Certain types of employer-sponsored retirement plans are permitted to provide IRAs to employees as a part of the plan.[113] This option is available to qualified retirement plans, section 403(b) plans, and governmental section 457(b) plans. The Code permits these plans to allow employees to elect to make contributions to a separate account or annuity under the plan that are treated as contributions to a traditional IRA or a Roth IRA. To receive this treatment, under the terms of the plan, the account or annuity must satisfy the requirements of the Code for being a traditional or Roth IRA. Implementing the basic provision that the account satisfy the requirements to be an IRA, Treasury regulations require that the trustee with respect to the account be a bank or a nonbank trustee approved by the IRS.[114]

Payroll deduction IRA

An employer is permitted to establish a program under which each employee can elect to have the employer withhold an amount each pay period and contribute the amount to an IRA established by the employee. In the Conference report to the Taxpayer Relief Act of 1997,[115] Congress indicated that "employers that chose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs." Congress encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs."[116] In response to that directive, the IRS published guidance to remind employers of the availability of this option for their employees.[117]

In 1975, DOL issued a regulation describing circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an IRA will not constitute an employee pension benefit plan subject to ERISA.[118] In 1999, DOL restated and updated its positions on these programs.[119] Under the DOL guidance, the general rule is that, in order for an IRA payroll program not to be a pension plan subject to ERISA, the employer must not endorse the program. To avoid endorsing the program the employer must maintain neutrality with respect to an IRA sponsor in its communication to its employees and must otherwise make clear that its involvement in the program is limited to collecting the deducted amounts and

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[113] Sec. 408(q).

[114] Treas. Reg. sec. 1.408(q)-1. Special rules apply in the case of deemed IRAs under plans of State and local government employers.

[115] Pub. L. No. 105-34.

[116] H. Rep. No. 102-220, p. 775 (1997).

[117] Announcement 99-2, 1999-1 C.B. 305. The IRS also includes information on its website concerning the rules for this option and the pros and cons for an employer adopting a payroll deduction IRA program.

[118] 29 C.F.R. sec. 2510.3-2(d).

[119] Interpretive Bulletin 99-1, 64 Fed. Reg. 32999 (June 18, 1999); 29 C.F.R. sec. 2509.99-1.

remitting them promptly to the IRA sponsor and that it does not provide any additional benefit or promise any particular investment return on the employee's savings.

As announced in January 2014,[120] the Treasury Department has established a new type of payroll deduction IRA program, called myRA, consisting of Roth IRAs for employees of participating employers (generally employees who do not have access to an employer-sponsored retirement plan) as well as other individuals.[121] A myRA is invested in U.S. Treasury savings bonds and earns interest at the same rate as investments in the Government Securities Fund under the Thrift Savings Plan for Federal employees. An individual opens a myRA online, and contributions can be made by payroll deduction through a participating employer, by transfers from the individual's bank account, or by deposit of the individual's income tax refund. An individual may roll amounts held in a myRA over to another Roth IRA (a private-sector Roth IRA) at any time. In addition, once a myRA account reaches $15,000 (or after 30 year), the balance will be transferred to a private-sector Roth IRA.

[120] Treasury Department, *myRA: A Simple, Safe, Affordable Savings Account*, available at http://www.treasury.gov/connect/blog/Documents/FINAL%20myRA%20Fact%20Sheet.pdf.

[121] See https://myra.gov/ for further information on the myRA program.

D. Early Distributions and Required Minimum Distributions

1. Early distributions

The Code imposes an early distribution tax on distributions made from qualified retirement plans, 403(b) plans and IRAs before employee or an IRA owner attains age 59½[122] The tax is equal to 10 percent of the amount of the distribution that is includible in gross income unless an exception applies. The 10-percent tax is in addition to the taxes that would otherwise be due on distribution. This additional tax is designed to help insure that distributions from qualified retirement plans are preserved for retirement.

There are a number of exceptions to the early distribution tax. Some exceptions apply to all plans and others apply only to IRAs or only to qualified retirement plans and section 403(b) annuities. The exceptions that apply to all plans include distributions due to death or disability; distributions made in the form of certain periodic payments; distributions made on account of a tax levy on the plan; distributions to the extent that they do not exceed the amount allowable as a deduction for amounts paid during the taxable year due to medical care (determined without regard to whether the employee itemizes deductions for such year);[123] or distributions made to a member of a reserve unit called to active duty for 180 days or longer.

The exceptions that only apply to distributions from IRAs include distributions used to purchase health insurance for certain unemployed individuals; used for higher education expenses; and used for first-time homebuyer expenses of up to $10,000. The exceptions that only apply to distributions from qualified retirement plans and 403(b) plans include distributions made subsequent to the employee's separation from service after attaining age 55;[124] distributions made to an alternate payee pursuant to a qualified domestic relations order: and distribution of dividends paid with respect to stock held by an ESOP.

2. Minimum distribution requirements

<u>In general</u>

Minimum distributions rules apply to tax-favored employer-sponsored retirement plans and IRA, and limit the tax deferral allowed for these plans and arrangements. By requiring that minimum annual distributions at a required beginning date (generally at age 70½), the rules are designed to ensure that these plans are used to provide funds for retirement. Distributions to an employee are required to begin no later than the required beginning date and to be distributed, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the

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[122] Sec. 72(t). The early distribution tax does not apply to distributions from governmental section 457(b) plans.

[123] Sec. 213.

[124] Age 50 is substituted for age 55 in the case of distributions to certain public employees.

employee or the life expectancy of the employee and a designated beneficiary).[125] Minimum distribution rules also apply to benefits payable with respect to an employee or IRA owner who has died.

The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy. Failure to comply with the minimum distribution requirement may result in an excise tax imposed on the individual who was required to be the distributee equal to 50 percent of the required minimum distribution not distributed for the year.[126] The excise tax may be waived in certain cases.

Lifetime rules

General rules

While an employee or IRA owner is alive, distributions of the individual's interest starting from the required beginning date are required to be made (in accordance with regulations) over the life or life expectancy of the employee or IRA owner, or over the joint lives or joint life expectancy of the employee or IRA owner and a designated beneficiary.[127] For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee or IRA owner is alive, is the factor from the uniform lifetime table included in the Treasury regulations.[128] This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70½. For tax-favored employer-sponsored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under a tax-favored employer-sponsored retirement plan in the year the employee attains

[125] Sec. 401(a)(9)(A).

[126] Sec. 4974.

[127] Sec. 401(a)(9)(A).

[128] Treas. Reg. sec. 1.401(a)(9)-5.

age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

Lifetime income rule for annuities commencing at age 85

In July 2014, the minimum required distribution regulations were amended to allow the value of a qualifying longevity annuity contract held in a defined contribution plan account or traditional IRA to be disregarded in some circumstances in determining minimum required distributions for years before annuity payments under the contract are scheduled to begin.[129] Among the conditions on such disregard, the regulations limit the portion of an account that can be invested in a longevity annuity contract (the lesser of 25 percent or $125,000), require the annuity to begin no later than age 85, and include reporting requirements for the annuity issuer.

Distributions after death

Payments over a distribution period

The after-death rules vary depending on (1) whether an employee or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit. A designated beneficiary is an individual designated as a beneficiary under the plan.[130] Similar to the lifetime rules, for defined contribution plans and IRAs, the required minimum distribution for each year after the death of the employee or IRA owner is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee or IRA owner dies on or after the required beginning date, the statutory rule is that the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death.[131] For individual accounts, if there is a designated beneficiary, the distribution period is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the

[129] Treasury Decision 9673, 79 F.R. 37633 (July, 2, 2014) and Treas. Reg. secs. 1.401(a)(9)-5, A-3 and 1.401(a)(9)-6, A-12. The regulations, and the conditions on longevity annuity contracts, do not apply to Roth IRAs because an individual is not required to take distributions from a Roth IRA at age 70½. The regulations also do not apply to defined benefit plans but the preamble to the final regulation requests comments regarding the desirability of making available in defined benefit plans a form of benefit that replicates the structure for qualified longevity annuity contracts.

[130] Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee or IRA owner's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

[131] Sec. 401(a)(9)(B)(i)

death.[132] If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee or IRA owner's life, as of the year of death.[133]

If an employee or IRA owner dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions are permitted to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.[134] For individual accounts, the distribution period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.[135]

In all cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee or IRA owner or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period. If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

Five-year rule

If an employee or IRA owner dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee or IRA owner must generally be distributed by the end of the fifth year following the individual's death.[136]

Defined benefit plans and annuity distributions

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant

[132] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[133] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

[134] Sec. 401(a)(9)(B)(iii). Special rules apply if the beneficiary of the employee or IRA owner is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee or IRA owner would have attained age 70½. If the surviving spouse dies before the employee or IRA owner would have attained age 70½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee or IRA owner.

[135] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[136] Treas. Reg. sec. 1.401(a)(9)-3, A-2.

percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.[137] If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee or IRA owner, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee or IRA owner.[138] The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

[137] Treas. Reg. sec. 1.401(a)(9)-6, A-14.

[138] Treas. Reg. sec. 1.401(a)(9)-6, A-2.

II. ECONOMIC ISSUES RELATING TO RETIREMENT PLANS

Policymakers often desire to reinforce individual retirement security and boost economic growth. To this end, they attempt to develop policies that encourage personal saving. A variety of policy designs target individual saving behavior by offering incentives through the tax system. These include, among others, individual tax subsidies and tax subsidies to employers who provide retirement plans. An important question is whether these subsidies have the desired effect on retirement saving outcomes. This section explores two sets of economic issues relating to retirement plans: the effect of retirement policies on saving; and the relationship of consumption tax principles to incentives in retirement policies.

The effect of retirement policies on saving

The life-cycle models

Standard economic models show that rational individuals maximize their well-being by choosing to smooth their consumption over their life-cycles.[139] That is, individuals save during their working years and dissave when they retire from work. According to these standard life-cycle models, tax subsidies to workers and to employers that effectively increase the net rate of return may encourage individuals to delay additional consumption and encourage employers to provide retirement plans, thereby increasing saving by individuals during their working years.[140] However, there are a number of reasons why individuals may not smooth consumption by increasing saving in this way.

First, individuals may be sufficiently liquidity constrained that they do not respond to small changes in the rate of return by altering their saving.[141] Since government subsidies for retirement saving are often accompanied by additional taxes for early withdrawal, individuals must accurately anticipate their current and future need for liquidity to avoid additional taxes and may choose alternative methods of saving rather than risk these additional taxes.

Second, uncertainty over liquidity needs over the life-cycle creates a need for precautionary saving. Because precautionary saving tends to be relatively insensitive to the after-tax rate of return,[142] the existence of uncertainty over a life-cycle may reduce the extent to

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[139] This idea is captured in models built on the Life-Cycle Hypothesis. See F. Modigliani and R. Brumberg, "Utility Analysis and the Consumption Function: an Interpretation of Cross-Section Data," in K.K. Kurihara, ed., *Post-Keynesian Economics*, Rutgers University Press, New Brunswick, NJ, 1954, pp. 388-436.

[140] A.J. Auerbach, L.J. Kotlikoff, and J. Skinner, "The Efficiency Gains From Dynamic Tax Reform," *International Economic Review,* Vol. 24, 1983, pp. 80-100.

[141] See Douglas W. Elmendorf, "The Effect of Interest-Rate Changes on Household Saving and Consumption: a Survey," *Finance and Economics Discussion Series,* 96-27, (Board of Governors of the Federal Reserve System), 1996.

[142] Doug Bernheim, "Taxation and Saving," in A.J.Auerbach and M. Feldstein, eds., *Handbook of Public Economics*, Vol. 3, Elsevier, 2002, pp. 1173-1249.

which individuals alter their saving behavior in response to tax subsidies that attempt to encourage saving.[143]

Third, implicit in the life-cycle models is the assumption that individuals have the cognitive ability to save and dissave the correct amounts at the correct times throughout their lives. Due to the high level of complexity in intertemporal planning, individuals often do not make correct economic calculations about when and how much to save and dissave.[144] Furthermore, the life-cycle models assume perfect self-control, that is, the ability to forego short-term rewards to reap long-term gains. In practice, individuals often do not practice adequate self-control. Some researchers attempt to formalize these cognitive and self-control problems and incorporate them into the standard life-cycle models.[145] In doing so, the implications of saving policies on individual saving decisions are no longer clear. One study posits that individuals in fact have neither the cognitive ability nor the willpower to make optimal decisions about retirement savings. They note that effective policy must take into account a correct set of assumptions about individual behavior.[146]

Empirical evidence

Empirical investigations of the responsiveness of personal saving to the taxation of investment earnings provide no conclusive results. Some find personal saving responds strongly to increases in the net return to saving, while others find little or a negative response.[147] Studies of retirement savings incentives follow a similar pattern, with some finding an increase in saving as a result of the incentives,[148] while others find little or no increase as retirement plan savings

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[143] E.M. Engen and W.G. Gale, "Taxation and Saving: the Role of Uncertainty," *Mimeo* (Federal Reserve Board, Washington DC), 1997.

[144] B.D. Bernheim, "Personal Saving, Information, and Economic Literacy: New Directions for Public Policy," in C.E. Walker, M. Bloomfield, and M. Thorning, eds., *Tax Policy for Economic Growth in the 1990's* (American Council for Capital Formation, Washington DC), 1994, pp. 53-78.

[145] D. Laibson, A. Repetto, J. Tobacman, "Self-Control and Saving for Retirement," *Brookings Papers on Economic Activity*, Vol. 1, 1998, pp. 91-196.

[146] Benartzi, Shlomo and Richard H. Thaler, "Heuristics and Biases in Retirement Savings Behavior," *Journal of Economic Perspectives*, vol. 21, no. 3, Summer, 2007, pp. 81-104.

[147] George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Brookings Institution), 1981.

[148] Daniel J. Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics*, vol. 87, issues 5-6, May 2003, pp. 1259-1290; James M. Poterba, Steven F. Venti, and David A. Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?" *Journal of Public Economics,* vol. 58, issue 1, September 1995, pp. 1-32; James M. Poterba, Steven F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving," *The Journal of Economic Perspectives*, vol. 10, no. 4, Autumn, 1996, pp. 91-112.

substitute for other saving.[149] In particular, economists disagree as to whether tax-advantaged saving vehicles raise total wealth accumulation or whether they "crowd-out" existing saving, and merely induce shifting of saving across vehicles.[150] Because of limitations in available data and in research designs, the answer to this question largely remains unclear.

One area of empirical research that has yielded some valuable insights is the evaluation of auto-enrollment and default features in retirement saving vehicles. Some recent work by behavioral economists find that policies that incentivize saving by setting appropriate defaults significantly increase saving. For example, an evaluation of Save More Tomorrow, a prescriptive saving program in which individuals commit now to automatic increases in saving in the future, shows a significant increase in the saving rate of individual participants.[151] Similarly, studies show that auto-enrollment features such as default contribution rates and investment choices have a strong effect on individual saving behavior within a plan.[152] Furthermore, some new research in this area tentatively shows that auto-enrollment and default features which raise retirement contributions through passive decision making induce not only increased saving within retirement plans, but also higher levels of overall individual saving. In other words, these policy features do not appear to produce significant crowd-out of existing saving.[153]

<u>Consumption tax principles and retirement plans</u>

<u>In general</u>

Tax policy experts often describe the U.S. individual income tax system as a hybrid of an income tax system and a consumption tax system. This assertion may appear counterintuitive, because an income tax and the best-known forms of consumption taxes (*e.g.*, a sales tax or a value added tax ("VAT")) at first glance seem to be very different. Economists, however, look to the underlying incidence (the parties on whom the burden of a tax actually comes to rest) and the effect of different taxes, rather than their form. From this perspective, the substantive

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[149] Karen M. Pence, "401(k)s and Household Saving: New Evidence from the Survey of Consumer Finances" (December 2001), FEDS Working Paper No. 2002-06; William G. Gale and John Karl Scholz, "IRAs and Household Saving," *The American Economic Review,* vol. 84, no. 5, pp. 1233-1260, December, 1994.

[150] Bernheim, *supra* note 4.

[151] Richard Thaler and Shlomo Benartzi, "Save More Tomorrow ™: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, 112, 2004, pp. 164-187.

[152] Bridgitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, 116, 2001, pp. 1149-1187.

[153] Raj Chetty, John Friedman, Soren Leth-Petersen, Torben Nielsen, and Tore Olsen, "Active vs. Passive Decisions and Crowdout in Retirement Savings Accounts: Evidence from Denmark," *NBER Working Paper No. 18565*, January, 2014.

difference between an idealized income tax and an idealized consumption tax is that an income tax, but not a consumption tax, taxes income from savings (*i.e.* the "return to waiting").[154]

Because the purpose of saving is to fund future consumption, an idealized income tax imposes greater burdens on a taxpayer's decision to defer consumption than does an idealized consumption tax. For this reason, some tax policy analysts assert that, at least in their pure form, income taxes distort the decision to invest current after-tax income rather than to spend it: current consumption bears one level of income tax, while deferred consumption bears two – current tax, only after payment of which are there savings to be invested, and tax on the time value of money (the return to waiting) while consumption is being deferred. Since by definition that time value of money is the market's mechanism for compensating a taxpayer for his or her agreement to defer consumption, taxing the return to waiting discourages postponed consumption (*i.e.*, savings), compared to current consumption.

IRAs, qualified retirement plans (including section 401(k) plans), and other tax-favored forms of saving modify the tax treatment of saving that would apply in a pure income tax, by permitting taxpayers to defer income tax on a portion of current income. As described below, in an income tax system, the deferral of income tax on income that is saved indirectly achieves substantially the same economic effects (that is, an exemption from tax on the normal return to saving) as a consumption tax.[155] The existence of IRAs and other tax-advantaged forms of saving is thus a principal reason why the U.S. individual income tax system is described as a hybrid of an income tax and a consumption tax.

There is voluminous literature on consumption taxation and the relative merits of consumption taxation versus income taxation.[156] Proponents of consumption taxation have argued its superiority to income taxation on various grounds, including that (1) it is better to tax what one takes from society (consumption) rather than one's contribution to society (income), (2) consumption is simpler to measure than income, (3) consumption is less variable than income

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[154] See Joseph Bankman and David Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," *Stanford Law Review*, vol. 58, 2005-2006. The difference between income taxes and consumption taxes can be seen by considering the classic Haig-Simons definition of income, which states that: Income = Consumption + Change in Wealth. A consumption tax, of course, imposes tax on only on the first term of the right-hand side of the equation (*i.e.*, consumption). The only difference then between a pure consumption tax and a pure income tax is the second term on the right-hand side of the equation. This term, "change in wealth," comprises new investment (or withdrawals of previously-invested capital) and returns on capital. In other words, in a pure income tax, savings come out of after-tax income (because new savings are included in the definition of "income"), and returns on those savings are taxed.

[155] The general observation made in the text does not strictly apply to equity investments in taxable "C" corporations because in that case there is an income tax imposed at the corporate level that is not deferred by the investor-level deferral rules for IRAs, or similar retirement plans. The extent to which the corporate income tax succeeds in taxing capital income is itself a controversial topic beyond the scope of this pamphlet.

[156] For an overview of some of the issues raised by consumption taxation, see David F. Bradford and the U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform, *Tax Analysts*, 1984; Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995; Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, July 1997.

and thus a better measure of an individual's lifetime well-being, and (4) consumption taxation does not tax the return to saving, and thus encourages saving, capital formation, and economic growth. Moving from an income tax to a consumption tax has drawbacks as well, including (1) the need for a higher nominal rate of tax to raise the same revenue (since consumption of current income is usually less than that income), (2) difficulties in making a consumption tax as progressive as an income tax, since the poor consume a larger share of their income immediately, and (3) many difficult transition issues in moving from an income tax system to a consumption tax, including whether and how to tax "old" capital that was created under an income tax system.

Cash-flow approach to consumption taxation

Because income equals the sum of consumption and changes to wealth, consumption represents income that is not saved. Accordingly, one way to tax consumption is to begin with income as the base, but allow a full deduction for savings. This approach to consumption taxation is known as a "consumed income" tax, or a "cash-flow" tax. It is called a cash-flow tax because it measures the tax base through cash-flow accounting: monetary income is included in the tax base, and monetary outflows to savings are deductible.

Under present law, cash-flow consumption tax is similar to the treatment of IRAs to which deductible contributions are made ("deductible IRAs"). Using deductible IRAs, taxpayers deduct contributions to qualified accounts in the year they make contributions, but upon withdrawal they include in income the entire amount withdrawn. A full cash-flow consumption tax treats all saving as if it were done in a qualified account. Furthermore, under a cash-flow consumption tax there would be no requirement to hold the savings until retirement, nor any required distributions from the account in retirement. The accounts would be subject to taxation whenever the account holder chose to withdraw funds for consumption for any purpose.

The effect of cash-flow treatment, as in a deductible IRA, is that the taxpayer receives a tax-free return on his savings, assuming the tax rate is the same at the time of deduction and withdrawal. Specifically, the taxpayer is able to defer consumption from one period to the next and earn the full pre-tax rate of return on the deferred consumption.

The following example illustrates how the cash-flow or deductible IRA approach (initial deduction plus inclusion of all proceeds) results in the exemption from tax of the return to saving. Assume that the marginal tax rate is 20 percent and the taxpayer saves $1,000 of his income in a savings account. The $1,000 of savings gives the taxpayer a $1,000 deduction and thereby reduces the taxpayer's tax liability by $200 (20 percent of $1,000). Thus, the taxpayer has reduced current period consumption by $800. Assume that the taxpayer withdraws the savings (plus interest) one year later. If the account yields a five percent rate of return, the taxpayer withdraws $1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an extra tax liability of $210, leaving the taxpayer with net proceeds of $840. The $840 represents the $800 prior period reduction in consumption plus the full five-percent return.

Tax prepayment approach to consumption taxation

Another way to implement a consumption tax indirectly is to include in the base only earned income. Taxpayers claim no deduction for savings, but their returns to saving, whether in the form of interest, dividends, rents, royalties, or capital gains, are excluded from the base of the tax and thus are received tax-free. This "tax prepayment" approach[157] treats all savings as coming from after-tax dollars. In terms of the previous example, a taxpayer initially pays tax of $200 on the $1,000 he sets aside from current consumption. When he withdraws the $840 in the following year (the $800 he was able to put in the account plus a five-percent return), none of that is included in the tax base. This tax prepayment approach is similar to that provided under present law for Roth IRAs and to the individual portion of the Hall-Rabushka flat tax [158] and the Bradford X-tax.[159]

[157] This approach is sometimes described as a "yield exemption" approach.

[158] Robert E. Hall and Alvin Rabushka, *The Flat Tax,* Hoover Institution Press, Stanford, CA, 2nd ed. 1995.

[159] David F. Bradford, "A Tax System for the Twenty-First Century" in Alan J. Auerbach and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform,* AEI Press, 2005. See also David F. Bradford, *The X Tax in the World Economy,* AEI Press, 2004. See also David F. Bradford, *Untangling the Income Tax,* Harvard University Press, 1986.

III. DATA RELATING TO RETIREMENT SAVINGS

A. General Data on Retirement Plan Participation

According to the National Compensation Survey ("NCS"),[160] in 2015, 66 percent of U.S. workers employed in the private sector had access to a qualified retirement plan and 49 percent of workers employed in the private sector participated in a qualified retirement plan.[161] This translates to a take-up rate of 74 percent, meaning 74 percent of those with access participated. Take-up rates were stable at between 74 and 76 percent over the five year period, 2011 to 2015. These take-up rates indicate that while a large percentage of employees participate in an employer plan if available to them, some employees do not.

Table 1.–Retirement Benefits: Access, Participation and Take-Up Rates in the Private Sector (percentage of all workers)

Year	Access	Employee Participation	Take-Up Rate
2011	64	49	76
2012	65	48	75
2013	64	49	76
2014	65	48	75
2015	66	49	74

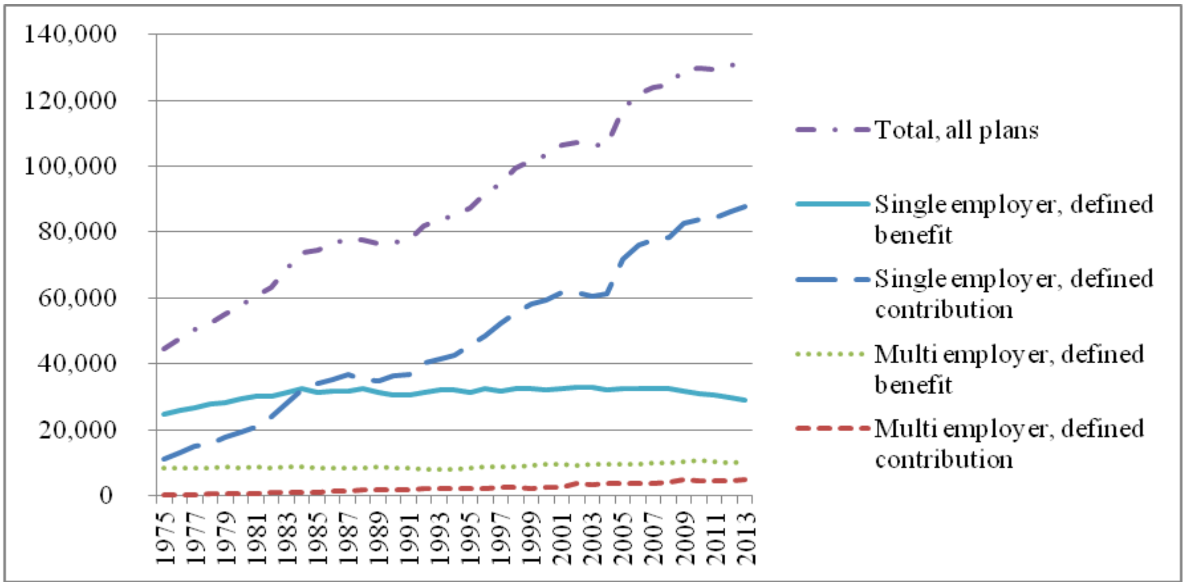
Source: Bureau of Labor Statistics, National Compensation Survey Data, 2011-2015.
Note: All workers = 100 percent. Rates are rounded to the nearest percent. As a result, take-up rates may not be exactly equal to the employee participation rate divided by the access rate as presented in this table.

Figure 1 below shows that the number of participants in private-sector single-employer defined contribution plans has consistently increased since at least 1975 and up to 2013, while the number of participants in private-sector single-employer defined benefit plans has held steady over this same period. Both defined contribution and defined benefit plan participation rates have remained steady for those in multiemployer plans. Almost all of the total rise in plan participation over this period can be attributed to the increase in private-sector single-employer defined contribution plan participation.

[160] The National Compensation Survey ("NCS") is an annual survey conducted by the U.S. Department of Labor, Bureau of Labor Statistics ("BLS"). Each release contains data on civilian, private industry, and State and local government workers in the United States. Excluded are federal government workers, the military, agricultural workers, private household workers, and the self-employed.

[161] Includes both defined contribution and defined benefit plans. Workers are considered as having access or as participating if they have access to or are participating in at least one of these plan types.

Figure 1.−Number of Private-Sector Plan Participants by Type of Plan 1975-2013 (thousands)



Source: Form 5500 filings with the U.S. Department of Labor.
Note: The term "Participants" refers to active, retired, and separated vested participants not yet in pay status. The number of participants also includes double counting of workers in more than one plan. For Form 5500 Short Form filers, this number may also include deceased participants whose beneficiaries are receiving or are entitled to receive benefits. Excludes plans covering only one participant.

Table 2 shows the percentage of households in 2010 with an IRA balance, defined contribution account balance, or a defined benefit pension. These data show that a greater percentage of older households have defined benefit pensions relative to defined contribution accounts and a greater percentage of younger households have defined contribution accounts relative to defined benefit pensions. This is consistent with an overall decline in defined benefit plan coverage over the past few decades, and a concurrent increase in defined contribution plan coverage.[162]

[162] See for example, Barbara A. Butrica, Karen Elizabeth Smith, and Eric Toder *et al*., *The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Boomers*, Center for Retirement Research, January 2, 2009.

Table 2.−Percentage of Households in 2010 with an IRA Balance, Defined Contribution Account Balance, or a Defined Benefit Pension, By Age Category

Single Household				Married Household			
Age	**IRA**	**DC**	**DB**	**Age**	**IRA**	**DC**	**DB**
<35	10.3	24.0	7.8	<35	17.1	39.6	16.6
35 − 44	13.9	30.4	14.2	35 − 44	25.8	49.5	22.6
45 − 54	19.9	29.5	21.4	45 − 54	33.5	52.7	32.8
55 − 64	30.3	21.1	32.0	55 − 64	48.8	43.3	46.0
65 − 74	25.6	3.0	42.0	65 − 74	50.1	16.4	49.9
75+	22.0	0.8	52.9	75+	43.5	3.5	62.4

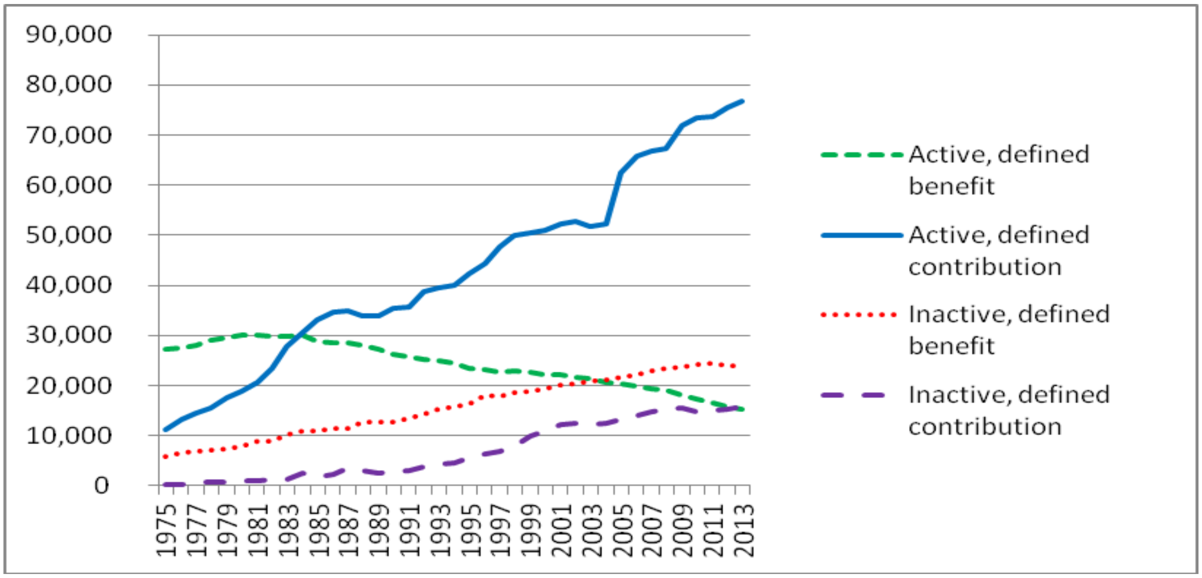
Source: Congressional Research Survey, *U.S. Household Savings for Retirement in 2010.* Analysis of the 2010 Survey of Consumer Finances.

Note: Percentages represent percentages of households that had the type of plan at the time of the survey. Households may have had more than one type of plan.

Figure 2 below shows trends from 1975 to 2013 in the number of participants by active and inactive status. Active participants are current employees who participate in an employer's retirement plan. Inactive participants are former employees who still have an accrued benefit or account balance under an employer's retirement plan, including retirees receiving benefits. The numbers of inactive participants in defined benefit and defined contribution plans both increased over this period, though there are larger numbers of inactive participants in defined benefit plans than defined contribution plans throughout. Between 1975 and 2013, the number of active participants in defined benefit plans decreased and the number of active participants in defined contribution plans increased. The percent of active participants in defined benefit plans relative to active participants in defined contribution plans declined relatively sharply over this period.

The data in Figure 2 also show that a decreasing proportion of defined benefit participants are active participants (and an increasing proportion of defined benefit participants are inactive). Consistent with overall patterns, an increasing proportion of defined contribution participants are active participants (and a decreasing proportion of defined contribution participants are inactive).

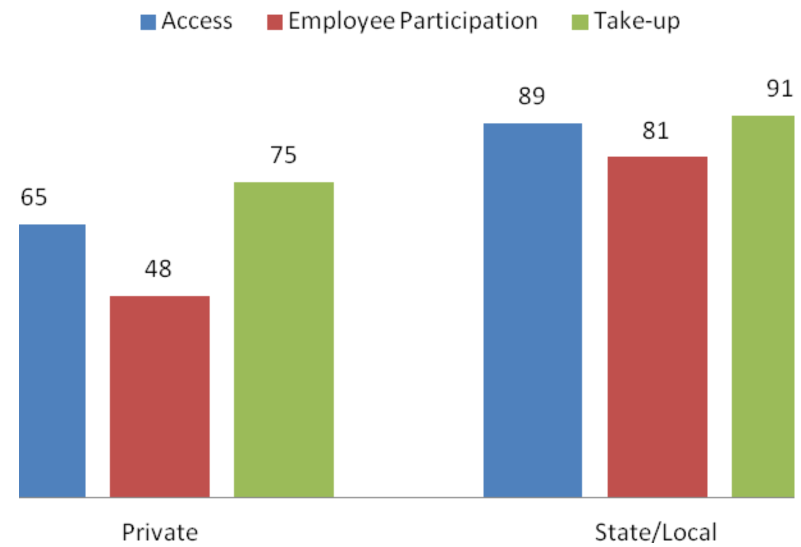
Figure 2.−Number of Private-Sector Participants by Active or Inactive Status and Type of Plan 1975-2013 (thousands)



Source: Form 5500 filings with the U.S. Department of Labor.

Rates of access and participation in qualified retirement plans vary by a number of worker and industry characteristics. Figure 3 shows that access rates are lower in the private sector than they are in the State and local government sector. In addition, rates of employee participation are lower in the private sector than in the government sector. As a result, the take-up rate in the private sector is 75 percent compared to a 91 percent take-up rate in the State and local government sector.

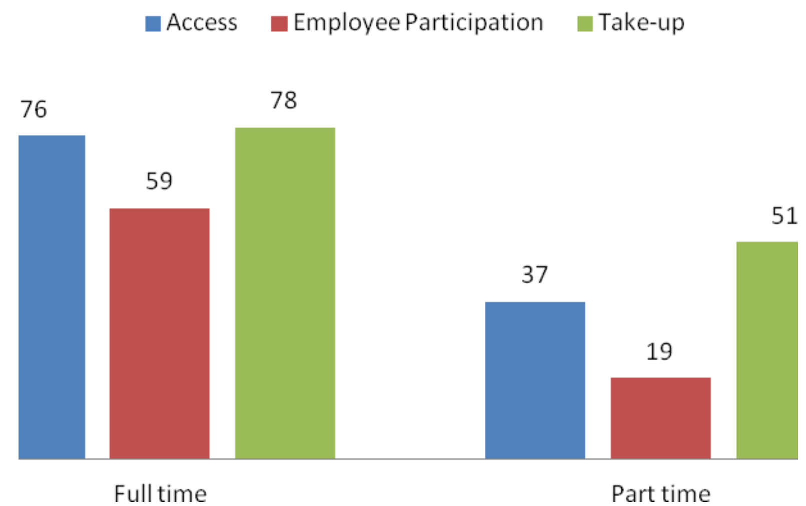
Figure 3.−Access, Participation, and Take-up Rates by Sector in 2015 (percentage)



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2015.
Note: All workers=100 percent.

The data in Figure 4 show that access, employee participation, and take-up rates are significantly higher for full time workers than for part time ones. Overall take-up rates are only 51 percent for part time workers, compared to a 78 percent take-up rate for full time workers.

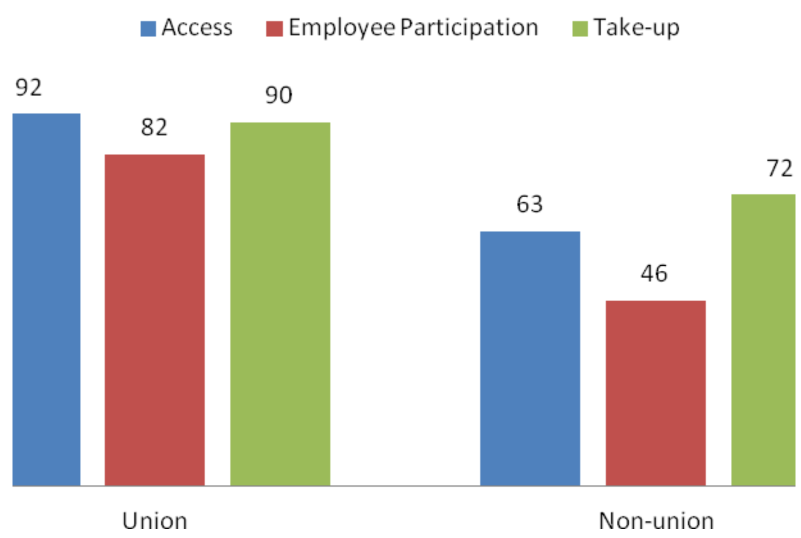
Figure 4.−Access, Participation, and Take-up Rates in the Private Sector by Full-time Status in 2015 (percentage)



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2015.
Note: All workers=100 percent.

There is also a disparity in take-up rates between union and non-union workers. As shown in Figure 5, access, participation, and take-up rates are significantly higher for union workers than they are for non-union workers.

Figure 5.−Access, Participation, and Take-up Rates in the Private Sector by Union Status in 2015 (percentage)

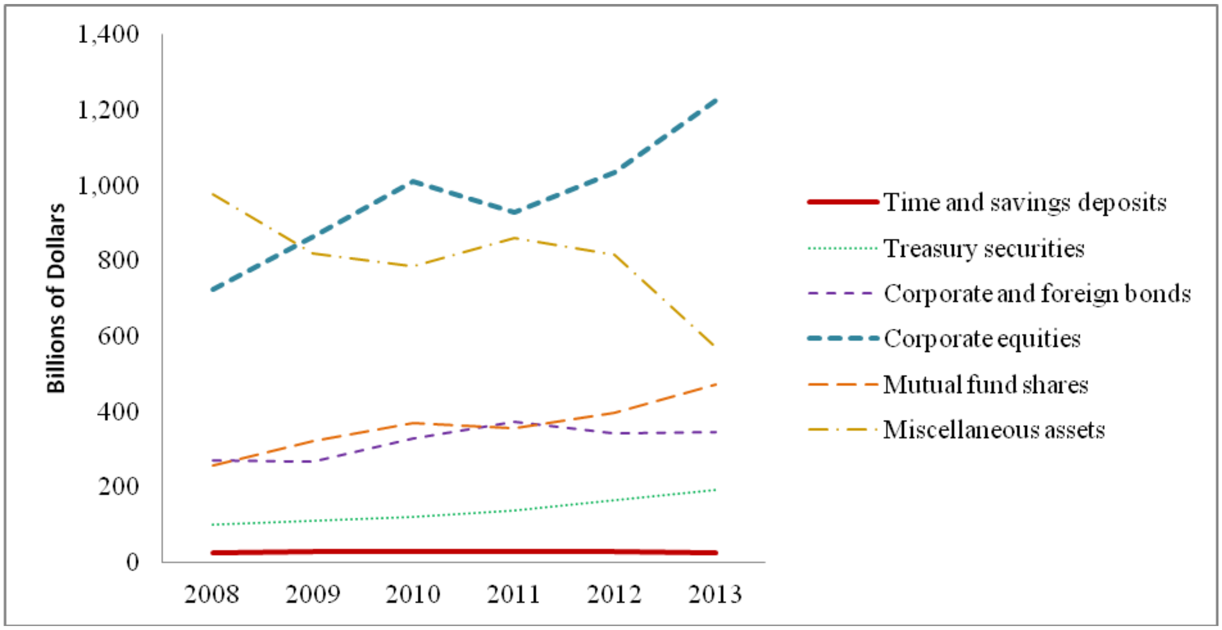


Source: Bureau of Labor Statistics, National Compensation Survey Data, 2015.
Note: All workers=100 percent.

B. Data on Retirement Plan Assets

Data from the Board of Governors of the Federal Reserve, Flow of Funds Accounts show some of the types of assets held in qualified retirement plans. Figure 6 below shows a large share of assets in private defined benefit plans is held in corporate equities, with smaller holdings of Treasury securities, time and savings deposits, and corporate and foreign bonds. In 2013, the total value of assets held in private defined benefit plans was $3,068.5 billion. Of these total assets, 40 percent were in corporate equities. The data show that the value of holdings of corporate equities has increased at a moderate to rapid rate since 2008.

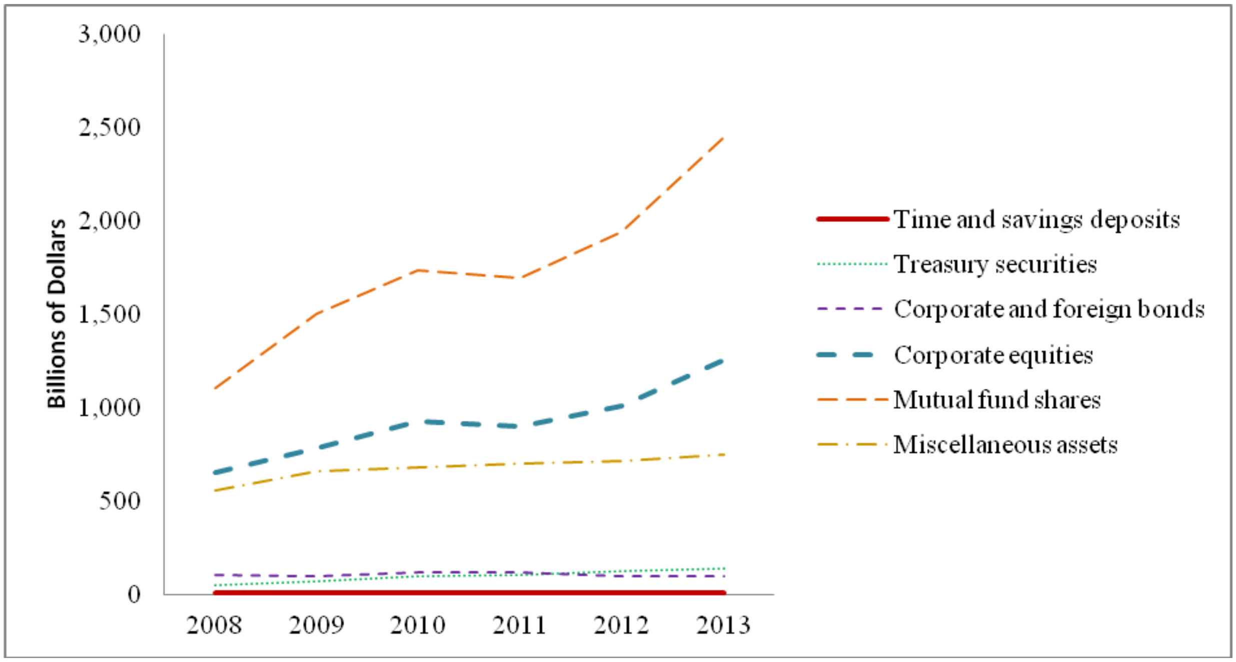
Figure 6.−Composition of Selected Assets Held in Private Defined Benefit Plans (billions of dollars)



Source: Board of Governors, Federal Reserve, Flow of Funds Accounts, 2014.

In contrast to private defined benefit plans, Figure 7 below shows the largest share of assets in private defined contribution plans is held in mutual fund shares. In 2013, the total value of assets held in defined contribution plans was $4,905.1 billion. In 2013, 49.9 percent of this total value was held in mutual funds. Corporate equities also represent a significant share of holdings. In 2013, corporate equities constituted 25.6 percent of total holdings. There are smaller holdings of other miscellaneous assets in private defined contribution plans, and nominal holdings of time and savings deposits and Treasury securities.

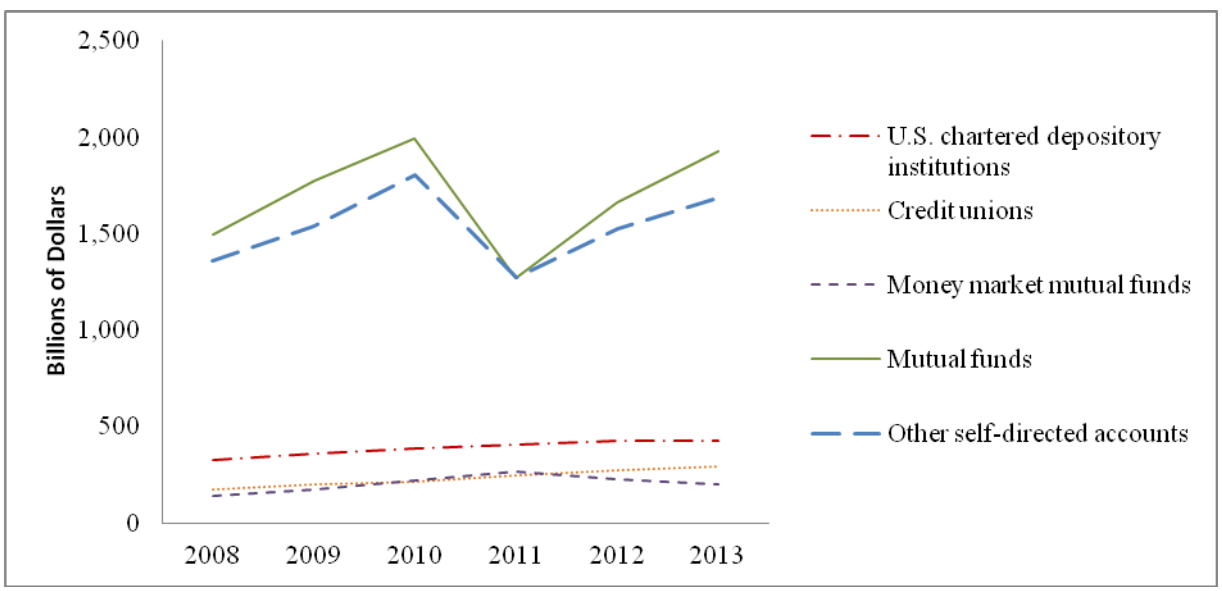
Figure 7.−Composition of Selected Assets Held in Private Defined Contribution Plans (billions of dollars)



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

According to the data in Figure 8 below, the largest share of assets held in IRAs is in mutual funds and other self-directed accounts. The market value of assets held in money market mutual funds and commercial banking is also significant though much smaller than the value of assets held in mutual funds and other self-directed accounts.

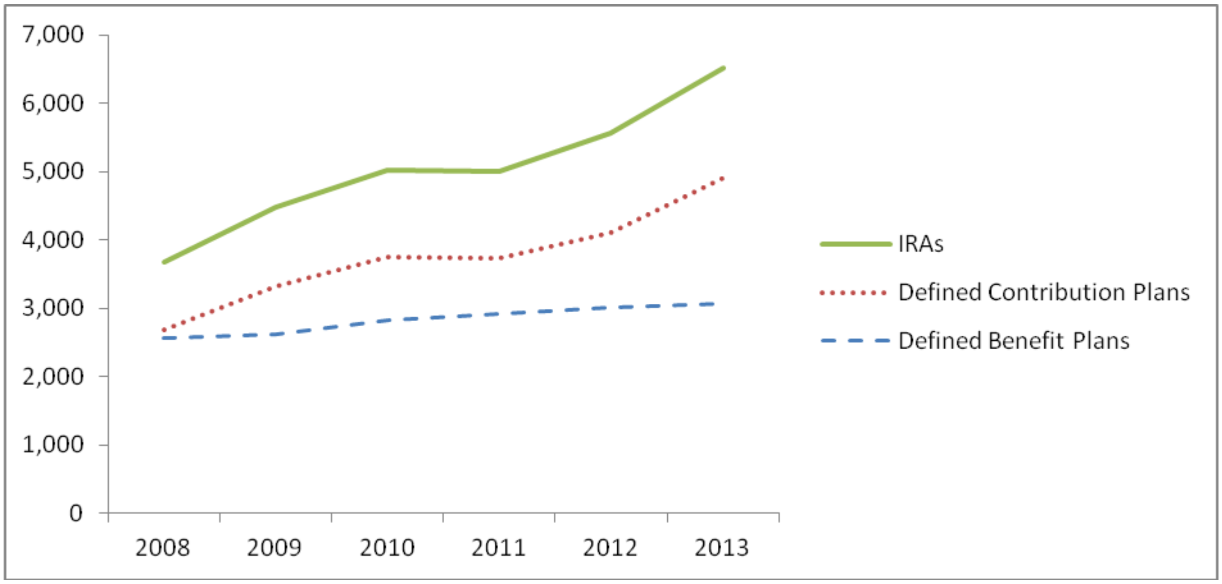
Figure 8.−Assets Held in IRAs by Financial Institution (billions of dollars)



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

Figure 9 below shows the market value of assets held in private defined contribution plans is consistently higher than those held in private defined benefit plans since at least 2008. Market value in IRAs and defined contribution plans exhibited modest to rapid growth since 2008. Assets held in defined benefit plans also exhibited growth, though this growth was more modest than in the defined contribution plans. As of December 31, 2013,[163] total assets held in private defined benefit plans was $3,068.5 billion; in private defined contribution plans was $4,905.1 billion; and in IRAs was $6,521.0 billion.

Figure 9.−Market Value of Holdings in Private Qualified Retirement Plans, By Type of Plan, and IRAs (billions of dollars)



Source: Board of Governors, Federal Reserve, Flow of Funds, 2014.

[163] This is the most recent year for which data on financial assets held in IRAs is available.

IV. SELECTED LEGISLATIVE PROPOSALS RELATING TO TAX-FAVORED RETIREMENT SAVINGS[164]

A. Background

Adequacy of retirement savings

Tax subsidies for retirement savings are designed to encourage employers to offer retirement plans to their employees and to encourage individuals to contribute to plans available in the workplace, as well as to IRAs. These subsidies have led to the widespread availability of employer-sponsored retirement plans and to the accumulation of significant amounts in those plans and in IRAs.

Nonetheless, concern about the adequacy of savings to provide income security during retirement is a frequent topic of public discussion and of congressional attention. Costs associated with sponsoring a retirement plan may discourage some employers, particularly small employers, from establishing a plan. In addition, even employees with access to a workplace plan may not take full advantage of it, and savings intended for retirement may be used for other purposes (referred to as "leakage") and not replaced.

In connection with the work last year of the bipartisan Finance Committee Tax Working Groups, the report issued by the Savings & Investment Working Group focuses on the area of private retirement savings and identifies three key goals for policy makers: (1) increasing access to tax-deferred retirement savings; (2) increasing participation and levels of savings; and (3) discouraging leakage while promoting lifetime income.[165] The Working Group report discusses various legislative proposals relating to each of those goals, which are described below.

Retirement savings bills

The proposals described below come from the following bills (as indicated in each description):[166]

- S. 606, 113th Cong., the "Shrinking Emergency Account Losses (or SEAL) Act of 2013, sponsored by Senators Nelson and Enzi;

[164] Effective dates are subject to change to reflect the timing of legislative activity and thus are omitted from the discussions of the proposals.

[165] The report is available at http://www.finance.senate.gov/imo/media/doc/The%20Savings%20&%20Investment%20Bipartisan%20Tax%20Working%20Group%20Report.pdf.

[166] As indicated in the descriptions below, some proposals (referred to herein as "President's FY 2016 budget proposal") are contained in Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

- S. 1270, 113th Cong., the Secure Annuities for Employee (or SAFE) Retirement Act of 2013, sponsored by Senator Hatch;
- S. 1970, 113th Cong., the Retirement Security Act of 2014, sponsored by Senators Collins and Nelson;
- S. 1979, 113th Cong., the USA Retirement Funds Act, sponsored by Senators Harkin and Brown;
- S. 1212, 114th Cong., the Promotion and Expansion of Private Employee Ownership Act of 2015, sponsored by Senator Cardin and others, including, Senators Roberts, Crapo, Thune and Stabenow;
- H.R. 2117, 113th Cong., the Retirement Plan Simplification and Enhancement Act of 2013, sponsored by Representative Neal; and

B. Increasing Access to Retirement Plans

1. Expand open multiple-employer plans (open MEPs)

Present Law

In general

Qualified retirement plans, either defined contribution or defined benefit plans, are categorized as single-employer plans or multiple-employer plans. A single-employer plan is a plan maintained by one employer. For this purpose, businesses and organizations that are members of a controlled group of corporations, a group under common control, or an affiliated service group are treated as one employer (referred to as "aggregation").[167] A multiple-employer plan generally is a single plan maintained by two or more unrelated employers (that is, employers that are not treated as a single employer under the aggregation rules).[168]

Multiple-employer plans are commonly maintained by employers in the same industry and are used also by professional employer organizations ("PEOs") to provide qualified retirement plan benefits to employees working for PEO clients.[169] The administrative costs associated with a multiple-employer plan may be lower than the combined administrative costs that would result if each employer participating in the multiple-employer plan maintained its own separate plan. In recent years, interest has arisen in arrangements under which a plan service provider, such as a financial institution, establishes a plan in which any employers (whether in the same industry or not) may participate. Such an arrangement is sometimes referred to as an "open" multiple-employer plan or "open MEP."

Application of requirements to multiple-employer plans and EPCRS

Some requirements are applied to a multiple-employer plan on a plan-wide basis.[170] For example, all employees covered by the plan are treated as employees of all employers participating in the plan for purposes of the exclusive benefit rule. Similarly, an employee's service with all participating employers is taken into account in applying the minimum participation and vesting requirements. In applying the limits on contributions and benefits, compensation, contributions and benefits attributable to all employers are taken into account.[171]

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[167] Secs. 414(b), (c), (m) and (o).

[168] Sec. 413(c) and ERISA sec. 210(a). Multiple-employer status does not apply if the plan is a multiemployer plan, defined under sec. 414(f) and ERISA sec. 3(37) as a plan maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers and to which the employers are required to contribute under the collective bargaining agreement(s). Multiemployer plans are also known as Taft-Hartley plans.

[169] Rev. Proc. 2003-86, 2003-2 C.B. 1211, and Rev. Proc. 2002-21, 2002-1 C.B. 911, address the application of the multiple-employer plan rules to qualified defined contribution plans maintained by PEOs.

[170] Sec. 413(c) and ERISA sec. 210(a).

[171] Treas. Reg. sec. 1.415-1(e).

Other requirements are applied separately, including the minimum coverage requirements, nondiscrimination requirements (both the general requirements and the special tests for section 401(k) plans) and the top-heavy rules, as discussed in Part I.[172] However, the qualified status of the plan as a whole is determined with respect to all employers maintaining the plan, and the failure by one employer (or by the plan itself) to satisfy an applicable qualification requirement will result in disqualification of the plan with respect to all employers.[173]

Because of the complexity of the requirements for qualified retirement plans, errors in plan documents, as well as plan operation and administration, commonly occur. Under a strict application of these requirements, such an error would cause a plan to lose its tax-favored status, which would fall most heavily on plan participants because of the resulting current income inclusion of vested amounts under the plan. As a practical matter, therefore, the IRS rarely disqualifies a plan. Instead, the IRS has established the Employee Plans Compliance Resolution System ("EPCRS"), a formal program under which employers and other plan sponsors can correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.[174]

EPCRS has three components, providing for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Multiple-employer plans are eligible for EPCRS, and certain special procedures apply.[175] A VCP request with respect to a multiple-employer plan must be submitted to the IRS by the plan administrator, rather than an employer maintaining the plan, and must be made with respect to the entire plan, rather than a portion of the plan affecting any particular employer. In addition, if a failure applies to fewer than all of the employers under the plan, the plan administrator may choose to have a VCP compliance fee or audit CAP sanction calculated separately for each employer based on the participants attributable to that employer, rather than having the compliance fee calculated based on the participants of the entire plan. For example, the plan

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[172] Treas.Reg. secs. 1.413-2(a)(3)(ii)-(iii) and 1.416-1, G-2.

[173] Treas.Reg. secs. 1.413-2(a)(3)(iv) and 1.416-1, G-2.

[174] Rev. Proc. 2013-12, 2013-04 I.R.B. 313, modified by Rev. Proc. 2015-27, 2015-16 I.R.B. 914, and Rev. Proc. 2015-28, 2015-16 I.R.B. 920.

[175] Section 10.12 of Rev. Proc. 2013-12.

administrator may choose this option when the failure is attributable to the failure of an employer to provide the plan administrator with full and complete information.

Multiple-employer plan status under ERISA

Under ERISA, an employee pension benefit plan (also called a pension plan) must be sponsored by an employer, by an employee organization, or by both.[176] The definition of employer is any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan, and includes a group or association of employers acting for an employer in such capacity.[177]

DOL interprets these definitional provisions of ERISA as permitting a multiple-employer plan to be established or maintained by a cognizable, bona fide group or association of employers, acting in the interests of its employer members to provide benefits to their employees.[178] This approach is based on the premise that the person or group that maintains the plan is tied to the employers and employees that participate in the plan by some common economic or representational interest or genuine organizational relationship unrelated to the provision of benefits. Based on the facts and circumstances, the employers that participate in the benefit program must, either directly or indirectly, exercise control over that program, both in form and in substance, in order to act as a bona fide employer group or association with respect to the program. However, an employer association does not exist where several unrelated employers merely execute participation agreements or similar documents as a means to fund benefits, in the absence of any genuine organizational relationship between the employers. In that case, each participating employer establishes and maintains a separate employee benefit plan for the benefit of its own employees, rather than a multiple-employer plan.

Retirement plan reporting and employee notices

Under the Code, an employer maintaining a qualified retirement plan generally is required to file an annual return containing information required under regulations with respect to the qualification, financial condition, and operation of the plan.[179] ERISA requires the administrator of certain pension and welfare benefit plans to file annual reports disclosing certain information to DOL.[180] These filing requirements are met by filing a completed Annual

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[176] ERISA sec. 3(2). A similar requirement applies to an employee welfare benefit plan under ERISA section 3(1).

[177] ERISA sec. 3(5).

[178] See, for example, DOL Advisory Opinions 2012-04A, 2003-17A, 2001-04A, and 1994-07A, and other authorities cited therein.

[179] Sec. 6058. In addition, under section 6059, the plan administrator of a defined benefit plan subject to the minimum funding requirements is required to file an annual actuarial report.

[180] ERISA secs. 103 and 104. Under ERISA section 4065, the administrator of certain defined benefit plans must provide information to the PBGC.

Return/Report of Employee Benefit Plan, Form 5500. Forms 5500 are filed with DOL, and information from Forms 5500 is shared with the IRS.[181]

ERISA requires that plan participants be provided with information about the plan, including a summary of benefits, rights and procedures under the plan (referred to as a summary plan description).[182] ERISA also requires that participants be provided with periodic benefit statements.[183]

Description of Proposals

S. 1270, 113th Cong., sec. 207

Code rules

Under the proposal, if a multiple-employer plan is sponsored by employers that have a common interest other than having adopted the plan, or has a designated plan provider, the failure of the portion of the plan covering the employees of an employer maintaining the plan to meet a qualification requirement generally will not affect the qualified status of any portion of the plan covering employees of an employer that has satisfied the qualification requirements. However, that treatment will not apply if a plan's designated plan provider does not perform its duties (as described below) so as to reasonably ensure the plan meets the qualification requirements. In that case, the determination of whether the plan, or any participating employer, meets the qualification requirements is to be made in the same manner as with respect to a plan without a designated plan provider.

For this purpose, "designated plan provider" means the person designated under the terms of the plan as the person responsible to perform all administrative duties that are reasonably necessary to ensure that the plan, and each participating employer, meets the qualification requirements, including conducting proper testing of the plan and employers. A person will not be treated as a designated plan provider with respect to any plan unless the person registers with the Secretary of the Treasury and provides such identifying information as the Secretary may require and consents to audits by the Secretary at such times as the Secretary determines appropriate to ensure the person is performing its duties.

The proposal directs the Secretary to issue guidance as the Secretary determines appropriate to carry out the proposal, including guidance to identify a designated plan provider's administrative duties and require, if appropriate, that the portion of the plan attributable to participating employers not meeting the qualification requirements be spun off to plans maintained by those employers.

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[181] Information is shared also with the PBGC, as applicable. Form 5500 filings are also publicly released in accordance with sec. 6104(b) and Treas. Reg. sec. 301.6104(b)-1 and ERISA secs. 104(a)(1) and 106(a).

[182] ERISA sec. 102.

[183] ERISA sec. 105.

ERISA rules

Under the proposal, a "qualified multiple employer plan" will not fail to be treated as an employee pension benefit plan (or a pension plan) solely because the employers sponsoring the plan share no common interest. A qualified multiple employer plan is a multiple-employer plan as described in the Code that is a defined contribution plan meeting the requirements below and that includes in its annual report the name and identifying information of each participating employer and each person designated as a designated plan provider.

In order to be a qualified multiple employer plan, under the plan, each participating employer must retain fiduciary responsibility for (1) the selection and monitoring of the person designated as the designated plan provider and the named fiduciary if different from the designated plan provider, and (2) the investment and management of the portion of the plan's assets attributable to employees of the employer to the extent not otherwise delegated to another fiduciary. In addition, under the plan, a participating employer must not be subject to unreasonable restrictions, fees, or penalties by reason of ceasing participation in, or otherwise transferring assets from, the plan.

The proposal also authorizes the Secretary of Labor to prescribe simplified summary plan description, annual report and pension benefit statement requirements, and waive the requirement to engage an independent qualified public accountant in cases where the Secretary determines appropriate, with respect to an "eligible small multiple employer plan." An eligible small multiple employer plan is, with respect to any plan year, a qualified multiple employer plan that, for the preceding plan year, did not have more than 2,500 participants or any participating employer with more than 500 employees as participants.

S. 1970, 113th Cong., secs. 2-3

The proposal directs the Secretary of the Treasury, not later than a year after the date of enactment of the proposal, to prescribe final regulations under which a multiple-employer plan may be treated as satisfying the qualification requirements despite the violation of the requirements with respect to one or more participating employers. Treasury rules may require that the portion of the plan attributable to the violating employers be spun off to plans maintained by those employers.

The proposal also amends ERISA to provide that a qualified multiple employer plan will not fail to be treated as an employee pension benefit plan (or pension plan) solely because the employers sponsoring the plan share no common interest. Qualified multiple employer plan is defined similar to the definition under S. 1270 (described above), except that each participating employer is required to have no more than 500 employees who received at least $5,000 of compensation from the employer for the preceding year, with a five-year grace period for an employer that previously met that requirement.

The proposal also authorizes the Secretary of Labor to prescribe simplified summary plan description, annual report and pension benefit statement requirements, and waive the requirement to engage an independent qualified public accountant in cases where the Secretary determines appropriate, with respect to an "eligible small multiple employer plan." Under the proposal, eligible small multiple employer plan is, with respect to any plan year, a qualified multiple employer plan or any other multiple-employer plan under the Code, all of the participating employers of which have no more than 500 employees who received at least $5,000 of compensation from the employer for the preceding year, with a five-year grace period for an employer that previously met that requirement.

S. 1979, 113th Cong., secs. 201-202

Under the proposal, for purposes of ERISA, a "pooled employer plan" is treated as a single employee pension benefit plan (or single pension plan) without regard to whether the participating employers share a common interest other than participation in the plan. A pooled employer plan is a pension plan (without regard to whether any participating employers share a common interest other than participation in the plan) that is a single defined contribution plan established or maintained for the purpose of providing benefits to the employees of two or more employers and that meets certain requirements (described below). The term pooled employer plan does not include a multiemployer plan or a plan established before January 1, 2014, or any successor thereof.

A plan is a pooled employer plan only if (1) the terms of the plan designate a pooled plan provider; (2) under the plan each participating employer retains fiduciary responsibility for (a) the prudent selection and monitoring of the person designated as the pooled plan provider and, if different from the provider, the person designated as the plan's named fiduciary, and (b) to the extent not otherwise delegated to another fiduciary, the investment and management of that portion of the plan's assets attributable to the employees of that participating employer; (3) under the plan, a participating employer is not subject to unreasonable restrictions, fees, or penalties with regard to ceasing participation or otherwise transferring assets of the plan; and (4) the pooled plan provider provides to participating employers any disclosures or other information as the Secretary of Labor may require.

A pooled plan provider is a person who (1) is designated by the terms of a pooled employer plan as a pooled plan provider, (2) registers as a pooled plan provider with the Secretary of Labor and provides any other identifying information to the Secretary as the Secretary may require, and (3) has the educational or professional qualifications as the Secretary may require.[184] The proposal authorizes the Secretary of Labor to perform examinations and investigations of pooled plan providers as may be necessary to enforce and carry out the purposes of ERISA.

The proposal also authorizes the Secretary of Labor to prescribe simplified annual report requirements for a pooled employer plan that covers fewer than 1,000 participants, provided that no single participating employer has more than 100 participants covered by the plan. The proposal also requires the annual report with respect to a pooled employer plan to include a list of participating employers, a good faith estimate of the percentage of the total contributions made, or expected to be made, by each such participating employer for the plan year, and

[184] Corporations that provide services to a plan and are members of a controlled group of corporations under the Code and trades or businesses under common control are treated as a single pooled plan provider.

identifying information for the person designated under the terms of the plan as the pooled plan provider.

2. Expand start-up credit

Present Law

Present law provides a nonrefundable income tax credit for qualified start-up costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP, provided that the plan covers at least one nonhighly compensated employee.[185] Qualified start-up costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit is the lesser of a flat dollar amount of $500 per year or 50 percent of the qualified start-up costs. The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, the preceding year.

An eligible employer is an employer that qualifies as eligible employer for purposes of the SIMPLE IRA rules, which is generally an employer that had no more than 100 employees who received more than $5,000 in compensation from the employer for the preceding year. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of the same controlled group and affiliated service group are treated as a single employer for purposes of these requirements, and all eligible employer plans are treated as a single eligible employer plan.

Description of Proposals

S. 1270, 113th Cong., sec. 202

The proposal increases and changes the calculation of the present-law maximum flat dollar amount of the credit. Under the proposal, the maximum flat dollar amount for a taxable year is the greater of (1) $500 or (2) the amount that is the lesser of (a) $250 multiplied by the number of employees of the eligible employer who are nonhighly compensated employees[186] and who are eligible to participate in the eligible employer plan maintained by the eligible employer, or (b) $5,000. As under present law, the credit only applies to 50 percent of the qualified start up costs and for up to three years.

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[185] Sec. 45E.

[186] Under section 414(q), for purposes of these requirements, an employee generally is s highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $120,000 (for 2016). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee

President's FY 2016 budget proposal[187]

The proposal retains the basic calculation of the credit as 50 percent of qualified startup costs, but makes a number of changes. First, the credit is allowed not only against administrative costs but also employer plan contributions. Second, the maximum basic credit is increased to $1,500 per year. In addition, if the new plan adopted by a small employer includes automatic enrollment, the credit is increased by $500 per year for up to three years ($2,000 maximum per year). This $500 per year credit is available also to a small employer that adds an automatic enrollment feature to an existing plan.

Finally, a small employer that offers an automatic payroll deduction IRA arrangement is allowed a nonrefundable credit for expenses associated with the arrangement up to $1,000 per year for the first three years of the arrangement, as well as an additional credit of $25 per employee up to $250 per year for six years.[188] If the small employer adopts a new plan during the three years beginning when it first offers (or first is required to offer) an automatic payroll deduction IRA arrangement, the maximum number of taxable years for claiming the basic credit (maximum of $1500 but not the additional $500 for automatic enrollment) is expanded from three years to four years.

3. Expand safe harbor and provide a matching credit

Present Law

General rules for 401(k) plans

As discussed in Part I, a section 401(k) plan is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement under which employees may make elective deferrals. An employee's elective deferrals must be fully vested. Section 401(k) plans may provide for employer matching contributions, which are contributions made on account of elective deferrals,[189] and may provide for employer nonelective contributions.

Automatic enrollment

Section 401(k) plans may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the section

[187] For a more detailed description and analysis of this credit proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015, pp. 161-162, and Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, pp. 40-58.

[188] An automatic payroll deduction IRA arrangement is an arrangement under which an employer makes contributions to an IRA for each employee participating in the arrangement at a specified percentage of the employee's compensation, absent an employee's affirmative election not to contribute to an IRA, or to contribute a different percentage of compensation or dollar amount, through payroll deduction.

[189] Sec. 401(m). Matching contributions can also be made on account of after-tax employee contributions.

401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (*i.e.*, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

<u>Nondiscrimination requirements</u>[190]

<u>General rule</u>

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to elective deferrals under a section 401(k) plan.[191] The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within certain specified limits. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or "ACP test") which compares the average rate of matching and after-tax contributions to the plan of the two groups.[192]

<u>Design-based safe harbors</u>

The ADP test is deemed to be satisfied if a 401(k) plan includes certain minimum benefits (either matching or nonelective contributions), provides certain notices and elections, and includes certain rights and features. There are presently three safe harbor plan designs (a general safe harbor,[193] a simple design for certain small employers, and an automatic enrollment safe harbor.

Under the automatic enrollment ADP safe harbor, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 10 percent and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the

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[190] These requirements are discussed in more detail in Part I.B.3.

[191] Sec. 401(k)(3).

[192] Sec. 401(m)(2).

[193] A plan generally satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan. The matching contribution requirement under the safe harbor is 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contributions must be immediately nonforfeitable (*i.e.*, 100 percent vested) when made.

fourth year and thereafter.[194] Under the safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent (for a total matching contribution of up to 3.5 percent of compensation). The rate of the safe harbor nonelective contribution is three percent, as under the regular safe harbor. However, under the automatic enrollment ADP safe harbor, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being immediately vested).

There are also parallel design-based ACP safe harbors for any plan that satisfies the regular or automatic enrollment ADP safe harbor, provided the plan satisfies certain additional requirements: the plan must not match contributions in excess of six percent; the rate of matching contributions must not increase as the employee's rate of compensation or elective deferrals increase; and the rate of matching contribution with respect to any highly compensated must not be greater than that with respect to any nonhighly compensated employee.[195]

Description of Proposals

S. 1270, 113th Cong., sec. 220 and S. 1970, 113th Cong., secs. 4-6 - in general

The proposals provide a new plan design, a "secure deferral" plan, as another automatic enrollment ADP safe harbor, and also provide a new employer start up credit for employers that adopt this plan design.

Secure deferral arrangement ADP safe harbor

Both proposals retain the basic structure of the present law automatic enrollment ADP safe harbor (such as the notice and election requirements) as well as the present law nonelective contributions alternative. As under the present-law automatic enrollment ADP safe harbor, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service. The difference between the present-law automatic enrollment ADP safe harbor and the secure deferral alternative is the structure of the default rates and the minimum matching contribution schedule. Both proposals provide that the default employee contribution rates must be between six percent and ten percent for the first year, increasing to reach at least eight percent the next year and at least ten percent in subsequent years, with no maximum rate. Under both proposals the schedule for safe harbor matching contributions for nonhighly compensated employees is changed so that an employee must defer ten percent of compensation to receive the full minimum required safe harbor matching contributions. The proposals also provide a parallel change to the design-based ACP safe harbor allowing matching contributions up to ten percent of compensation. However, the schedules for minimum required matching contributions is not the same under the two proposals.

[194] Secs. 401(k)(13) and (m)(12).

[195] Sec. 401(m)(11).

Under S. 1270, the minimum safe harbor matching schedule is an amount equal to the sum of 50 percent of the elective contributions of the employee to the extent that such contributions do not exceed two percent of compensation plus 30 percent of so much of such contributions as exceed two percent but do not exceed ten percent of compensation. Thus the total minimum matching contribution is 3.4 percent (in contrast to 3.5 percent under the present-law automatic enrollment ADP safe harbor).

Under S. 1970, the minimum safe harbor matching schedule is an amount equal to the sum of 100 percent of the elective contributions of the employee to the extent that such contributions do not exceed one percent of compensation plus 50 percent of so much of such contributions as exceed one percent but do not exceed six percent of compensation plus 25 percent of so much of such contributions as exceed six percent but do not exceed ten percent. Thus the total minimum contribution is 4.5 percent (in contrast to 3.5 percent under the present law automatic enrollment ADP safe harbor).

Secure deferral arrangement tax credit

Under the proposals, a new general business tax credit is created for eligible employers that adopt secure deferral arrangements, but the calculation of the credit under the two proposals is different. As under the present-law start up credit, an eligible employer is an employer that qualifies as an eligible employer for purposes of the SIMPLE IRA rules, which is generally an employer that had no more than 100 employees who received more than $5,000 in compensation from the employer for the preceding year.

Under S. 1270, the new secure deferral arrangement credit can be claimed by an eligible employer for a maximum of three consecutive taxable years. The amount that can be claimed for any taxable year is an amount equal to 10 percent of all matching and nonelective contributions under a secure deferral arrangement made during the plan year ending with or within the taxable year of the eligible employer by or on behalf of nonhighly compensated employees, not in excess of $10,000. The first of the three consecutive taxable years for which the credit can be claimed is the taxable year of the eligible employer with which or within which ends the first plan year during which the secure deferral arrangement was in effect for the entire year, or at the election of the eligible employer, the taxable year preceding such taxable year.

S. 1970 provides a credit, for the first five years a nonhighly compensated employee participates in the plan, in the amount of matching contributions provided to the employee, up to two percent of the employee's compensation. Thus, this credit is not tied to a certain number of years after the plan is adopted but is instead an ongoing credit for the first five years each employee participates in the plan.

Direction to Treasury to provide guidance

Both proposals direct the Secretary of the Treasury to prescribe rules to facilitate the administration of the present-law qualified automatic enrollment arrangement safe harbor and the secure deferral arrangement safe harbor, specifically with respect to the notice requirements and automatic contribution increases under these arrangements. Such rules are especially to address cases where employees become eligible under such arrangements upon becoming employed or shortly thereafter, or the employer has employees subject to multiple or different payroll and administrative systems.

C. Increasing Participation and Contribution Levels

1. Allow part-time workers to enroll in plans

Present Law

Section 401(k) plans

As previously discussed, a section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a qualified cash or deferred arrangement under which employees may make elective deferrals. An employee's elective deferrals must be fully vested. Section 401(k) plans may provide for matching contributions, which are contributions made on account of elective deferrals,[196] and may provide for employer nonelective contributions.

Participation requirement

A qualified retirement plan generally can delay participation in the plan based on attainment of age or completion of years of service but not beyond the later of completion of one year of service (that is, a 12-month period with at least 1,000 hours of service) or attainment of age 21.[197] In addition, once an employee has completed 1,000 hours of service during a plan year, the employee cannot be precluded from making elective deferrals based on a service requirement.[198] Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement.

Vesting

In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan.[199] The portion of an employee's account balance attributable to employee after-tax contributions and elective deferrals must be nonforfeitable at all times.[200] Generally, the portion of an employee's account balance attributable to nonelective or matching contributions must become nonforfeitable (meaning vested) after the completion of a specified

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[196] Sec. 401(m). Matching contributions can also be made on account of after-tax employee contributions.

[197] Secs. 401(a)(3) and 410(a)(1). Parallel requirements generally apply to plans of private employers under section 202 of ERISA. Governmental plans under section 414(d) and church plans under section 414(e) are generally exempt from these Code requirements and from ERISA.

[198] Sec. 401(k)(2)(D).

[199] Sec. 411(a)(7)(A)(ii). Requirements parallel to the vesting requirements generally apply to plans of private employers under sections 203 and 204 of ERISA. Governmental plans under section 414(d) and church plans under section 414(e) are generally exempt from these Code requirements and from ERISA.

[200] Secs. 411(a)(1) and 401(k)(2)(C). Certain nonelective contributions under a section 401(k) plan and employer matching contributions with respect to elective deferrals must also be nonforfeitable at all times.

number of years of service in accordance with a minimum vesting schedule.[201] Generally, a year of vesting service is only required to be credited if an employee completes 1,000 hours of service during the year.[202] The minimum vesting schedules specify the maximum periods of service that a plan can require for the account balance to become 100 percent vested.

For matching and nonelective contributions under a defined contribution plan, there are two alternative minimum vesting schedules. Under the first vesting schedule, the participant's accrued benefit derived from employer contributions must become 100 percent vested upon completion of no more than three years of service (often referred to as "three-year cliff vesting"). Under the second vesting schedule (referred to as "graduated vesting"), the participant's accrued benefit derived from employer contributions must become vested ratably at least over the period from two to six years of service.

<u>Minimum coverage and nondiscrimination requirements</u>

<u>In general</u>

As discussed in Part I, a qualified retirement plan is prohibited from discriminating in favor of highly compensated employees,[203] referred to as the nondiscrimination requirements. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.[204]

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement are generally disregarded.[205] However, a plan that covers employees with less than a year of service or who are under age 21 must generally include those employees in any nondiscrimination test for the year but can test the plan for nondiscrimination in two parts:

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[201] Sec. 411(a)(2)(B).

[202] Sec. 411(a)(5).

[203] Under section 414(q), for purposes of these requirements, an employee generally is a highly compensated employee if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $120,000 (for 2016). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee.

[204] Sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in section 401(a)(5). In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by a single employer. Detailed regulations implement the statutory requirements. Governmental plans are generally exempt from these requirements.

[205] A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements.

(1) by separately testing the portion of the plan covering employees who have not completed a year of service or are under age 21 and treating all of the employer's employees with less than a year of service or under age 21 as the only employees of the employer; and (2) then testing the rest of the plan taking into account the rest of the employees of the employer and excluding those employees. If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be aggregated with another plan, and the two plans tested together as a single plan.

Special nondiscrimination tests for section 401(k) plans

A special annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to test the amount of elective deferrals under a section 401(k) plan.[206] The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees. The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within limits. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or "ACP test") which compares the average rate of matching and after-tax contributions to the plan of the two groups.[207] There are also designed-based safe harbor methods for satisfying the ADP and ACP tests.

Top-heavy rules

Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees. If a plan is top-heavy, minimum contributions or benefits are required for participants who are non-key employees, and, in some cases, faster vesting is required. Non-key employees who have become participants in a defined contribution plan, but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the top-heavy defined contribution minimum. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees.

Description of Proposals

President's FY 2016 budget proposal[208] and H.R. 2117, 113th Cong., sec. 103

Under the proposal, a section 401(k) plan is not permitted to exclude an employee from being eligible to make elective deferrals by reason of not having completed a year of service if the employee has worked at least 500 hours per year with the employer for at least three

[206] Sec. 401(k)(3).

[207] Sec. 401(m)(2).

[208] For a more detailed description and analysis of this proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015, pp. 166-172.

consecutive years. For this proposal, an employee is referred to as a "long-term part-time employee" after having completed this period of service. The proposal does not require a long-term part-time employee to be otherwise eligible to participate in the plan. Thus, the employee can continue to be ineligible under the plan for employer nonelective and matching contributions by reason of not having completed a year of service. However, for a plan that does provide employer contributions for long-term part-time employees, the proposal requires the plan to credit, for each year in which such an employee worked at least 500 hours after the employee becomes a long term part-time employee, a year of service for purposes of vesting in any employer contributions.

With respect to long-term part-time employees, the proposal provides nondiscrimination testing relief (similar to the present-law rules for plans covering otherwise excludable employees) and the exclusion of these employees from top-heavy vesting and top-heavy benefit requirements.

2. Expand saver's credit

Present Law

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[209] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2016, married taxpayers filing joint returns with AGI of $61,500 or less, taxpayers filing head of household returns with AGI of $46,125 or less, and all other taxpayers filing returns with AGI of $30,750 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2016 are provided in the table below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Table 3.−Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $37,000	$0 – $27,750	$0 – $18,500	50 percent
$37,001 – $40,000	$27,751 – $30,000	$18,501 – $20,000	20 percent
$40,001 – $61,500	$30,001 – $46,125	$20,001 – $30,750	10 percent
Over $61,500	Over $46,125	Over $30,750	0 percent

[209] Sec. 25B.

The saver's credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

Qualified retirement savings contributions consist of (1) elective deferrals to a section 401(k) plan, a section 403(b) plan, a governmental section 457 plan, a SIMPLE plan, or a SARSEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a qualified retirement plan or section 403(b) plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount (for example, in 2016, $5,500 in the case of an IRA of an individual under age 50) or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year for which the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

Description of Proposal

H.R. 2117, 113th Cong., sec. 105

The proposal makes the saver's credit fully refundable and provides for the credit to be deposited in an employer-sponsored retirement plan or IRA designated by the eligible taxpayer.

In place of the current 10-percent/20-percent/50-percent credit for qualified retirement savings contributions up to $2,000 per individual, the proposal provides a refundable credit of 50 percent of contributions up to an initial level of $500 (of contributions) per individual. The $500 contribution amount is increased by $100 a year over a ten-year period until it reaches $1,500 and is indexed for inflation thereafter.

The AGI threshold for eligibility is increased to $65,000 for married couples filing jointly, $48,750 for heads of households, and $32,500 for other filers. The AGI thresholds are indexed for inflation. Eligibility for the credit is phased out ratably based on AGI exceeding the applicable threshold, using AGI ranges of $20,000 for married couples filing jointly, $15,000 for heads of households, and $10,000 for other filers.

A taxpayer's credit amount is doubled if the taxpayer consents to the payment of the credit by the IRS into a "designated retirement account," that is, an employer-sponsored retirement plan or IRA for the benefit of the taxpayer, to which qualified retirement savings contributions can be made and which is designated by the taxpayer on his or her income tax return for the year. In that case, any dollar limit on contributions to the plan or IRA is increased by the amount of the credit paid into the plan or IRA, the individual does not receive basis as a result of the amount paid in, and the amount paid in is treated as an employer contribution for purposes of certain nondiscrimination tests.

3. Extend nonrecognition of gain on sale of employer securities to an S Corporation ESOP

Present Law[210]

In general

A taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by a C corporation if certain requirements are met.[211] Nonrecognition applies to the extent that the taxpayer reinvests the sale proceeds in qualified replacement property within a specified replacement period.

For a taxpayer to be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP; (2) the ESOP or eligible employee worker-owned cooperative must own, immediately after the sale, at least 30 percent of each class of outstanding stock, or the total value of all outstanding stock of the corporation issuing the qualified securities; and (3) the taxpayer must provide certain information to the Secretary of the Treasury. In addition, the taxpayer's holding period with respect to the qualified securities must be at least three years at the time of the sale.

The ESOP must preclude the allocation to certain individuals of assets attributable to the qualified securities received in the sale; an excise tax may apply in the case of a prohibited allocation.[212] In addition, an excise tax may apply if the ESOP or eligible employee worker-owned cooperative disposes of the qualified securities within three years of the date of the sale.[213]

Qualified securities

Qualified securities are qualifying employer securities (as defined for ESOP purposes) that (1) are issued by a domestic C corporation that, for at least one year before and immediately after the sale, has no readily tradable securities outstanding (and no member of the C corporation’s controlled group has readily tradable securities outstanding), and (2) have not

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[210] See Part I for a further discussion of present law relating to ESOPs.

[211] Sec. 1042. Deferred recognition of gain may apply also to a sale of qualified securities to an eligible worker-owned cooperative. A sale of securities to an ESOP or eligible employee worker-owned cooperative by an underwriter in the ordinary course of the trade or business as an underwriter (whether or not guaranteed), or by a C corporation, is not eligible for nonrecognition treatment under section 1042. Special rules apply in the case of a sale of stock of an agricultural or horticultural refiner or processor to an eligible farmers' cooperative.

[212] Secs. 409(n) and 4979A.

[213] Sec. 4978.

been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer.

Qualified replacement property

Qualified replacement property consists of any security[214] issued by a domestic operating corporation, which did not, for the corporation's taxable year preceding the taxable year in which the security was purchased by the taxpayer seeking nonrecognition treatment, have passive investment income[215] exceeding 25 percent of the corporation's gross receipts for such preceding taxable year. In addition, securities of the domestic corporation that issued the qualified securities (and of any member of a controlled group of corporations with such corporation) are not qualified replacement property.

The qualified replacement property must be purchased within a replacement period beginning on the date three months prior to the date the qualified securities are sold and ending twelve months after the date of the sale.

The basis of the taxpayer in qualified replacement property acquired during the replacement period is reduced by an amount not greater than the amount of gain realized on the sale that was not recognized pursuant to the taxpayer's election. If more than one item of qualified replacement property is acquired, an allocation rule applies to determine the taxpayer's basis in each item. Under the allocation rule, the basis of each item designated as qualified replacement property is reduced by an amount determined by multiplying the total gain eligible for nonrecognition treatment by a fraction. The numerator of the fraction is the cost of the item of replacement property and the denominator is the total cost of all such items.

Recapture of gain

If a taxpayer disposes of any qualified replacement property, notwithstanding any other provision of the Code, gain (if any) must be recognized to the extent of the gain that was not recognized on the sale of stock to the ESOP or eligible employee worker-owned cooperative, subject to certain exceptions. Exceptions to recapture include transfers by gift or by reason of the death of the individual.

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[214] Security is defined for this purpose as under section 165(g), *i.e.*, a share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

[215] Passive investment income is defined for this purpose as under section 1362(d)(3)(D).

Description of Proposal

S. 1212, 114th Cong., sec. 3[216]

The proposal amends the definition of qualified securities to remove the requirement that the securities be issued by a C corporation. As a result, subject to the present-law requirements applicable with respect to the sale of qualified securities to an ESOP, a taxpayer may elect to defer the recognition of long-term capital gain on the sale of qualified securities to an ESOP maintained by an S corporation.

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[216] S. 1212 also contains provisions that (1) require the Secretary of the Treasury to establish the S Corporation Employee Ownership Assistance Office to foster increased employee ownership of S corporations, and (2) amend the Small Business Act to enable a small business concern eligible for a loan, preference, or other program before the date on which more than 49 percent of the business concern is acquired by an ESOP (an "ESOP business concern") to continue to qualify for loans, preferences, and other programs.

D. Preserving Savings and Making Them Last through Retirement

1. Improve portability of lifetime income investments[217]

Present Law

Distribution restrictions for accounts under employer-sponsored plans

Types of plans and contributions

Contributions to a qualified defined contribution plan or section 403(b) plan may include some or all of the following types of contributions:

- pretax elective deferrals (that is, pretax contributions made at the election of an employee in lieu of receiving cash compensation),
- after-tax designated Roth contributions (that is, elective deferrals made on an after-tax basis to a Roth account under the plan),
- after-tax employee contributions (other than designated Roth contributions),
- pretax employer matching contributions (that is, employer contributions made as a result of an employee's elective deferrals, designated Roth contributions, or after-tax contributions), and
- pretax employer nonelective contributions (that is, employer contributions made without regard to whether an employee makes elective deferrals, designated Roth contributions, or after-tax contributions).

Contributions to a governmental section 457(b) plan generally consist of pretax elective deferrals and, if provided for under the plan, designated Roth contributions.

Restrictions on in-service distributions

The terms of an employer-sponsored retirement plan generally determine when distributions are permitted. However, in some cases, statutory restrictions on distributions may apply.

[217] The report of the Savings & Investment Working Group also discusses a proposal to allow a percentage of otherwise taxable lifetime annuity payments from an IRA or defined contribution plan to be excluded from income, with the exclusion phased out at higher levels of income. In connection with policies that encourage lifetime income distribution choices and encourage retirees to be knowledgeable about and select distributions that provide a stream of income payments over the course of their retirement, the report discusses proposals that provide a safe harbor for the selection of a lifetime income contract if certain requirements are met (including an analysis that considers costs, benefits and product features and reviews an insurer's financial ability to meet its obligations under the contract), that require lifetime income disclosures on benefit statements, and that provide lifetime income as the default form of distribution.

Elective deferrals under a qualified defined contribution plan are subject to statutory restrictions on distribution before severance from employment, referred to as "in-service" distributions.[218] In-service distributions of elective deferrals (and related earnings) generally are permitted only after attainment of age 59½ or termination of the plan. In-service distributions of elective deferrals (but not related earnings) are also permitted in the case of hardship.

Other distribution restrictions may apply to contributions under certain types of qualified defined contribution plans. A profit-sharing plan generally may allow an in-service distribution of an amount contributed to the plan only after a fixed number of years (not less than two).[219] A money purchase pension plan generally may not allow an in-service distribution before attainment of age 62 (or attainment of normal retirement age under the plan if earlier) or termination of the plan.[220]

Elective deferrals under a section 403(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, and, in some cases, other contributions to a section 403(b) plan are subject to similar restrictions.[221] Deferrals under a governmental section 457(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, except that in-service distributions under a governmental section 457(b) plan apply until age 70½ (rather than age 59½).[222]

Distributions and rollovers

A distribution from an employer-sponsored retirement plan is generally includible in income except for any portion attributable to after-tax contributions, which result in basis.[223] Unless an exception applies, in the case of a distribution before age 59½ from a qualified retirement plan or a section 403(b) plan, any amount included in income is subject to an additional 10-percent tax, referred to as the "early withdrawal" tax.[224]

A distribution from an employer-sponsored retirement plan generally may be rolled over on a nontaxable basis to another such plan or to an IRA, either by a direct transfer to the recipient

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[218] Sec. 401(k)(2)(B). Similar restrictions apply to certain other contributions, such as employer matching or nonelective contributions required under the nondiscrimination safe harbors under section 401(k).

[219] Rev. Rul. 71-295, 1971-2 C.B. 184, and Treas. Reg. sec. 1.401-1(b)(1)(ii). Similar rules apply to a stock bonus plan. Treas. Reg. sec. 1.401-1(b)(1)(iii).

[220] Sec. 401(a)(36) and Treas. Reg. secs. 1.401-1(b)(1)(i) and 1.401(a)-1(b).

[221] Sec. Secs. 403(b)(7)(A)(ii) and 403(b)(11).

[222] Sec. 457(d)(1)(A).

[223] Secs. 402(a), 403(b)(1) and 457(a)(1). Under section 402A(d), a qualified distribution from a designated Roth account under an employer-sponsored plan is not includible in income.

[224] Sec. 72(t).

plan or IRA or by contributing the distribution to the recipient plan or IRA within 60 days of receiving the distribution.[225] If the distribution from an employer-sponsored retirement plan consists of property, the rollover is accomplished by a transfer or contribution of the property to the recipient plan or IRA.

Investment of accounts under employer-sponsored plans

Qualified defined contribution plans, section 403(b) plans, and governmental section 457(b) plans commonly allow employees to direct the manner in which their accounts are invested. Employees may be given a choice among specified investment options, such as a choice of specified mutual funds, and, in some cases, may be able to direct the investment of their accounts in any product, instrument or investment offered in the market.

The investment options under a particular employer-sponsored retirement plan may change at times.[226] Similarly, a plan that allows employees to direct the investment of their accounts in any product, instrument or investment offered in the market may be amended to limit the investments that can be held in the plan. In these cases, employees may be required to change the investments held within their accounts.

The terms of some investments impose a charge or fee when the investment is liquidated, particularly if the investment is liquidated within a particular period after acquisition. For example, a lifetime income product, such as an annuity contract, may impose a surrender charge if the investment is discontinued.

If an employee has to liquidate an investment held in an employer-sponsored retirement plan because of a change in investment options or a limit on investments held in the plan, the employee may be subject to a charge or fee as described above. In addition, restrictions on in-service distributions may prevent the employee from preserving the investment through a rollover.

Description of Proposals

S. 1270, 113th Cong., sec. 221

The proposal amends the rules relating to qualified retirement plans (including section 401(k) plans), section 403(b) plans, and governmental section 457(b) plans to allow a qualified distribution of a lifetime income investment, or a distribution of a lifetime income investment in the form of a qualified plan distribution annuity contract, during the 90-day period before the date on which the lifetime income investment is no longer authorized to be held as an

[225] Secs. 402(c), 402A(c)(3), 403(b)(8) and 457(e)(16).

[226] In the case of a plan subject to ERISA, a participant's exercise of control over the investment of the assets in his or her account by choosing among the investment options offered under the plan does not relieve a plan fiduciary from the duty to prudently select and monitor the investment options offered to participants. 29 C.F.R. sec. 2550.404c-1(d)(2)(iv) (2010); *Tibble v. Edison International*, No. 13-550, 135 S. Ct. 1823 (2015). The duty to monitor investment options may result in a change in the options offered.

investment option under the plan except as may otherwise be provided by regulations. Thus, a plan does not violate the restrictions on in-service distributions merely because of providing for a transfer to another plan as permitted under the proposal.

The proposal provides the following definitions:

- A qualified distribution is a direct trustee-to-trustee transfer to an eligible retirement plan, that is, a qualified retirement plan, section 403(b) plan, governmental section 457(b) plan, or IRA.
- A lifetime income investment is an investment option designed to provide an employee with election rights that are (1) not uniformly available with respect to other investment options under the plan and (2) to a lifetime income feature available through a contract or other arrangement offered under the plan, or under another eligible retirement plan through a direct trustee-to-trustee transfer to the other eligible retirement plan.
- A lifetime income feature is (1) a feature that guarantees a minimum level of income annually (or more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (2) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (not less frequently than annually) over the life of the employee or the joint lives of the employee and the employee's designated beneficiary, under rules similar to the rules for required minimum distributions.
- A qualified plan distribution annuity contract is an annuity contract purchased for a participant and distributed to the participant by a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan.

President's FY 2016 budget proposal[227]

Under the proposal, when a lifetime income investment held within an employee's account under an employer-sponsored retirement plan is no longer an authorized investment under the plan, the plan could permit the distribution of the investment by means of a direct transfer to another employer-sponsored retirement plan in which the employee participates, or to an IRA of the employee, without regard to whether a distribution would otherwise be permitted.

[227] For a further discussion and analysis of this proposal, see Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2016 Budget Proposal* (JCS-2-15), September 2015, Part X.F, at pp. 174-179.

2. Plan loans

Present Law

Taxation of retirement plan distributions

General rule

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan) is generally includible in gross income, except to the extent that the distribution is a recovery of basis under the plan, or the amount of the distribution is contributed to another tax-favored employer-sponsored retirement plan or an IRA ("eligible retirement plan") in a tax-free rollover. In the case of a distribution from a retirement plan to a participant under age 59½, the distribution (other than a distribution from a governmental section 457(b) plan) is also subject to a 10-percent early distribution tax, unless an exception applies.

Rollovers

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover"). Amounts that are rolled over are usually not included in gross income. Generally, any distribution of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.[228]

Tax-favored employer-sponsored retirement plans are required to offer a direct rollover with respect to any eligible rollover distribution before paying the amount to the participant or beneficiary.[229] If an eligible rollover distribution is not directly rolled over into an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.[230]

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[228] Sec. 402(c)(4). Treas. Reg. sec. 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under section 72(p), and dividends on employer securities as described in section 404(k). In addition, pursuant to section 402(c)(11), any distribution to a beneficiary other than the participant's surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.

[229] Sec. 401(a)(31). Unless a participant elects otherwise, a mandatory cash-out of more than $1,000 must be directly rolled over to an IRA chosen by the plan administrator or the payor.

[230] Treas. Reg. sec. 1.402(c)-2, Q&A-1(b)(3).

Plan loan as a deemed distribution

Tax-favored employer-sponsored retirement plans may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan.[231] These requirements include the following: the amount of the loan must not exceed the lesser of 50 percent of the participant's account balance or $50,000; the terms of the loan must provide for a repayment period of not more than five years[232] and provide for level amortization of loan payments (with payments not less frequently than quarterly); and the terms of the loan must be legally enforceable. The rules do not limit the number of loans an employee may obtain from a plan.

If a plan participant ceases to make payments on a loan before it is repaid according to the required schedule, a deemed distribution of the outstanding loan balance generally occurs. This deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. However, a deemed distribution is not eligible for rollover to another eligible retirement plan.

Loan offset amount

A plan may also provide that, in certain circumstances (for example, upon a participant's termination of employment with the employer), a participant's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in participant's account balance is offset by the amount attributable to the loan (the amount of the unpaid loan balance). In the case of a loan offset, an actual distribution equal to the unpaid loan balance (as opposed to a deemed distribution as described above) occurs, and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

Description of Proposal

S. 606, 113th Cong., sec. 2

Under the proposal, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs (meaning the taxable year in which such amount is treated as distributed by the plan). Under the proposal, a qualified plan loan offset amount is a plan loan offset amount which is treated as distributed from a tax-favored employer-sponsored retirement plan to a participant or beneficiary solely by reason of either the termination of the plan, or the failure to meet the repayment terms of the loan from such plan

[231] Sec. 72(p).

[232] Loans specifically for home purchases may be repaid over a longer period.

because of the separation from service of the participant (whether due to layoff, cessation of business, termination of employment, or otherwise). As under present law, a loan offset amount under the proposal is the amount by which a participant's accrued benefit under the plan is reduced to repay a loan from the plan.

S. 606, 113th Cong., sec. 4

Under the proposal, a plan loan that is made through the use of a credit card or similar arrangement does not meet the requirements for loan treatment and is therefore a deemed distribution.

3. Hardship distributions

Present Law

Elective deferrals under a section 401(k) plan may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee.[233] The amount allowed to be distributed on account of hardship is limited to the dollar amount of the employee's elective deferrals, reduced by the amount of elective deferrals previously distributed on account of hardship. Applicable Treasury regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.[234]

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective deferrals and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution. The same rules apply to hardship distributions of elective deferrals from section 403(b) plans.

Description of Proposals

S. 606, 113th Cong., sec. 3

The Secretary of the Treasury is directed to revise the applicable regulations within one year of the date of enactment to eliminate the requirement that an employee be prohibited from making elective deferrals and employee contributions for six months after the receipt of a hardship distribution in order for the distribution to be deemed necessary to satisfy an immediate and heavy financial need. It is intended that an employee not be prevented for any period after the receipt of a hardship distribution from continuing to make elective deferrals and employee contributions.

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[233] Sec. 401(k)(2)(B)(i)(IV).

[234] Treas. Reg. sec. 1.401(k)-1(d)(3).

<u>S. 1270, 113th Cong., sec. 214</u>

Under the proposal, in determining whether a distribution is made upon financial hardship of an employee, whether or not the employee makes contributions for any period after the distribution is not taken into account. The proposal thus overrides Treasury regulations requiring an employee to be prohibited from making contributions for any period after the receipt of a hardship distribution in order for the distribution to be deemed necessary to satisfy an immediate and heavy financial need.