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PLAN CONSOLIDATION: OPPORTUNITIES TO SIMPLIFY AS WELL AS RISKS OF CREATING COMPLEXITY AND BURDENS FOR GOVERNMENT, <u>EDUCATIONAL, CHURCH, AND NONPROFIT PLANS</u>

In recent years, some have suggested consolidating the different types of workplace retirement savings plans that now exist. These proposals have been offered largely as a means of reducing the complexity of the current retirement tax system. Reducing complexity is a goal we all share. To the extent we can reduce complexity, we help empower participants to achieve outcomes that will enhance their retirement security.

Consolidating retirement savings plans might appear at first glance to be an obvious choice for reducing complexity. Unfortunately, on closer review, it is clear that plan consolidation would actually create substantial complexity and burdens for the government, church, educational, and nonprofit employers that voluntarily offer retirement savings plans, and add further complexity for the employees who participate in these plans.

Others have suggested that instead of consolidating retirement savings plans, the rules for the different types of plans should be "streamlined" to be more uniform. As discussed further below, some forms of streamlining would be very problematic, while other forms could be very helpful.

Consolidation of Plans: Creating Complexity, not Reducing It.

Currently, there are several different types of retirement savings plans. Most common is the 401(k) plan, which generally may be maintained by any employer. Certain nonprofit organizations and public educational institutions may maintain 403(b) plans. State and local governments sponsor 457(b) and grandfathered 401(k) plans. Because the plans are similar, many have proposed "simplifying" the Code by replacing 403(b) plans, governmental 457(b) plans, and 401(k) plans with a single type of plan with one set of rules.[1] But despite many similarities, there are also a number of important differences among plan types – differences that Congress intended to address unique characteristics of workers in the governmental, church, educational, and nonprofit sectors. For example:

- **Exempt from early distribution tax.** Participants in governmental 457(b) plans are not subject to the 10% early distribution tax that generally applies to retirement plan distributions received before age 59 ½. Penalty-free early distributions from 457(b) plans can be critical in helping government early retirees bridge the income gap before pension or Social Security benefits are available, particularly first responders who retire early and, in many cases, are transitioning to new careers. Moreover, the exemption from the early distribution tax can be a prominent factor in enabling government employees to contribute – knowing that they can get the money without penalty if they need it. Generally, they do not need it, but knowing that the penalty will not apply is very helpful.
- **Catch-up contributions.** Because employees of nonprofits, churches, and governments—who are eligible to participate in 403(b) and/or 457(b) plans—are often paid less than those working in the private for-profit sector, they frequently cannot afford to save as much early in their career. Accordingly, the rules governing 403(b) and 457(b) plans allow special "catch-up" contributions by older employees, enabling them to make up for years when they were contributing less.
- **Right to buy pension credit.** Participants in certain 403(b) and 457(b) plans have special options to purchase service credit under a governmental defined benefit plan (in addition to the options available to participants in 401(k) plans). These options provide important portability for employees who over their careers provide services to multiple nonprofit, church, and/or governmental entities.
- **Different nondiscrimination testing rules.** Governmental 457(b), 401(k), and 403(b) plans are exempt from nondiscrimination testing rules. That is because public oversight of governments already ensures fairness with respect to benefits. Section 403(b) plans maintained by churches and qualified church-controlled organizations are similarly exempt to prevent excessive government entanglement in religion and avoid an undue compliance burden on small, nonprofit organizations. Meanwhile, 403(b) plans maintained by other nonprofit organizations (including those maintained by non-qualified church-controlled organizations) are subject to different nondiscrimination testing rules that reflect their unique workforce characteristics.
- **Protection for governmental 457(b) plans.** Unlike non-governmental plans, a governmental 457(b) plan cannot be disqualified for operational failures unless (1) the IRS provides the employer with notice of the operational failure, and (2) the employer fails to correct the failure. This reflects appropriate federal deference to state and local governments.
- **Special annual addition limits for church 403(b) plans.** Because church employees and missionaries may have little or no taxable income due to very low compensation, church 403(b)

[1] Some of the proposals go further and would eliminate SIMPLEs and SEPs, which are generally savings plans designed for small businesses. This paper only focuses on 401(k)/403(b)/457(b) consolidation.

plans provide a special annual addition limit of $10,000 per year (subject to a lifetime maximum of $40,000), regardless of the beneficiary's taxable income. This provides clergy, lay workers, and missionaries with an opportunity to save for retirement notwithstanding their low taxable income.

- **<u>Self-annuitization feature for church 403(b)(9) plans.</u>** IRS regulations permit sponsors of church defined contribution 403(b)(9) plans to "self-annuitize" benefits, providing valuable flexibility and stability through lifetime retirement income, at lower cost to participants than purchasing annuities from a commercial issuer. In addition, these regulations permit annuity reserve assets to be invested in accordance with the faith tradition and beliefs of the sponsoring religious denomination.
- **<u>Definition of compensation.</u>** The limits on contributions under the different types of plans are based in part on a participant's compensation. For this purpose, compensation is defined slightly differently with respect to 403(b) plans. The differences are attributable to special rules that should be retained, such as the ability to treat former employees as having compensation for five years (Code section 403(b)(3)), and the treatment of ministers (Code section 414(e)(5)(B)). From a policy perspective, there is no reason to harm either ministers or former employees of charities, churches or public schools who may need additional retirement savings.
- **<u>Direct contributions by self-employed clergy.</u>** Certain chaplains and self-employed ministers are authorized to make direct contributions to a church plan. Contributions to a 403(b)(9) plan are deductible by the minister under section 404(a)(10). This is a valuable retirement savings option for ministers who might otherwise lack the opportunity to participate in a church plan.
- **<u>Flexible investment options for church plans.</u>** Church 403(b)(9) plans offer broad latitude for denominational benefits boards (or their investment committees, which are typically composed of individuals with substantial investment expertise) to offer an array of investment alternatives beyond annuity contracts and mutual funds, such as pooled investments in stocks, bonds, collective investment funds and other prudent options that benefit from lower fees and economies of scale. Church 403(b)(9) plans are constitutionally permitted to consider faith-based screens in making their investments.

<u>Effects of Consolidation.</u>

On the surface, consolidating similar types of plans would appear to simplify the Internal Revenue Code. But on closer examination, consolidation does exactly the opposite and would have especially detrimental effects on governmental 457(b) plans and 403(b) plans if the consolidated plan structure is largely based on the 401(k) structure.

<u>Greater complexity produces new plan costs and confusion.</u> There are thousands of 403(b) and governmental 457(b) plans in existence today covering millions of employees of nonprofits, governments, and churches. For these millions of employees and thousands of employers, plan consolidation provides no simplification. <u>On the contrary, changes in the rules governing their retirement security will require the creation and maintenance of a new type of plan, and will inevitably lead to substantial confusion and increased cost</u> for both plan sponsors and plan participants. The confusion would be even more significant prior to regulations—which could be years away—that implement the new rules.

Maintaining a new type of plan is far from simple or inexpensive:

- New administrative systems will be needed, with substantial technological costs;
- Employers and employees will need education regarding the new plan;
- Legal and compliance costs will rise sharply as employers and providers struggle with new rules, posing a special burden to churches and other small nonprofit organizations; and
- Many of these plans will need to work through difficult state law compliance challenges that arise whenever a public plan is modified.

The most significant impact of creating new layers of complexity is on participant retirement security outcomes. Behavioral science research shows us that the greater the complexity, the greater the likelihood that employees disengage and fail to take action. This produces risks of lower savings, investment errors, and ultimately poorer outcomes with respect to the most fundamental objective of these plans – to support Americans in achieving retirement income security.

Transition costs and challenges. Moreover, the mechanics of the consolidation will create a new set of problems. For example, if distributions from governmental 457(b) plans become subject to the 10% early distribution penalty, will existing account balances be grandfathered? If the answer is yes, the maintenance of separate accounting for the grandfathered accounts will be burdensome and complex, especially in cases of partial distributions. On the other hand, failing to grandfather existing account balances would almost certainly be viewed by employees as unfair, as employees had contributed under one set of rules and expectations, and those rules would be changed after the fact.

Associated complexities abound. For instance: what about older employees who counted on making the special 403(b) or 457(b) catch-up contributions? Will they be grandfathered so that employers have to administer two sets of rules for different employees? If so, the grandfather should apply to employees who move from one nonprofit to another or from one government employer to another, but applying that rule would be exceedingly complex. If the employees are not grandfathered, that again would likely be viewed as unfair.

Helpful Ways to Streamline the Rules for the Different Types of Plans.

As noted above, certain simplifications can be achieved without consolidation. Key examples of such simplifications are set forth below.

Withdrawal rules. Different withdrawal rules apply to the different types of plans. For example, in-service distributions from 401(k) and 403(b) plans may be made upon attainment of age 59 ½ or the occurrence of a hardship, while 457(b) requires attainment of age 70 ½ or an unforeseeable emergency.

Proposal. The rules could be made uniform by conforming all of the rules to the 401(k) withdrawal rules. This was done in section 305 of bills introduced in 2005 by then Representatives Rob Portman (R-OH) (H.R. 1960) and Ben Cardin (D-MD) (H.R. 1961).

457(b) deferral elections. Code section 457(b)(4) requires employee deferral elections to be made prior to the beginning of the month in which the deferred compensation would be paid. On the other hand, 401(k) deferral elections can be made at any time before the compensation is payable. So for compensation payable on September 30, for example, a deferral election under 457(b) must be made by August 31, whereas a deferral election under 401(k) could be made any time up to September 29 (subject to the employer's advance notice rules).

Proposal. As in the 2005 Portman and Cardin bills referenced above, the 457(b) rules could be conformed to the 401(k) rules. See section 407 of both bills (though these provisions would need to be updated to reflect changes in the law since 2005). See also section 411 of H.R. 2117 introduced by Representative Neal (D-MA) in the 113th Congress ("Neal bill").

E-delivery. Under the three types of plans, use of electronic media to provide required disclosures to participants is subject to different and out of date standards.

- **ERISA standards.** For 401(k) and 403(b) plans subject to ERISA, regulations issued in 2002 (before the advent of smartphones, for example) govern disclosures under DOL's jurisdiction. Under

those out-of-date regulations, for example, an employee's use of electronic media to communicate with his or her employer alone is not enough to permit the employer to furnish disclosures electronically if those communications are not an integral part of the employee's job.

- **IRS standards.** The IRS electronic delivery standards, which were adopted in 2006, apply to all three types of plans with respect to disclosure rules under the IRS's jurisdiction. Thus, most 401(k) plans and many 403(b) plans are subject to two sets of different out of date rules – DOL's rules with respect to some disclosures and IRS's rules with respect to other disclosures. Also, like DOL's rules, despite the enormous changes in electronic delivery of information over the last 10 years, including the explosion of hand-held devices used to access links and websites, the IRS standards have not been updated.

Proposal. Great progress has been made in bipartisan House and Senate bills toward modernizing and streamlining the electronic delivery rules. Please see H.R. 2656, introduced in 2015 by Representatives Jared Polis (D-CO), Phil Roe (R-TN), Ron Kind (D-WI), and Mike Kelly (R-PA), and S. 3417, introduced in 2016 by Senator Sherrod Brown (D-OH) and Senator Mike Enzi (R-WY). Very generally, the bills create uniform up to date rules for electronic disclosures under both ERISA and the Code, subject to clear safeguards protecting participants' right to receive paper.

Uniform portability rules. Currently, certain portability rules treat plans and IRAs differently, creating both unnecessary complexity and a bias in favor of IRAs, instead of a level playing field that allows individuals to choose the retirement vehicle that best serves their needs. Specifically, a non-spouse beneficiary may directly roll his or her plan benefits to an IRA (as a beneficiary), but not to another plan (as a beneficiary).

In addition, current law permits pre-tax IRA amounts to be rolled to a plan, but does not permit Roth IRA money to be rolled to a plan. This difference also creates complexity and adversely affects participants' ability to consolidate their accounts in the retirement vehicle that works best for them.

Proposal. The portability rules would be made more uniform by permitting non-spouse beneficiaries to directly roll their plan benefits to another plan (as a beneficiary). Please see in this regard section 410 of the Neal bill. In addition, Roth IRA amounts would be permitted to be rolled to plans.

Uniform RMD rules.

- Under current law, the required minimum distribution ("RMD") rules do not apply to Roth IRAs until after the death of the IRA owner. But the pre-death RMD rules do apply to Roth accounts held in all types of plans.
- In addition, plans do not have the same exclusion from income for charitable distributions up to $100,000 as IRAs do under Code section 408(d)(8).
- Moreover, spousal beneficiaries may elect to treat a deceased IRA owner's account as their own for RMD purposes, but may not do the same for an inherited retirement plan account.

Again, these differences create complexity and create tax incentives to roll plan assets to IRAs, as opposed to letting participants choose the vehicle best suited to their needs.

Proposal. The RMD rules would be made more uniform by extending (1) the Roth IRA treatment to Roth plan accounts, (2) charitable distribution options to plans, and (3) spousal IRA beneficiary rules to inherited plan accounts. In the case of the charitable distribution and inherited plan account proposals, no plan would be required to offer these features, but plans would be permitted to do so.

Consolidation of redundant notices. Over the years, layers of additional disclosure requirements have been imposed on plans. None of the disclosures in isolation raises issues, but in the aggregate, there is tremendous overlap among the notices, creating an unhelpful situation where plans are burdened by unnecessary costs (many of which are passed on to participants) and participants are so overloaded with information that many stop reading any of it.

Proposal. There is bipartisan support for directing Treasury and DOL to consolidate a series of overlapping notices required to be provided to participants under the rules regarding nondiscrimination safe harbors, automatic enrollment arrangements, fee disclosure, and default investments. See section 222(a) of S. 1270 introduced by Senator Hatch (R-UT) in the 113th Congress and section 408 of the Neal bill.

Harmful Streamlining Proposals

The differences among the plans highlighted in the bullets on pages 1-3 of this document were enacted to reflect the unique nature of the workforces of churches, charities, public schools, and state and local governments. Eliminating those differences to achieve uniformity would create participant confusion, be viewed as unfair, and create real risks of undermining retirement savings and retirement income security for those employees doing such important work for these critical institutions.