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THE SIMPLIFIED EMPLOYEE PENSION: AN INCREASINGLY ATTRACTIVE ALTERNATIVE AMONG QUALIFIED RETIREMENT PLANS

by

RICHARD J. KOVACH*

INTRODUCTION

When Congress added subsection (k) to § 408 of the Internal Revenue Code, thus creating a new kind of qualified retirement plan based upon Individual Retirement Accounts,¹ it did so believing that other forms of qualified retirement plans had already become complicated enough to discourage implementation despite substantial tax attractions.² Congress predicated qualification upon a short set of rules compatible with the "do-it-yourself" IRA vehicle introduced in 1974 under ERISA.³ In so doing, Congress provided an alternative to the long and detailed set of rules under I.R.C. § 401(a), the formidable wasteland which must be traveled to attain (and retain) tax benefits for standard pension, profit sharing, and other popular retirement savings plans.

In one regard, creation of the simplified employee pension (SEP) as a retirement savings alternative actually added to the complexity faced by tax advisors and potential plan sponsors. Because the two distinct sets of rules under I.R.C. § 408 and 401(a) do not afford identical opportunities for plan design, a knowledgeable choice between the two can be exercised only after carefully weighing the complexities of the latter, under particular circumstances, against the relative loss of planning flexibility associated with the former.

In other words, choosing a simplified employee pension over more complicated retirement plans will result in easier plan administration, but only after a rather complicated planning decision has been made. This planning decision cannot be intelligently made without a full understanding of both the plan administration

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¹ Revenue Act of 1978, Pub. L. No. 95-600, § 152, 92 Stat. 2763 (1978). Subsequent textual and footnote references to the Internal Revenue Code will be expressed in the form "I.R.C. § _____."

² S. REP. No. 600, 95th Cong., 2d Sess. 92, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6791, 6855 states: "The committee is aware that many qualified pension plans have been terminated in the recent past, due, in part, to the complex and burdensome rules they are required to satisfy. The committee believes that these rules have also had the effect of retarding the introduction of new pension plans."

³ Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

complexities avoided and the plan design features (and potential cost savings) foregone as a result of implementing the simplified format. Furthermore, the planning decision may not constitute a one-time headache; the changing circumstances of a sponsoring employer may necessitate a reevaluation that could result in terminating the plan chosen and implementing a different kind of plan.⁴

Logically, the simplified employee pension will become an increasingly attractive choice as I.R.C. § 401(a) plans continue to be subjected to more complex and restrictive regulation,⁵ and as a growing number of plan sponsors view the perceived design advantages of more complicated plans as insignificant.⁶ Indeed, at some point, Congress may be urged to eliminate at least some forms of I.R.C. § 401(a) plans--perhaps all defined contribution plans--in a move towards ultimate simplification that will leave the simplified employee pension as the only practical alternative for employers who wish to promote tax-favored retirement savings.

Such a prospect might become more palatable if Congress were to implement a few more changes to I.R.C. § 408, directed toward a further narrowing of the current design and cost savings gaps between the SEP and I.R.C. 401(a) plans. The purpose of this Article is to comment upon these existing differences and suggest potential changes in the SEP legislative scheme that would encourage a widespread abandonment and possible legislative elimination of more complicated retirement plans.

Congress has already expressed a willingness to tinker with the SEP rules so as to broaden the simplified pension's appeal. Under the Tax Reform Act of 1986,⁷ the SEP scheme was amended to permit cash or deferred arrangements that serve as a limited alternative to I.R.C. § 401(k) plans.⁸ From a policy perspective favoring

⁴ Examples of such changing circumstances include a substantial reduction (or expansion) of an employer's workforce, an acceleration (or deceleration) of the employees' turnover rate, and the introduction (or cessation) of the collective bargaining process respecting retirement benefits.

⁵ At the time this article was written, pension practitioners were most notably struggling to understand the voluminous "Nondiscrimination Regulations" issued under I.R.C. § 401(a)(4)(1990). *Treas. Reg. § 1.401(a)(4)(1991)*.

⁶ Both public and professional attitudes toward tax complexity were explored in recent surveys conducted by The University of Akron Center for Taxation Studies. One survey, involving 601 members of the tax sections of the American Bar Association and the American Institute of Certified Public Accountants, indicated that fifty-five percent of its respondents thought that complexity of the Internal Revenue Code was an "extremely serious problem" for American government. Seventy-three percent of respondents believed that the Tax Reform Act of 1986, (Pub. No. 99-514, 100 Stat. 2085 (1986)), which significantly affected qualified retirement plans, had made tax law "a lot more complex", and sixty percent of respondents faced complaints about tax complexity from more than half of their client base. *UNIVERSITY OF AKRON CENTER FOR TAXATION STUDIES REPORT, COMPLEXITY AND COMPLIANCE CONSEQUENCES OF THE 1986 TAX REFORM ACT* 12, 13, and 20 (March, 1989).

⁷ Pub. L. No. 99-514, 100 Stat. 2085 (1986).

⁸ Unfortunately, I.R.C. § 408(k)(6)(B) (1990) disallows SEP cash or deferred arrangements if the employer has more than 25 eligible employees at a designated time. Consequently, employers having a greater number of employees are left to choose only an I.R.C. § 401(k) (1990) cash or deferred arrangement, which means that the plan must meet the complex requirements of both I.R.C. § 401(k) (1990) and I.R.C. § 401(a) (1990). *See* I.R.C. § 401(k)(1) (1990).

simplification of tax benefits, further changes to increase the attractiveness of simplified employee pensions should be encouraged.

Even if the SEP rules remain unaltered for the next several years, employers will want to continue questioning whether their retirement contribution objectives are best served by conventional plans that are increasingly more difficult to administer and keep tax-qualified.⁹ In effect, the SEP may become more attractive by default, as I.R.C. § 401(a) plans continue to become less attractive as a result of the overly complex legislative and regulatory tinkering to which they are subject. Practitioners should reconsider this point when reviewing each new change or interpretation of law affecting standard qualified retirement plans.

The discussion that follows is organized under headings reflecting the major plan design differences that distinguish the SEP from its more complicated alternatives.

PARTICIPATION STANDARDS

Participation standards for non-SEP retirement plans are set forth in I.R.C. §§ 401(a)(26) and 410. Those sections permit significant individually designed exclusions from participation through a complex interaction of a number of rules and subrules, including allowance for "statutory" exclusions based on age, length of service, and an employee's status as a nonresident alien or member of a collective bargaining unit.¹⁰ Three of these four designated categories of exclusion are fully incorporated into the SEP participation standards,¹¹ leaving the length of service criterion as a key distinction between the SEP and I.R.C. § 401(a) plans.

Whereas a simplified employee pension predicates participation upon performance of any service by an employee during at least three of the immediately preceding five calendar years,¹² I.R.C. § 410(a)(1)(A) permits a plan to require an employee to complete a "year of service," defined in I.R.C. § 410(a)(3) as 1000 hours of service, within a designated 12-month period, in order to be eligible to participate. Thus, no matter how long a worker has been employed, he or she can be excluded from participation in an I.R.C. § 401(a) plan as long as his or her status remains "part-time" within the 1000 hour standard. Part-time workers of an employer adopting a simplified employee pension can be excluded from the plan only in years during

⁹ Internal Revenue Service audit activity against qualified retirement plans can be extremely focused at times. Recently, the I.R.S. targeted 18,000 plans under its "small plan actuarial program." Robert Brauer, I.R.S. Assistant Commissioner for Employee Plans and Exempt Organizations, commented on April 3, 1990 respecting this program: "We have over 30 cases in litigation on those issues. Every case that has been completed has been resolved on terms highly favorable to the government." LEXIS, Tax Analysts, "Tax Notes Today," April 4, 1990.

¹⁰ I.R.C. § 410(a)(1), (b)(3)(A),(C) (1990).

¹¹ I.R.C. § 408(k)(2) (1990).

¹² I.R.C. § 408(k)(2)(B) (1990).

which their compensation is less than \$300,¹³ once the age and three-in-five years service requirement are met.

Since many I.R.C. § 401(a) plans rely only upon the "statutory" exclusions to define their participation requirements, any participation-related cost savings advantage of such plans over simplified employee pensions results solely from this disparate treatment of part-time employees. However, in particular cases, no such advantage can be automatically assumed, because part-time employees earning more than \$300 per year might nonetheless be excluded from a simplified employee pension if their duration of employment fails to meet the three-in-five years standard.¹⁴ To the extent part-time employees for a particular employer or in a particular industry tend to have a moderately frequent turnover rate, an employer's ability to exclude employees who work less than 1000 hours per year becomes less significant as a cost savings incentive for choosing a conventional retirement savings vehicle over a simplified employee pension.

Respecting employers who would achieve significant cost savings by excluding from participation employees who work fewer than 1000 hours per year, the SEP rules might easily be amended to provide relief, simply by increasing the \$300 base compensation limitation to some higher amount that permits more than a de minimis exclusion of part-time workers with longer durations of employment. For example, the compensation base could be expressed as a multiple of the minimum wage.¹⁵ In any event, the best way to address the disparate treatment of part-time workers via legislative changes to I.R.C. § 408(k) would be to focus on compensation earned, rather than to incorporate an hours of service standard into the SEP rules. The latter concept carries substantial regulatory baggage,¹⁶ while employers would undoubtedly find it easy to determine exclusions under a uniform definition of compensation.¹⁷

With respect to employer-designed exclusions now permitted for I.R.C.

¹³ I.R.C. § 408(k)(8) (1990) permits the \$300 amount to rise with inflation.

¹⁴ Of course, many businesses, such as restaurants, experience a high turnover rate among part-time employees, with the result that very few part-time employees will perform service for the employer throughout any three year period.

¹⁵ To illustrate, the dollar limitation could be expressed as 1000 times the current hourly minimum wage, which limitation would be consistent with the I.R.C. § 410(a)(3)(A) (1990) definition of a "year of service." Or, the limitation could be set at 500 times the current hourly minimum wage, making it consistent with the 500 hours definition of a "break in service" set forth in I.R.C. § 411(a)(6)(A) (1990) and I.R.C. § 410(a)(5)(C) § (1990).

¹⁶ A review of the voluminous computation of service regulations promulgated by the Department of Labor at 29 C.F.R. § 2530.200b-1-8 (1991) makes this point well.

¹⁷ The Internal Revenue Code contains a statutory definition of compensation at I.R.C. § 414(q)(7) (1990), which is applicable to the "highly compensated employee" concept generally defined in I.R.C. § 414(q) (1990) and used primarily for purposes of minimum coverage testing under I.R.C. § 410(b) (1990) and the prohibition of discrimination against rank and file employees expressed in I.R.C. § 401(a)(4) (1990). The definition also applies to the \$300 in compensation SEP participation standard by express reference in I.R.C. § 408(k)(2)(C) (1990).

§ 401(a) plans under I.R.C. § 410(b)(1), the SEP ostensibly suffers a distinct disadvantage. This is largely because many employers who have undertaken the complexities of the § 410(b)(1) rules would likely find that a switch to the SEP three-five years rule would substantially increase plan coverage and thus funding costs.¹⁸ Consequently, if the SEP is to have appeal for such employers, I.R.C. § 408(k) would have to be altered to permit at least some prospect for employer-designed participation exclusions.

The inherent complexities of the "average benefit percentage test" of I.R.C. § 410(b)(2) and the "line of business exception" of I.R.C. § 410(b)(5) make these provisions unlikely candidates for incorporation into the simplified employee pension rules.¹⁹ Between the two "safe harbor", mechanical coverage rules of I.R.C. § 410(b)(1), that contained in I.R.C. § 410(b)(1)(B),²⁰ if transferred into the SEP rules, would probably best serve the interests of employers who wish to preserve coverage design flexibility and avoid undue complexity, particularly if the SEP rules remained free from the onerous strictures of I.R.C. § 401(a)(26).²¹ This is because the employer can decide to eliminate certain highly compensated employees from coverage as a "leveraged" means to greatly reduce the number of rank and file employees who must be covered, thus, in many cases, permitting a qualified plan to cover only a fraction of the employer's workforce, if desired.²² In effect, the I.R.C.

¹⁸ For example, if an employer were using I.R.C. § 410(b)(1)(A) (1990), the simplest of the minimum coverage rules, to exclude from plan participation the employees of a particular division containing as many as thirty percent of the employer's otherwise eligible employees, switching to a simplified employee pension would create an obligation to cover any employee in such division who meets the I.R.C. § 408(k)(2) (1990) criteria. On the other hand, any employee otherwise covered under the seventy percent standard of I.R.C. § 410(b)(1)(A) (1990) who did not meet the I.R.C. § 408(k)(2) (1990) criteria could have been excluded from coverage under a simplified employee pension. This dual effect would have to be translated into a contributions cost differential in order to gauge the effect of such a hypothetical substitution of plans.

¹⁹ In addition to the "nondiscriminatory classification" concept mentioned hereafter and incorporated at I.R.C. § 410(b)(2)(A)(i) (1990) and I.R.C. § 410(b)(5)(B) (1990), these coverage provisions present other definitional problems, such as that associated with the "line of business" concept. The "line of business" concept was considered difficult enough that the conference report pertaining to I.R.C. § 410(b)(5) (1990) contained a detailed explanation of it, as well as multiple references to clarifying regulations to be promulgated by the Treasury Department. H. R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-523-526, reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4611-4614.

²⁰ I.R.C. § 410(b)(1)(B) (1990) permits a plan to cover only as many rank and file employees as constitute a percentage of all such employees equal to 70 percent of the percentage of highly compensated employees who are covered.

²¹ It might be argued that there would be less need to retain I.R.C. § 401(a)(26) (1990), which requires a plan to cover a minimum of 50 employees (or, if less, 40 percent of all nonexcludable employees), in the event that Congress would streamline the minimum coverage requirements by getting rid of those coverage standards that create the most potential for abuse, such as the "average benefit percentage test" of I.R.C. § 410(b)(2) (1990). The existence of I.R.C. § 401(a)(26) (1990) as a separate participation coverage test seems, in any event, to suggest that the coverage tests of I.R.C. § 401(b) (1990) are deficient. A better cure for such deficiency than retention of I.R.C. § 401(a)(26) (1990) would be to directly simplify the I.R.C. § 410(b) (1990) standards.

²² The virtue of I.R.C. § 410(b)(1)(B) (1990) is that it permits an employer to reduce coverage substantially, simply by excluding some of its highly compensated employees from plan coverage. Of course, any highly compensated employees thus sacrificed can be compensated handsomely outside the plan with additional bonuses or nonqualified plan contributions intended to make up for their exclusion from the employer's qualified plan.

§ 410(b)(1)(B) rule permits something like the limited coverage available under the complicated I.R.C. Section 410(b)(2) and (5) rules, but without the need to make the facts and circumstances determination of a proper "nondiscriminatory classification" required by these latter rules.²³

Although the "classification" concept permits employers to include a greater number of highly compensated employees in the designated coverage group than might otherwise be allowed under I.R.C. § 410(b)(1)(B), the uncertainty and complexity occasioned by the concept strongly favors its ultimate demise. By contrast, the I.R.C. § 410(b)(1)(B) rule is quite simple in its application, and from a policy perspective it could easily be altered to meet either a more liberal or more conservative view of the desirable coverage flexibility that should be accorded plan sponsors.²⁴ Properly incorporated into the SEP rules, the I.R.C. § 410(b)(1)(B) concept could greatly contribute to the obsolescence of I.R.C. § 410(a) plans respecting participation standards.

VESTING

Vesting as a cost savings mechanism for I.R.C. § 401(a) plans may already be greatly overrated as a result of the Tax Reform Act of 1986,²⁵ which substantially reduced permitted vesting schedules under I.R.C. § 411. In theory, accrued benefits forfeited by departing employees under vesting schedules constitute either offsets against employer contributions or, if employer contributions are left constant, augment the accrued benefits of plan participants who remain with the employer. In either case, the economic benefit of vesting forfeitures is dependent upon the extent and frequency of employee turnover.

Unfortunately, high employee turnover also invokes potential technical problems affecting a plan's qualified status. These problems include potential discrimination against rank and file employees under I.R.C. § 401(a)(4), partial terminations that require accelerated vesting for affected employees under I.R.C. § 411(d)(3), and difficulties in crediting service for reemployed plan participants under I.R.C. § 411(a)(6) and (7).²⁶ Thus, the cost savings associated with vesting schedules are

²³ The Treasury Department's latest attempt to define a nondiscriminatory classification is contained in Prop. Treas. Reg. § 1.410(b)-4, 54 Fed. Reg. 21, 437 (1989).

²⁴ For example, if Congress wished to provide for strictly proportionate coverage for rank and file employees, the 70 percent ratio could be increased to 100 percent. Thus, if an employer had an eligible workforce of ten highly compensated employees and ninety rank and file employees, it could avoid plan coverage for forty-five of the rank and file employees by excluding five highly compensated employees from coverage. Under I.R.C. § 410(b)(1)(B) (1990) as it now exists, eliminating five highly compensated employees would permit exclusion of fifty-eight rank and file employees. However, I.R.C. § 401(a)(26) (1990) would require that the plan cover at least forty employees altogether.

²⁵ Pub. L. No. 99-514, 100 Stat. 2085 (1986).

²⁶ For a detailed discussion of these problems see Kovach, *Qualified Retirement Plans for Small Businesses: An Evaluation of the Utility of Vesting Schedules After the Tax Reform Act of 1986*, 93 Dick. L. Rev. 497 (1989).

achieved by encountering a great deal of regulatory complexity and some risk of exposure to loss of a plan's special tax benefits.

These problems do not affect a simplified employee pension, because I.R.C. § 408(k)(1) defines the SEP as an employee's Individual Retirement Account, and I.R.C. § 408 (a)(4) requires that an interest in an Individual Retirement Account be nonforfeitable. No doubt this feature should not be altered, since introducing vesting rules into the SEP would not be consistent with keeping it "simple." But if the SEP were to supplant existing I.R.C. § 401(a) defined contribution plans, many plan sponsors would nonetheless lament the loss of vesting schedules, believing that, cost savings aside, vesting promotes a personnel policy of rewarding extended service while discouraging deleterious employee turnover.

A response to this concern might be twofold: First, permitted vesting schedules under current law are already so short (three, five, six, or at most, seven years)²⁷ that significant rewards via vesting for truly long and faithful service are simply unavailable in any event. Second, probationary employees not destined to become members of an employer's long term workforce are likely to terminate service after only a few months of employment in many industries. The three-in-five years participation standard of I.R.C. § 408(k)(2)(B), left intact, would be more than sufficient to prevent such employees from sharing in employer contributions in any event. Many employees who would meet the three-in-five years test and become eligible to share in employer contributions under a simplified employee pension would also eventually accumulate sufficient service to achieve full or substantial vesting under currently permitted vesting schedules. The fact that some employees might terminate service after working three years for an employer--but prior to earning the years of service necessary for substantial vesting under currently permitted schedules--hardly seems sufficient to justify retention of inordinately complicated vesting rules under a revised SEP scheme.

DEDUCTION/CONTRIBUTION LIMITATIONS

For some plan sponsors, a key economic disparity between the simplified employee pension and I.R.C. § 401(a) defined contribution plans results from the more restrictive limitation on employer contributions applicable to the SEP. Under I.R.C. § 404(h), the amount deductible in a taxable year for a simplified employee pension cannot exceed 15 percent of the total compensation paid to participating employees. Moreover, I.R.C. § 402(h) provides that contributions made on behalf of any one employee cannot exceed the lesser of 15 percent of the employee's compensation or the I.R.C. § 415(c)(1)(A) limitation, a base amount set at \$30,000.²⁸

²⁷ I.R.C. 411(a)(2) (1990) and I.R.C. § 416(b)(1) (1990).

²⁸ Under I.R.C. § 415(c)(1)(A) (1990) and I.R.C. § 415(d) (1990), the \$30,000 amount will rise with inflation.

I.R.C. § 415(c)(1)(A) and (B) set contribution limitations for conventional defined contribution plans as the lesser of the \$30,000 “dollar” limit or 25 percent of the participant’s compensation. This creates a potential 10 percent disparity that, when considered with the I.R.C. § 404 deduction limitations applicable to conventional defined contribution plans, applies to profit sharing and stock bonus plans, as well as simplified employee pensions, but not to money purchase pension plans.²⁹

Interestingly, this distinction among I.R.C. § 401(a) defined contribution plan formats has meant that plan sponsors wishing to make deductible contributions that take advantage of the I.R.C. § 415(c)(1)(B) 25 percent limitation must implement a money purchase pension plan either in addition to or in lieu of a profit sharing or stock bonus plan. This predicament has contributed much additional complexity to the process of retirement savings planning and administration, because a money purchase pension plan is subject to rules and restrictions beyond those applicable to profit sharing or stock bonus plans.³⁰ In many cases, the sponsoring employer adopts and maintains two plans as a result of the 10 percent disparity between contribution and deduction limitations, although only one plan is desired.³¹

Simplified employee pensions, because of their 15 percent of compensation limitations, share this problem with profit sharing and stock bonus plans. If the SEP rules were altered to permit employer contributions and corresponding deductions up to the lesser of 25 percent of compensation or \$30,000 per participant, employers and plan participants could realize full tax benefits consistent with the I.R.C. § 415(c)(1) limitation in the most efficient and uncomplicated manner. If the SEP rules were amended in conjunction with a statutory elimination of I.R.C. § 401(a) defined contribution plans, simply altering the I.R.C. § 415(c)(1) limitation could address any concerns about potential revenue losses resulting from increased use of qualified plans. For example, the percentage component of the limitation could be reduced from 25 percent to 20 percent, the inflation adjustment for the \$30,000 “dollar” component could be retarded, or the full 25 percent of compensation contribution allocation allowance could be predicated upon attainment of a certain age and/or fulfillment of other conditions.³²

²⁹ I.R.C. § 404(a)(3)(A)(i) (1990) sets the deduction limit for stock bonus and profit sharing plans, but not money purchase pension plans, at 15 percent of the participants’ compensation.

³⁰ For example, because it is a “pension plan”, a money purchase pension plan must provide for fixed contributions not geared to the employer’s profits. Treas. Reg. § 1.401-1(b)(1)(i) (1990).

³¹ An employer, usually a professional having few employees, wishing to contribute and deduct the maximum amount in some but not all years may need both a profit sharing plan that permits contribution discretion up to 15 percent of compensation and a money purchase plan to increase contributions up to the 25 percent of compensation limit allowed by I.R.C. § 415(c)(1)(B) (1990). The contribution to the money purchase pension plan remains fixed, but the profit sharing plan contribution can drop to zero if the employer does not wish to effect maximum funding in a particular year.

³² For example, participants nearing retirement age who have only a limited number of years of “active” participation in qualified retirement plans could be given a higher I.R.C. § 415 percentage limitation in order to permit “catch-up” contributions. Cf., I.R.C. § 415(c)(4)(B) and (C) (1990), which permit special “catch-up” elections for tax-sheltered annuity holders eligible for the tax benefits available under I.R.C. § 403(b) (1990).

Because of the manner in which the I.R.C. § 415(c)(1) limitation is expressed, the 10 percent gap between its percentage component and the 15 percent deduction limitations for simplified employee pensions, profit sharing plans, and stock bonus plans becomes insignificant with regard to persons whose compensation is high enough to invoke the "dollar" component of the limitation.³³ Consequently, closing the 10 percent gap may be of little interest to plan sponsors operating under current rules whose key personnel earn substantial compensations. Likewise, plan sponsors who would in no event contribute more than 15 percent of their participants' compensation are not directly affected by this issue. Absent a change in the SEP rules, those who would otherwise find a simplified employee pension attractive but are concerned about this issue can proceed like plan sponsors attracted to profit sharing plans: they can maximize contributions and deductions by adopting a second (I.R.C. § 401(a)) qualified plan.³⁴ For the most part, however, the appeal of the SEP would be greatly enhanced, thus avoiding much complexity, if its deduction limits were directly coordinated with the I.R.C. § 415(c)(1) limitation.

DISCRIMINATION FAVORING HIGHLY COMPENSATED EMPLOYEES

Perhaps the concept generating the most complexity in the implementation and administration of qualified retirement plans is the notion that contributions and benefits must not inordinately favor highly compensated employees.³⁵ For conventional plans, the concept pervades various plan features, including coverage criteria, vesting schedules, contribution and benefit allocations, distribution options, and virtually any flexibly applied right designed into a plan.³⁶

As previously discussed, simplified employee pensions avoid complex non-discrimination determinations pertaining to participation and vesting standards, because coverage limitations are precisely defined and vesting schedules are not permitted.³⁷ However, I.R.C. § 408(k)(3) expresses a nondiscrimination rule analogous to that of I.R.C. § 401(a)(4), except that the SEP formulation specifically states that contributions must "bear a uniform relationship to the compensation (not in excess of the first \$200,000) of each employee maintaining a simplified employee

³³ The "dollar" limitation (\$30,000) takes the place of the "percentage limitation" (25 percent of compensation) once a participant's compensation exceeds \$120,000 under I.R.C. § 415(c)(1) (1990) as of the time of this writing. At \$200,000 of compensation the "dollar" limitation equals 15 percent of compensation.

³⁴ Under I.R.C. § 415(f)(1)(B) (1990) multiple defined contribution plans are treated as one plan for purposes of applying the I.R.C. § 415(c) (1990) limitation. I.R.C. § 415(k)(1) (1990) treats both I.R.C. § 401(a) (1990) and I.R.C. § 408 (1990) vehicles as "defined contribution plans." Thus, an employer with a simplified employee pension could increase contributions and deductions by implementing any other I.R.C. § 401(a) (1990) plan, including a profit sharing plan as well as a money purchase pension plan.

³⁵ The notion is expressed generally in I.R.C. § 401(a)(4) (1990) and particularized respecting participation coverage in I.R.C. § 410(b) (1990).

³⁶ See Treas. Reg. § 1.401(a)(4)-0 (1990) for a table of contents that provides a succinct outline of the various problems primarily associated with the nondiscrimination concept.

³⁷ I.R.C. § 408(k)(2) (1990) and I.R.C. § 408(a)(4) (1990).

pension.’’³⁸ In effect, this stricture requires that contributions by an employer be allocated among the participants’ Individual Retirement Accounts using the same percentage of compensation. This is a methodology that has always been allowed for conventional retirement plans by virtue of I.R.C. § 401(a)(5)(B) and its predecessor provisions.

Accordingly, simplified employee pensions cannot allocate contributions using such methodologies as point systems, which often skew contribution allocations beyond strict compensation proportionality by giving credit for age, duration of service, and other characteristics that vary greatly in most workforces.³⁹ Of course, this loss of plan design flexibility is of no consequence to the majority of employers with conventional plans who, given the choice, have foregone the rigors of constant monitoring for discriminatory effect, in favor of the simplicity and basic fairness of allocating contributions strictly according to compensation earned.⁴⁰ Consistent with this observation, there appears to be little reason why a legislative restructuring of the SEP rules, even if accompanied by elimination of popular forms of conventional defined contribution plans, should not retain the requirement that contribution allocations be made uniformly according to the proportionate compensations of plan participants.

In one important regard, the SEP rules already reflect a desirable adaptation from I.R.C. § 401(a) respecting a traditional accommodation for highly compensated employees under the nondiscrimination concept. I.R.C. § 408(k)(3)(D) specifically incorporates by reference I.R.C. § 401(l)(2), which permits so-called “Social Security integration” for conventional I.R.C. § 401(a) defined contribution plans. The rules recognizing an employer’s regressive contributions to the Social Security system, by allowing a moderate skewing of plan contributions in favor of highly compensated employees, are uniformly applicable to simplified employee pensions, as well as other kinds of qualified plans. Thus, the SEP is equally “competitive” with I.R.C. § 401(a) plans on this point, and no benefit perceived to result from “Social Security integration” would be lost if conventional defined contribution plans were statutorily eliminated.

Simplified employee pensions dispense with one troublesome facet of the nondiscrimination concept not connected with plan allocations of contributions. Some conventional plans contain provisions that create a variety of distribution

³⁸ I.R.C. § 408(k)(3)(C) (1990).

³⁹ See *Auner v. United States*, 440 F.2d 516 (7th Cir. 1971), wherein the employer’s point system for allocating plan contributions led to the plan’s disqualification for tax purposes.

⁴⁰ Presumably, if the attainment of age, length of service, education levels, and other criteria used in point allocation systems are virtues to be rewarded, they should already be reflected in direct compensation levels and thus are indirectly accounted for in contribution allocations uniformly based on proportionate compensation. There may be little reason to further reward such attainments via allocations in deferred compensation plans, at the expense of much complexity and the potential loss of a plan’s qualification status, if the same effect can be more easily accomplished by manipulating raises, bonuses, and the like.

options exercisable by participants, or distribution alternatives under the discretionary control of the plan sponsor. If these distribution features are found to operate to the disadvantage of rank and file participants, a plan can have its qualified status questioned under the general nondiscrimination rule of I.R.C. § 401(a)(4).⁴¹ The SEP avoids this problem because the I.R.C. § 408 individual retirement accounts used in simplified employee pensions leave the issue of distributions timing and method entirely to the discretion of the plan participants, sparing the employer from potentially discriminatory applications.

CONTROL OVER PLAN ASSETS

Actually, an employer choosing to sponsor a simplified employee pension loses most ministerial control over plan assets, not just control over the timing and method of distributions. Under I.R.C. § 408(a)(2), the trustee for each individual retirement account established in conjunction with a simplified employee pension must be a bank "or such other person who demonstrates to the satisfaction of the Secretary [of the Treasury] that the manner in which such other person will administer the trust will be consistent with the requirements of [I.R.C. § 408]."⁴² This rule makes it impractical for a simplified employee pension to use other than an institutional trustee. Consequently, the widespread practice of employers sponsoring I.R.C. § 401(a) plans who name themselves or a key employee (often the employer's principal owner) as trustee cannot exist under the SEP scheme.

In the event conventional defined contribution plans were to be statutorily eliminated, retention of this rule would certainly create a boon for institutional trustees. Fortunately, however, such circumstance would also remove many employers and key employees from exposure to potential prohibited transactions violations under I.R.C. § 4975 and its ERISA counterpart.⁴³ Sometimes it is difficult for employers or key employees who serve as trustee for small plans, in particular, to appreciate that the assets so held are not simply another resource available for business or (worse) personal use by those in control. Persons who might have difficulty with this proposition likely do not have a good understanding of the fiduciary obligations imposed upon trustees by ERISA § 404.⁴⁴

Pension policy makers and commentators who have expressed concern about

⁴¹ See Treas. Reg. § 1.401(a)(4)-4 (1991).

⁴² A nonbank trustee of an IRA must demonstrate to the Internal Revenue Service that it has sufficient continuity, an established place of business, fiduciary experience, fiduciary responsibility, and financial responsibility. Treas. Reg. § 1.408-2(b)(2)(ii) (1990) [incorporating by reference Treas. Reg. § 1.401-12(n)(3) (1990)].

⁴³ Of course, institutional trustees can still engage in prohibited transactions and violations of fiduciary responsibility. However, they tend to be less subject to conflicts of interest and incentives for self-dealing than persons who own the entity that makes contributions to a qualified plan or persons who have an accrued benefit under the plan.

⁴⁴ Pub. L. No. 93-406, 88 Stat. 829 (1974).

“letting the rabbits guard the lettuce” under the conventional retirement plan scheme might welcome universal application of the IRA/SEP rule respecting trustee selection.⁴⁵ Retirement plan sponsors who might argue that mandatory surrender to institutional trustees of control over plan assets would promote certain institutional investment biases to the detriment of asset growth and/or stability should be reminded that a great variety of institutional trustees for IRAs have, since 1974,⁴⁶ competed for such funds. These institutions include not just banks, but brokerage houses, insurance companies, and an array of investment fund enterprises. Undoubtedly all basic investment philosophies -- from stodgily conservative to creatively aggressive -- are available to IRA/SEP investors, who, as individual account holders, can freely change trustees.⁴⁷

Now that individual retirement accounts have existed for the better part of two decades, one somewhat minor but frustrating problem resulting from the exclusive use of institutional trustees should be addressed, even if the current SEP scheme is not legislatively altered. This problem involves the difficulty some IRA holders experience in effecting IRA transfers, especially direct trustee-to-trustee transfers.⁴⁸

To be sure, some IRA trustees find it convenient to delay and even discourage such transfers. With respect to small accounts, the trustee's focus may be on the administrative burden of the transfer. Respecting large accounts, the trustee may, of course, be more concerned about its loss of substantial revenues otherwise generated from the assets invested with it. In either case, the IRA customer might benefit from a penalty-enforced rule that would require any IRA trustee to make a prompt transfer or distribution upon request. Such a rule could be added to the growing group of federal tax provisions designed to protect and assist the taxpayer, rather than the Treasury.⁴⁹ By imposing a nondeductible penalty upon IRA trustees who fail to effect a transfer or distribution pursuant to a written request within a designated number of days following receipt of such request, all IRA holders, including participants in simplified employee pensions, would be protected against

⁴⁵ Some might observe, in view of the recent savings and loan financial disasters, that institutional “rabbits” can be as difficult to restrain as employers and key employees.

⁴⁶ Individual retirement accounts were introduced in the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

⁴⁷ Would a substantial increase in the number of participants having this freedom to change trustees jeopardize the security of inordinately large amounts of pension assets? Absent a clear showing that individual employees would be less adept at choosing trustees and sound investments than their employers, there would seem to be no good reason to protect participants from themselves, any more than we now protect them from their employers who control trustee and investment selection under I.R.C. § 401(a) (1990) plans.

⁴⁸ IRA funds can also be transferred without taxation to a new trustee indirectly, via a “rollover” involving a distribution to the account holder and a redepositing with the new trustee within sixty days. Unfortunately, I.R.C. § 408(d)(3)(B) (1990) permits only one such rollover per year. This rule could be altered to permit more frequent use of the IRA “rollover” in the event the SEP scheme were to be expanded.

⁴⁹ See e.g., see the voluminous set of rules under I.R.C. § 6103 (1990) designed to protect taxpayers against breaches of confidentiality in the handling of tax information.

inordinate delays in placing their funds with new institutions.⁵⁰ In particular, such a rule would be a "fair price" for institutional trustees to "pay" if the SEP were to be given statutory preference over conventional defined contribution plans, because institutional trustees would have a greatly expanded market.

INVESTMENT RESTRICTIONS

Portions of I.R.C. § 408 impose restrictions limiting the application of funds held under a simplified employee pension that do not apply to conventional I.R.C. § 401(a) plans. The latter plans, to begin with, can receive contributions in kind, whereas an IRA created under a simplified employee pension can receive contributions only in cash.⁵¹ Some modification of this rule would have to occur if the SEP were to become the only statutory alternative for qualified defined contribution plans, in order to accommodate employee stock ownership plans⁵² and stock bonus plans both of which are designed to receive direct contributions of securities issued by the sponsoring employer.

Another portion of I.R.C. § 408 that currently affects the manner in which assets are held under a simplified employee pension could just as well be extended to all qualified defined contribution plans. Under I.R.C. § 408(m), investments in "collectibles"⁵³ are treated as (taxable) distributions from an IRA. Certainly the volatility associated with markets in collectibles, and the potential for self dealing resulting from the personal appeal of collectibles, would continue to provide strong sentiment for the preservation of this rule,⁵⁴ even if the statutory role of simplified employee pensions were to be expanded. Indeed, if the SEP were to become the only defined contribution vehicle for retirement savings, Congress might well consider further restrictions on the kinds of investments that properly belong in a qualified retirement plan. Presumably, after nearly two decades of viewing questionable plan investments made in arguable violation of the fiduciary standards imposed by ERISA,⁵⁵ the Department of Labor would now be in a position to suggest that certain kinds of plan investments tend to invite trouble or otherwise promote loss of

⁵⁰ Currently, trustee delays in transferring funds must be addressed under the somewhat vague concepts of fiduciary duty imposed on trustees by ERISA. See Section 404 of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

⁵¹ I.R.C. § 408(a)(1) (1990).

⁵² See I.R.C. § 4975(e)(7) (1990).

⁵³ "Collectible" is defined to include certain specific items, like antiques or gems, but is also defined openly to include "any other tangible personal property specified by the Secretary [of the Treasury] for purposes of this subsection." I.R.C. § 408(m)(2)(F) (1990).

⁵⁴ This sentiment was not strong enough to prevent a recent amendment permitting an exception to the "collectibles" definition for certain domestically minted gold coins. I.R.C. § 408(m)(3) (1990).

⁵⁵ Aside from exercising general prudence in the selection of plan asset investments, investments chosen by a fiduciary must be diversified "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." Section 404(a)(1)(C) of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 88 Stat. 829 (1974).

retirement income security.⁵⁶ In any event, a shift to a qualified plan scheme embracing widespread individually-directed investment choices would invite a serious look at potential statutory protections (as I.R.C. § 408(m) may now be regarded) that promote long term investment stability.

One other rule of I.R.C. § 408 that directly affects how plan contributions are invested is the direct prohibition against investing trust funds in life insurance contracts.⁵⁷ The prospect for doing so under conventional I.R.C. § 401(a) plans has generated some measure of administrative complexity that is avoided under the SEP scheme. Life insurance agents know that business persons who would not otherwise purchase additional (or any) life insurance will frequently do so indirectly, through qualified I.R.C. § 401(a) retirement plans, because premiums can thereby be paid with deductible dollars.⁵⁸

Unfortunately, the purchase of life insurance contracts by I.R.C. § 401(a) plan trustees creates a conceptual difficulty that pits the primary purpose of life insurance--providing death benefits to surviving beneficiaries--against the primary purpose of qualified plans--retirement income security during the remaining life of ex-workers. Thus, the Internal Revenue Service has issued authorities designed to limit the use of life insurance in view of this conflict.⁵⁹ Ignoring the limitations thus imposed creates another regulatory threat to a conventional plan's qualified status.⁶⁰

Furthermore, the existence of life insurance in qualified plans can lead to much confusion respecting the distributions taxation consequences of such under relatively esoteric provisions of I.R.C. § 72.⁶¹ Other income tax complications resulting from life insurance coverage under qualified plans also affect the immediate tax posture of plan participants.⁶² Overall, it is likely that insurance agents would be

⁵⁶ One could cynically speculate that generally the kinds of investments that cause the greatest difficulty are those involving the highest sales commissions for their promoters.

⁵⁷ I.R.C. § 408(a)(3) (1990).

⁵⁸ The plan participant is currently taxed on the cost of life insurance protection provided under a qualified plan. I.R.C. § 72(m)(3)(B) (1990). The amount taxed, however, is rather favorably determined under the so-called "P.S. 58" rules set forth in Rev. Rul. 55-747, 1955-2 C.B. 228.

⁵⁹ In general, the cost of ordinary life insurance contracts purchased for a participant under a qualified defined contribution plan must be less than one-half the aggregate of contributions allocated to the participant at any particular time. Rev. Rul. 66-143, 1966-1 C.B. 79.

⁶⁰ Disqualification of a plan implemented under I.R.C. 401(a) (1990) can potentially affect the tax posture of all of the plan's participants, including many persons totally innocent of the acts or omissions that caused the disqualification. I.R.C. § 402(b) (1990). Under the SEP scheme, if life insurance were purchased with the funds accrued for just one participant, only that participant would have an adverse tax consequence, since only his or her IRA would be disqualified under I.R.C. § 408(a)(3) (1990). This is another point in favor of the statutory elimination of conventional defined contribution plans.

⁶¹ For example, under I.R.C. § 72(m)(3)(C) (1990) the death of an insured participant necessitates an allocation of the insurance proceeds between taxable (the cash surrender value of the contract) and nontaxable portions.

⁶² See *supra* note 58.

more upset than would plan administrators by the prospect of a universal application of the IRA/SEP prohibition against life insurance contracts.

Ironically, because of their sponsorship of investment funds, insurance companies do generate some business from IRA placements, although their primary product, life insurance, is excluded from IRA holdings. Thus, as competitors for the widened institutional trustee market that would result from an elimination of I.R.C. § 401(a) plans, insurance companies might better tolerate their losing a direct market for life insurance contracts now purchased in I.R.C. § 401(a) defined contribution plans.

Even if one were to accept the general proposition that life insurance, by its very nature, should be prohibited from use in qualified plans, such a view would not necessarily be incompatible with the assertion that life insurance is important enough to merit expansion of tax benefits when used *outside* qualified retirement plans. In other words, in the event the SEP scheme were to be mandatorily expanded, with the prohibition against life insurance left intact, the best way to placate the insurance lobby might be to liberalize some of the provisions, such as I.R.C. § 79,⁶³ that currently restrict the tax benefits accorded life insurance in other contexts.

REGULATION OF DISTRIBUTIONS

As previously mentioned, the I.R.C. § 408(k)(4)(B) requirement that there be no employer-imposed prohibition against employee withdrawals under a simplified employee pension eliminates discrimination problems associated with an employer's control over the timing and method of making distributions under I.R.C. § 401(a) plans. In addition, this feature of the SEP scheme eliminates qualification problems related to an employer's selection of distribution *events*. Conventional defined contribution pension plans, profit sharing plans, and cash or deferred arrangements under I.R.C. Section 401(k) all have distinct qualification criteria that prevent distributions not occasioned by a "proper" occurrence.⁶⁴ In particular, the definition of "hardship" relevant to an in-service distribution from an I.R.C. § 401(k) plan has generated a considerable amount of technical complexity⁶⁵ not experienced under a simplified employee pension cash or deferred arrangement.⁶⁶

⁶³ The I.R.C. § 79 (1990) \$50,000 limitation on the tax-favored use of group term life insurance may be long ripe for adjustment in any event. \$500,000 might well be a more reasonable limitation in view of the considerable inflation that has occurred since I.R.C. § 79 (1990) was enacted.

⁶⁴ See Treas. Reg. § 1.401-1(b)(1)(i) (1990), Rev. Rul. 71-295, 1971-2 C.B. 184, and I.R.C. § 401(k)(2)(B) (1990), respectively.

⁶⁵ See Treas. Reg. § 1.401(k)-1(d)(2) (1990).

⁶⁶ Under I.R.C. § 408(k)(6) (1990), which creates the simplified employee pension version of a cash or deferred arrangement, no parallel to I.R.C. § 401(k)(2)(B) (1990) exists, because a simplified employee pension consists of individual retirement accounts established directly for plan participants who are permitted to effect distributions at will under I.R.C. § 408 (1990).

If the SEP scheme were to be the only statutory choice for defined contribution plans, should it be altered to impose distributions restrictions relating to qualifying occurrences? One statutory mechanism already in place that discourages premature distributions from conventional plans and IRA/SEP arrangements alike is the 10 percent penalty on early distributions imposed by I.R.C. § 72(t).⁶⁷ Obviously, raising the penalty tax thus imposed from 10 percent would further ensure that qualified plans not be used for short term deferrals contrary to the basic retirement savings concept promoted under such plans. Additional qualification-oriented definitions of distribution events are probably both unnecessary and undesirable in view of the relative simplicity⁶⁸ of the I.R.C. § 72(t) approach, and its focus on penalizing only offending parties without consequences to other participants.⁶⁹

Expanding SEP usage would raise other interesting policy issues not so easily addressed. Since 1974, I.R.C. § 401(a) plans have incorporated progressively complex rules⁷⁰ pertaining to the general requirement that a joint and survivor or pre-retirement survivor annuity be provided as a distribution feature in order to protect the surviving spouses of deceased participants. These rules have not yet found their way into I.R.C. § 408, but might readily be considered for inclusion in a simplified employee pension scheme designed to supplant conventional defined contribution plans. Of course, the goals of simplicity and ease of administration are not compatible with the survivorship rules. Certainly, those who would advocate the social policy underlying the survivorship rules should be called upon to suggest ways to simplify those rules in the event of their adoption into the SEP scheme.⁷¹

Yet another distributions-related policy consideration that should precede a widespread expansion of SEP usage pertains to participant loans. I.R.C. § 408(e)(2) and (4) create a calamitous tax result for any owner of an individual retirement account who borrows money from the account or pledges the account as security for a loan.⁷² Although participant loans have always been popular under conventional

⁶⁷ Actually, "early", as used in the heading for I.R.C. § 72(t) (1990), is somewhat of a misnomer, because penalty-free distributions can be made at any age, depending upon the circumstances. For example, under I.R.C. § 72(t)(2)(A)(iv) (1990), casting a distribution in the form of qualifying equal periodic payments can prevent imposition of the 10 percent penalty no matter what age the distributee has attained.

⁶⁸ I.R.C. § 72(t) (1990) itself might be streamlined to eliminate any definitional difficulties, such as that arising from the penalty exception of I.R.C. § 72(t)(2)(A)(iii) (1990) pertaining to distributions resulting from disability. Compare I.R.C. § 72(m)(7) (1990) and Treas. Reg. § 1.72-17A(F) (1990) with the Social Security definition of "disability" found in 42 U.S.C. § 423(d) (1988). Disability determinations made under Social Security administration could be used for I.R.C. § 72(t) (1990) purposes if the I.R.C. § 72(m)(7) (1990) definition were wholly conformed with the Social Security definition.

⁶⁹ See *supra* note 60, regarding the general desirability of the SEP scheme in contrast to the I.R.C. § 401(a) (1990) qualification criteria approach, which can result in penalizing innocent participants.

⁷⁰ I.R.C. § 401(a)(11) (1990) and I.R.C. § 417 (1990).

⁷¹ For example, a rule could be devised that requires a distributee from an IRA to submit to the trustee a signed, standardized spousal consent form containing a stipulated warning to the effect that certain forms of distributions may ultimately affect the signatory spouse's own retirement income security.

⁷² The entire account loses its "exemption" from taxation, otherwise available under I.R.C. § 408(e)(1) (1990), if the account holder engages in any prohibited transaction set forth in I.R.C. 4975 (1990). I.R.C.

plans, they have generated an inordinate amount of regulatory complexity under federal tax laws,⁷³ as well as other state and federal laws that govern lending practices.⁷⁴ Fundamentally, borrowing from qualified retirement plan assets to accommodate pre-retirement economic advantages or exigencies is at odds with the basic purpose of providing retirement income security. At the very least, such a practice jeopardizes retirement savings to the extent of the participant's prospects for default of repayment.⁷⁵ Consequently, retention of the IRA/SEP bias against participant loans should be deemed appropriate under an altered statutory scheme that supplants conventional defined contribution plans with the SEP.⁷⁶

Finally, retention of special tax treatment for qualifying lump sum distributions, now accorded I.R.C. § 401(a) plans under I.R.C. § 402(e), would have to be considered under an expanded SEP scheme. Currently, this tax benefit is not available respecting distributions from an IRA/SEP.⁷⁷ Over the years, Congress has experimented with capital gains treatment, ten-year averaging, and now five-year averaging as techniques to mitigate the tax bunching effect of lump sum distributions from conventional retirement plans. After numerous interpretive rulings from the I.R.S. pertaining to the definitional criteria of a qualifying lump sum distribution,⁷⁸ as well as legislative attempts to "grandfather" abandoned techniques,⁷⁹ we are left with yet another complicated set of revenue rules. These frequently require a computational tax benefit analysis, because even if a distribution qualifies as a Code-defined lump sum distribution, the distributee must decide whether the permitted income averaging actually offers a tax benefit in view of the distributee's particular tax posture.⁸⁰

§ 4975(c)(1)(B) (1990) makes a direct loan between an IRA and its holder, who would meet the definition of a "disqualified person" under I.R.C. § 4972(e)(2) (1990), a prohibited transaction. Under I.R.C. § 408(e)(4) (1990) pledging the account as security for a loan from a non-IRA source results only in treating the amount pledged as a taxable distribution.

⁷³ See I.R.C. § 72(p), in particular.

⁷⁴ For a detailed discussion of the various regulatory complexities of participant loans from qualified retirement plans, see Kovach, *A Perspective on Participant Loan Provisions in Qualified Retirement Plans After the 1986 Tax Act*, 4 AKRON TAX J. 129 (1987).

⁷⁵ Additionally, default of repayment creates adverse tax consequences for the participant who has secured the loan with his or her accrued benefit, because the trustee's cancellation of the accrued benefit upon a declaration of default creates a taxable distribution to the participant under I.R.C. § 402. (1990)

⁷⁶ Elimination of participant loans could create problems for cash or deferred arrangements, because loan programs are often included in such plans to induce rank and file employees to elect deferrals that, in turn, permit highly compensated employees to take advantage of the plan without invoking discrimination sanctions. See I.R.C. § 401(k)(3) (1990). Apparently, some rank and file employees will elect deferrals only if the money set aside can be "made available" indirectly via a loan program. Perhaps this problem could be resolved simply by liberalizing the deferral ratio test of I.R.C. § 408(k)(6)(A)(iii) (1990) to permit highly compensated employees to effect reasonable deferrals without the necessity of using a complicated loan program as a "gimmick" to induce levels of participation that would not otherwise occur.

⁷⁷ I.R.C. § 402(e)(5)(A) (1990) does not refer to I.R.C. § 408 arrangements.

⁷⁸ For example, the I.R.S. has struggled with the definition of "separation from service" as used in I.R.C. 402(e)(4)(A)(iii) (1990). Rev. Rul. 63-22, 1963-1 C.B. 88; Rev. Rul. 69-647, 1969-2 C.B. 100; Rev. Rul. 81-26, 1981-1 C.B. 200.

⁷⁹ Tax Reform Act of 1986, 1122(h), Pub. L. No. 99-514, 100 Stat. 2085 (1986).

⁸⁰ Because the tax on lump sum distributions is a "separate tax" according to I.R.C. § 402(e)(1)(A) (1990),

The complexity stemming from the I.R.C. § 402(e) treatment of lump sum distributions may, once again, be a good reason not to incorporate a lump sum distributions preference into an expanded SEP scheme, especially in view of the anomaly that I.R.C. § 402(e) does not universally produce a tax benefit, even for distributees of relatively modest economic means.⁸¹ Furthermore, because the lump sum distribution tax treatment ostensibly offers at least marginal tax relief in many instances, it may encourage full distribution of pension assets to the detriment of ultimate retirement income security. Assets in excess of current needs left in a retirement savings vehicle in order to avoid standard taxation are, perhaps, less likely to be squandered.

MISCELLANEOUS CONSIDERATIONS

Retirement income security can be affected by any potential exposure of plan assets to a participant's creditors. Thus, conventional retirement plans have been given at least partial protection against such creditors under I.R.C. § 401(a)(13), a provision not paralleled in the IRA/SEP scheme.⁸² "Partial protection" is a preferred description for two reasons. First, I.R.C. § 401(a)(13) itself and Treasury Regulations promulgated thereunder contain certain exceptions to the general prohibition against alienation of plan assets, including rights in favor of former spouses⁸³ and the Internal Revenue Service.⁸⁴ Second, I.R.C. § 401(a)(13) is frequently ignored in bankruptcy proceedings involving a plan participant, because the policies supporting the federal bankruptcy law often clash with those behind the prohibition against alienation of plan assets.⁸⁵

Perhaps it is appropriate that I.R.C. § 401(a)(13) protects a plan participant against general creditors best when the participant is solvent and most likely to have the ability to satisfy creditors out of non-plan assets. In such event, creditors may not be able to use bankruptcy law to seize plan assets, the plan trustee will rebuff collection attempts against those assets under the direct authority of I.R.C. § 401(a)(13), and presumably creditors are left to pursue their interests against whatever assets the debtor-participant might own outside the qualified retirement plan. However, if the

distributees having recognizable losses in a particular taxable year may want to refrain from electing such special treatment and include a lump sum distribution into their regular gross income in order to "absorb" such losses.

⁸¹ A distributee under an I.R.C. § 401(a) (1990) plan may wish to forego a reduced tax available under I.R.C. 402(e) (1990), in favor of effecting a "rollover" to another qualified plan or IRA under I.R.C. § 402(a)(5) (1990), thereby incurring no immediate tax at all on the distribution.

⁸² I.R.C. § 408 only discourages a voluntary assignment in favor of creditors, and does not address involuntary assignments effected under state law attachment procedures. I.R.C. § 408(e)(4) (1990).

⁸³ See I.R.C. § 401(a)(13)(B) (1990) and the I.R.C. § 414(p) (1990) definition of "qualified domestic relations order."

⁸⁴ Treas. Reg. § 1.401(a)-13(b)(2) (1990).

⁸⁵ See generally Seiden, *The Bankruptcy Code and ERISA: Do They Conflict as to Whether a Debtor's Interest in or Rights Under a Qualified Plan Can Be Used to Satisfy Claims and Expenses?*, 3 BANKR. DEV. J. 1 (1986).

debtor-participant is insolvent, he or she will likely be drawn into a bankruptcy proceeding, whereby plan assets will be put in jeopardy⁸⁶ as a result of financial conditions that make the ultimate building of retirement income security questionable.⁸⁷ Regardless of one's philosophical view of this process,⁸⁸ there appears to be no good reason why retirement assets accumulated under the IRA/SEP scheme should be treated differently, since the purpose of such accumulations is precisely the same as for conventional I.R.C. § 401(a) plans. Consequently, an expanded role for the SEP might well suggest creation of a statutory protection similar to that of I.R.C. § 401(a)(13) so that creditors of solvent participants will likewise be forced to exhaust non-plan assets without directly pursuing assets set aside as qualified retirement savings.⁸⁹ Indeed, a revised statutory expression of the sentiment now expressed in I.R.C. § 401(a)(13) might even attempt a clarifying coordination with the federal bankruptcy rules. Such a move might parallel the manner in which the "domestic relations orders" rules were added to I.R.C. § 401(a)(13) to clarify the relationship between the general prohibition against alienation and the power of state domestic relations courts to effect an equitable disposition of the marital estate.⁹⁰

Another prospect for inquiry under an expanded SEP scheme is suggested by the treatment of employee-derived contributions made under I.R.C. § 401(a) plans. Respecting such contributions made under cash or deferred arrangements, I.R.C. § 408(k)(6) would have to be amended to permit unrestricted access to the SEP "salary reduction" feature if the SEP were to be made totally competitive with, or supplant, cash or deferred arrangements now permitted under I.R.C. § 401(k).⁹¹ With respect to employee-derived contributions not made under cash or deferred arrangements, the complex nondiscrimination tests of I.R.C. Section 401(m) might best be avoided under a modified SEP scheme by retaining limitations against such contributions.⁹² Under the I.R.C. Section 408 rules, the holder of an IRA cannot

⁸⁶ In particular, "self-settled" plans under the participant's direct control are subject to inclusion in a bankrupt's estate. *In re Goff*, 706 F.2d 574 (5th Cir. 1983).

⁸⁷ The Bankruptcy Code does contain its own limited exemption for qualified plan *payments* made "on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor". 11 U.S.C. § 522(d)(10)(E) (1988). However, even the subsistence standard suggested by this exemption would not assist a younger participant not yet in or near pay status under a plan.

⁸⁸ The view that plan assets should become part of a bankrupt's estate *and* be made available to one's creditors outside bankruptcy proceedings supports keeping the SEP scheme free of restraints now applicable only to conventional plans under I.R.C. § 401(a)(13) (1990). This is consistent with tax simplification, but inconsistent with the notion that retirement savings in qualified vehicles ought to be specially protected against a participant's own financial follies.

⁸⁹ Should the Internal Revenue Service also be limited in this manner when pursuing unpaid taxes owed by a plan participant? If so, we will need a statutory override of treasury regulations (Treas. Reg. § 1.401(a)-13(b)(2) (1990)) permitting the I.R.S. to do otherwise.

⁹⁰ Because such situations involve conflicts of existing law, adding statutory clarification might well result in overall simplification rather than the usual complexity that results from the addition of new qualification features.

⁹¹ See I.R.C. § 408(k)(6)(A) and (B) (1990).

⁹² Under I.R.C. § 401(m) (1990) large employee contributions from highly compensated employees can create a prohibited discrimination against rank and file participants.

directly contribute to it more than \$2,000,⁹³ an amount likely insufficient to invite nondiscrimination regulation attempts, even if simplified employee pensions were to be greatly expanded in usage.⁹⁴ Perhaps allowing the \$2,000 limit to be increased gradually under an inflation adjustment clause⁹⁵ would, under a revised SEP scheme, assist in placating those who might lament the loss of the employee contribution features now enjoyed under conventional retirement plans while avoiding a complex nondiscrimination rule like that now contained in I.R.C. § 401(m).

At least two other concepts associated with I.R.C. § 401(a) plans should be considered with regard to an expanded SEP scheme. The most hallowed of these is the "exclusive benefit" rule,⁹⁶ which, like the nondiscrimination concept, is simultaneously widespread in its potential applications and somewhat vague. Presumably, the rule has less potential application under the IRA/SEP scheme than for conventional retirement plans, because an IRA is under the exclusive and joint control of the plan participant and an institutional trustee. This circumstance affords employers fewer opportunities to use plan assets for purposes extraneous to the direct benefit of the IRA holder. However, one area of regulation developed under the exclusive benefit rule pertains to the return of employer contributions erroneously made, and this problem can potentially arise under a simplified employee pension as well as under conventional plans. Accordingly, rules like those set forth in Revenue Ruling 77-200⁹⁷ ought to be applied to simplified employee pensions even though promulgated under I.R.C. § 401(a)(2).

The other concept to consider from I.R.C. § 401(a) plans is a provision from Treasury regulations⁹⁸ that requires a profit sharing plan to be sustained with "recurring and substantial" contributions in order to retain its qualified status. A simplified employee pension operates much like a profit sharing plan, in that the employer has year-to-year discretion to determine whether and to what extent contributions will be made.⁹⁹ But under the "recurring and substantial" rule, contributions that are too infrequent or too small will jeopardize the plan's qualified status. If the simplified employee pension were to become the dominantly used defined contribution plan, adoption of this rule into the SEP statutory or regulatory

⁹³ I.R.C. § 408(a)(1) (1990).

⁹⁴ The deductibility of individual contributions to an IRA is governed by I.R.C. § 219 (1990), which, if left intact under an expanded SEP scheme, would continue to prevent deductions for such contributions in any year in which the individual was an "active participant" in a simplified employee pension. I.R.C. § 219(g)(5)(A)(v) (1990).

⁹⁵ Inflation adjustment clauses are quite equitable when an Internal Revenue Code limitation is expressed as a flat dollar amount. Yet, Congress can still easily use such devices to control revenue losses by simply "freezing" the adjustments for designated periods under the provisions of future revenue acts.

⁹⁶ I.R.C. § 401(a)(2) (1990) states generally that a conventional qualified plan must contain assets held only for the benefit of plan participants and their beneficiaries. Similarly, I.R.C. § 408(a) (1990) states that an IRA must exist "for the exclusive benefit of an individual or his beneficiaries".

⁹⁷ 1977-1 C.B. 98. The ruling permits an employer to retrieve plan contributions, subject to procedural conditions, if such are made by reason of a mistake or fact or certain "mistakes of law."

⁹⁸ Treas. Reg. § 1.401-1(b)(2) (1990).

⁹⁹ *Id.*

structure would surely tend to encourage SEP sponsors to make somewhat regular contributions to their plans. Unfortunately, however, the "recurring and substantial" rule as it now exists is simply another amorphous "facts and circumstances" concept that leaves employers guessing as to their contributory obligations. For this reason, it might be hoped that such a rule adopted into the SEP scheme would be expressed in a form that leaves no doubt as to its potential application.¹⁰⁰

CONCLUSION

As new and complex regulations projects continue to be issued, and audit activity respecting qualified retirement plans intensifies,¹⁰¹ plan sponsors may increasingly assume the view that creativity and flexibility in compensation planning should be directed more toward direct compensation, and less toward qualified deferred compensation. Because SEP plans, like I.R.C. § 401(a) plans, permit plan contributions for any particular participant to be directly proportionate to that participant's current salary or wages, the cost of such contributions can be indirectly controlled by tinkering with direct compensation, without the need to implement an unduly complicated retirement plan.¹⁰² Consequently, even if the SEP is not statutorily improved, current and prospective plan sponsors must continue to ask whether a complex retirement plan is really needed to effect their desired *overall* compensation policies. Retirement system planners should not simply assume that the participation, vesting, and other highly regulated features of conventional plans have substantial economic value in all events. A careful analysis of these features as applied to a particular workforce should always precede a rejection of the SEP alternative.

Most interesting, however, are the possibilities for amending the SEP scheme to make it even more competitive with conventional qualified plans. Both the public and practitioners are starting to express great dismay over the increasing complexity of the federal tax system.¹⁰³ An economic process as basic and important as preparation for retirement income security should be accorded both substantial tax benefits *and* ease of implementation and administration. As a general proposition, there is no compelling reason why employers who choose a simplified retirement plan format should not be able to get at least as good a package of tax benefits as those who choose much more complicated vehicles. Amendments to the SEP statutory structure directed toward tax benefit parity with conventional plans would be most welcome.

¹⁰⁰ For example, "recurring and substantial" could be defined as an average contribution of 3 percent of participants' compensation in three out of any five years.

¹⁰¹ See *supra* note 9.

¹⁰² An employer's discretion in selectively awarding bonuses and raises offers a much less complicated means of implementing basic personnel policies intended to enhance employee loyalty, morale, and productivity.

¹⁰³ See *supra* note 6.

Ultimately, the simplified employee pension could remain as the only qualified format for defined contribution plans;¹⁰⁴ however, amendments directed toward that result should be sparingly made in order to meet the goal of offering qualified plans that are indeed "simple." Qualified retirement plans cannot continue to exist in a regulatory climate that threatens to approximate that of "tax shelters" prior to the 1986 Tax Act.¹⁰⁵ When employers commit contributions to such plans, they should be reasonably assured that the tax mechanics will work as expected.

In the event Congress were to move toward the statutory elimination of at least some kinds of I.R.C. § 401(a) plans, procedures should be developed to facilitate the conversion of such plans into simplified employee pensions. Perhaps the normal I.R.S. review process for plan terminations and mergers¹⁰⁶ could be modified to "grandfather" the qualified status of conventional plans up to their date of conversion to the SEP format. If conventional plans having a reasonably recent determination letter could be converted without substantial further inquiry into operational defects that might have arisen since their last determination date, plan sponsors would be encouraged to effect prompt and efficient conversions and asset transfers.¹⁰⁷ In this manner, existing plans, as well as those implemented anew, could enjoy relief from the burdens of I.R.C. § 401.

¹⁰⁴ Perhaps the simplified employee pension could eventually replace even defined benefit plans, but the technical problems in doing so are beyond the scope of this article.

¹⁰⁵ At times it seemed that tax opinions offered with many investment prospectuses during the heyday of tax shelters contained so much "boilerplate" that they basically stated only that the shelter would work if the investor was not audited. Are we now approaching this condition respecting qualified retirement plans? If so, we should hope that the remedy to the situation is easier to swallow than the I.R.C. § 469 (1990) remedy devised for tax shelters.

¹⁰⁶ See Internal Revenue Service Form 5310.

¹⁰⁷ As practitioners are aware, merely obtaining a favorable determination letter from the I.R.S. does not assure that a retirement plan will retain its qualification. Operational violations of the I.R.C. § 401(a) (1990) rules can begin almost immediately thereafter, and, in any event, new rules affecting a plan's qualification status are promulgated with an alarming frequency.