



July 17, 2017

The Honorable Orrin G. Hatch, Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: AICPA Tax Reform Proposals on Savings and Investments

Dear Chairman Hatch:

The American Institute of CPAs (AICPA) applauds the leadership taken by the Senate Committee on Finance on comprehensive tax reform. We recognize the tremendous effort required to analyze the current complexities in the tax law, examine policy trade-offs, and consider the various reform options. This letter on the taxation of savings and investments, is submitted in response to your request of June 16, 2017, for comments and recommendations from stakeholders, regarding comprehensive tax reform. In addition to this letter, we are submitting separate letters on the following areas of tax:

- Business Income Tax
- Individuals, Families, and Tax Administration
- International Tax System

The AICPA is a long-time advocate for an efficient and effective tax system based on principles of good tax policy.¹ We need a tax system that is administrable, stimulates economic growth, has minimal compliance costs, and allow taxpayers to understand their tax obligations. These features of a tax system are achievable if principles of good tax policy are considered in the design of the system.

In the interest of good tax policy and effective tax administration, we respectfully submit comments on the following key issues related to employer-sponsored retirement plans and individual retirement accounts (IRAs):

1. Limit the Number of Employee Contributory Retirement Plans
2. Eliminate the Top-Heavy Rules
3. Create a Uniform Rule Regarding the Determination of Investment in the Contract for Retirement Distributions
4. Create a Uniform Attribution Rule
5. Create a Uniform Definition of Owners

¹ AICPA, "[Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," January 2017.

6. Change the Required Minimum Distribution Rules
7. Create Uniform Rules for Early Withdrawal Penalties
8. Modify the Hardship Withdrawal Rules
9. Mitigate Penalties Related to Automatic Enrollment Requirements

Simplify the Different Types of Retirement Plans

The AICPA urges Congress to consider simplification of the confusing array of employer-sponsored retirement savings options. The Internal Revenue Code (IRC) provides for more than a dozen tax-favored, employer-sponsored retirement planning vehicles (e.g., simplified employee pension (SEP) plan, savings incentive match plan for employees of small employers (SIMPLE IRA), savings incentive match plan for employees of small employers (SIMPLE- 401(k) plan, profit sharing plan, employee stock ownership plan (ESOP), money purchase pension plan, 401(k) plan, 403(b) contract or custodial arrangement, 457(b) plan, 415(m) plan, target benefit plan, defined benefit plan, cash balance plan and other hybrid plans, variable annuity plans, and defined benefit 401(k) combination plans). Each plan type is subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, availability of loans, portability, nondiscrimination, reporting and disclosure, which causes unnecessary complexity and confusion.

Taxpayers appreciate the opportunity to fund retirement plan accounts and save current tax dollars, the benefits of which are used as a main source of income for many individuals during their retirement years. Employer-sponsored retirement plans are the most important means to assist employees in achieving retirement goals. Taxpayers can make larger contributions to employer-sponsored plans than to IRAs or Roth IRAs. While it is not mandatory for employers to offer retirement benefits to their employees, there are powerful incentives for them (e.g., current deductions, tax deferred or tax-free accumulation of earnings for retirement plan contributions). Because tax-preferred retirement plans are a large source of retirement savings for many workers, it is important that the rules governing them are as simple as possible.

We encourage Congress to consider the following measures to simplify the operation of retirement plans:

1. Limit the Number of Employee Contributory Retirement Plans

The AICPA suggests that Congress limit the number of contributory retirement plans. Currently, there are four employee contributory retirement plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers. A suggested approach is to eliminate SIMPLE IRAs and amend the rules of SEPs to allow for salary reduction contributions, as previously permitted. In addition, Congress could eliminate the SIMPLE 401(k) plan because while the fees are similar to that of a 401(k) plan, the 401(k) plan is favored since it is more flexible.

2. Eliminate the Top-Heavy Rules

We propose eliminating the top-heavy rules because they constrain the adoption of 401(k) plans and other qualified retirement plans by small employers. Since the top-heavy rules were enacted in 1982, there have been a number of statutory changes which have made the need for separate top-heavy rules unnecessary. The existing discrimination rules for retirement plans ensure that non-highly compensated employees receive nondiscriminatory benefits such that the top-heavy rules often do not increase benefits in a meaningful way. In addition, the annual contribution limitations ensure that no employee's benefits are excessive.

The sole remaining top-heavy rule is a required minimum contribution or benefit. The determination of top-heavy status is difficult and the required 3 percent minimum contribution is often made for safe harbor 401(k) plans. Thus, the top-heavy rules often deter small businesses from adopting qualified retirement plans, including non-safe harbor 401(k) plans.

3. Create a Uniform Rule Regarding the Determination of Investment in the Contract for Retirement Distributions

The AICPA recommends that Congress create a uniform rule for determining the amount of investment in the contract for retirement plan distributions to allow for the distribution of nontaxable amounts first. Currently, depending on the plan type, there are different methodologies used to determine the investment in the contract in a distribution. For example, in a Roth IRA or Roth 401(k) plan, after-tax contributions are distributed first while in a traditional IRA or 401(k) plan, investment in the contract is distributed pro-rata. The creation of a uniform rule would simplify the determination of the amount of a distribution that is taxable. Many employees have very little investment in the contract in retirement plans. A rule allowing the immediate recovery of that amount would simplify the taxation of distributions and make it more likely that such investment in the contract is recovered.

4. Create a Uniform Attribution Rule

We encourage Congress to use section 267(b)² as the rule of attribution for qualified retirement plans. Currently, the rules of attribution are governed by different sections of the IRC and each has slight subtleties that are used for different purposes; for example:

- The attribution rules in section 267(c)(4) are used in determining who is a disqualified person for purposes of partnerships and trusts under the prohibited transaction rules.
- The attribution rules in section 318 are used for the determination of key employee status.

² All references herein to "section" or "§" are to Internal Revenue Code of 1986 (Code), as amended, or the Treasury Regulations promulgated thereunder.

We recommend using the section 267(b) rule since it is easier to apply and in many cases broader than the more complicated section 318 rules.

5. Create a Uniform Definition of Owners

We recommend that Congress use a consistent definition of owner and suggest using the highly compensated definition for defining key employees, if the top-heavy rules are not eliminated. Currently, there are different definitions for section 414(q) “highly compensated employee” and section 416 “key employee.” A defining factor in determining if someone is a highly compensated employee is if he or she is a 5 percent owner, which is further defined as an individual with a direct or indirect ownership interest of more than 5 percent. The ownership rules governing who is considered a key employee also use the 5 percent ownership rule, but also consider persons with compensation of \$150,000 who own directly or indirectly more than 1 percent, effectively expanding the definition to 1 percent owners.

6. Change the Required Minimum Distribution Rules

We recommend that Congress require minimum distributions only from retirement accounts greater than \$500,000 and only after the account holder attains the age of 80. Currently, account holders must begin taking withdrawals by April 1st following the attainment of age 70 ½, with the exception of 5 percent owners in employer-sponsored plans.

We suggest changing the age at which participants are required to begin taking distributions from 70 ½ to 80 since life expectancy has increased since these rules were adopted. An increase in the age requirement will provide incentive for retirement plan account holders to save longer which will help retirement savings to last over longer lives.

7. Create Uniform Rules for Early Withdrawal Penalties

The AICPA requests that Congress standardize the rules for the early distribution of retirement funds. Different rules govern penalties related to the early distribution of retirement funds depending on whether an account is an IRA or an employer-sponsored retirement plan. Generally, a taxpayer who has not attained age 59 ½ and who withdraws funds from their 401(k) plan, IRA, Roth IRA or 403(b) contract is subject to a 10 percent excise tax on the amount withdrawn or some portion thereof. However, various exceptions apply (e.g., there is no 10 percent excise tax on the distribution of funds used for higher education expenses, first-time homebuyer distributions, or distributions for medical insurance for unemployed persons with respect to an IRA). These exceptions do not apply to qualified plan distributions. Thus, while a participant in a qualified plan can roll over an amount received to an IRA to take advantage of the exceptions, there is no exception for amounts directly distributed from a qualified plan. The exceptions should apply without the need for a rollover contribution. The Internal Revenue Service (IRS) should issue regulations to allow an employer to rely on an employee’s representation as to whether a penalty applies.

8. Modify the Hardship Withdrawal Rules

The AICPA recommends that Congress expand the hardship withdrawal rules related to qualified defined contribution retirement plans. Currently, a qualified retirement plan may allow for certain hardship distributions for plan participants provided that the amount of the distribution meets an immediate and heavy financial need and is limited to the amount necessary to satisfy the financial need. In general, a plan may allow a plan participant to take a hardship distribution based either on facts and circumstances, or on the related regulatory safe harbor provisions.

Expanding the hardship withdrawal rules will encourage more Americans to begin saving for retirement or increase the amount that they save because they will have broader access to the funds in the case of a financial emergency.

We recommend the following modifications to the hardship distribution rules:

- Allow a plan participant to withdraw both contributions (including all employee and employer contributions) and earnings in the case of hardship distributions. Currently, the maximum distributable amount from a 401(k) plan generally does not include earnings, qualified non-elective contributions or qualified matching contributions, unless the plan provides that certain grandfathered amounts are included. In the case of 403(b) plans, the hardship rules are similar to that of 401(k) plans, with some restrictions to salary deferral sources if they are not maintained separately from other sources.

If plan participants can withdraw earnings in addition to their contributions, they can better cope with a financial emergency. In addition, the administrative burden placed on plan sponsors and vendors, who currently must track the amount of contributions and earnings, is reduced. The immediate and heavy financial need rule and the requirement that the withdrawal not exceed the amount necessary to satisfy the financial need are sufficient for limiting the amount of the distribution.

- Direct the IRS to remove the part of the safe harbor rule requiring a six-month suspension for deferrals following a hardship distribution. A hardship distribution is necessary to meet an immediate financial need and should not affect the timing of future savings.
- Direct the IRS to expand the deemed immediate and heavy financial need criteria to include the financing of any funeral and not solely for the funeral expenses of immediate family members.
- Direct the IRS to allow hardship withdrawals to cover delinquent mortgage payments on a principal residence. Currently, immediate and heavy financial need withdrawals are allowed only for plan participants in foreclosure or facing eviction.
- Direct the IRS to remove the requirement that plan participants must demonstrate that their financial needs are not satisfied by selling assets or other financing mechanisms, including

plan loans. Often it is not possible to sell assets quickly at fair market value, causing the individual to dispose of more wealth than necessary. Similarly, encumbering assets with debt, including retirement savings, is sometimes not a prudent financial decision.

9. Mitigate Penalties Related to Automatic Enrollment Requirements

The AICPA recommends that Congress reduce the amount of penalties incurred by employers who fail to implement their retirement plan's automatic contribution arrangement provisions in the case of a newly hired employee if the employer finds and corrects an error within two years of the date the employee is hired.

Currently, an employer is subject to a corrective contribution of up to 50 percent of a missed deferral for a newly hired employee should the employer fail to automatically enroll the employee in the employer's retirement plan. We appreciate the regulatory guidance which currently provides that no penalty is assessed for errors found within 9 ½ months after the end of a plan year on which a failure first occurred or the last day of the month the affected employee first notified the plan sponsor of the error, whichever is earlier.

While the automatic enrollment feature is designed to promote retirement savings, it can negatively impact an employer if one newly hired employee is not automatically enrolled. Small employers are especially vulnerable to errors since they do not have human resource departments who routinely handle new-hire paperwork. The fear that they are subject to steep penalties in the case of a mistake causes small employers to not adopt automatic enrollment. By extending the time-frame for the application of penalties and waiving penalties for any correction made within 2 years, more employers (especially small employers) will utilize this important retirement plan feature.

Comments on the Retirement Enhancement and Savings Act of 2016

In preparing this letter, we reviewed the legislative language of the Retirement Enhancement and Savings Act (RESA or the "Act") of 2016 and incorporated comments on select sections of the Act.

In the interest of good tax policy, we support Section 506 of the Act, which would repeal the technical termination of partnership rules. A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. The 12-month time-frame often spans a partnership's year-end. The partnership may not realize that a 30% change (a minority interest) in one year followed by a 25% change in another year, but within 12 months of the first, has caused the partnership to terminate.

When a partnership is technically terminated, the legal entity continues, however, for tax purposes, the partnership is treated as a newly formed entity. The partnership is required to select new accounting methods and periods, restart depreciation lives, and make other adjustments. Additionally, the final tax return of the "old" partnership is due the 15th day of the third month after the month end in which the partnership underwent a technical termination. The earlier filing requirement of the "old" partnership often goes unnoticed because companies are unaware of the

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accelerated filing deadline. Penalties are often assessed due to the missed filing. The acceleration of the filing date of the tax return, the reset of depreciation lives, and the selection of new accounting methods combine to serve more as a trap for the unwary than as a process to prevent tax abuse.

We oppose the increased penalties for failure to file retirement plan returns, which are proposed in Section 503 of the Act. The proposed penalty amounts are a significant increase over the current penalty amounts. The function of penalties is to promote compliance with tax law. The current penalty structure under section 6652(d), section 6652(e) and section 6652(h) are significant enough to encourage compliance.

Section 501 of RESA would impose, on a beneficiary, a five-year payout of defined contribution plan and IRA balances over \$450,000 if the beneficiary is not the surviving spouse, disabled, less than 10 years younger than the account owner, or a minor. The proposed threshold of \$450,000 applies to an aggregate balance of all of the individual's IRAs and defined contributions plans. Once a minor achieves the age of majority, the provision would apply to that beneficiary as well. The bill provides that the \$450,000 threshold is divided among all beneficiaries on a pro-rata basis.

The AICPA does not have an official position on Section 501 of the RESA, however, if this requirement to accelerate distributions to certain beneficiaries is included in legislation, the AICPA recommends that Congress modify Section 501 as follows:

- Clarify that the allocation of the threshold amount is not required among beneficiaries not subject to the acceleration rule (e.g., spouses, those within 10 years of the age of the decedent, disabled persons), and, therefore, the allocation of the threshold amount is only among the remaining beneficiaries.
- Require custodians to segregate the portion of an account not subject to these acceleration provisions in a separate, labeled IRA or plan in order to simplify administration.
- In addition to the current provision allowing non-spouse beneficiaries to use their own age for minimum distributions if the beneficiary is disabled or ten or fewer years younger than the decedent, base the payout period for beneficiaries affected by the acceleration rule on the decedent's age rather than a fixed period. A specific number of years should not determine the payout length. Use of the decedent's age provides parity with the existing rule for retirement distributions without a beneficiary when the decedent is over 70½.
- Provide a grandfather rule for certain conduit trusts. Conduit trusts provide that the trustee must pay all minimum distributions to the trust beneficiary annually based upon the beneficiary's life expectancy. We suggest that the grandfathering rule provide that the custodian may make distributions from the IRA or defined contribution plan under the current schedule in the following case:

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- if a conduit trust is drafted prior to the date that the legislation is enacted, and is named as the beneficiary prior to that date; and
 - there are no changes to the beneficiary designation and no material modifications to the terms of the conduit trust prior to the date of the decedent's death.
- Provide a transition period to allow taxpayers adequate time to restructure their financial affairs before the section 501 rules are applicable, for example, by making the provision effective for decedents who die after the date that is one year after section 501 is enacted.

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We understand the challenges that Congress faces as it tackles the complex issues inherent in drafting tax legislation, and note that both taxpayers and tax practitioners are interested in, and need, tax simplification. Federal tax laws and regulations governing retirement plans are overly complex, compounding the difficulty for employers who wish to offer retirement plans to employees and employees who receive distributions. To increase the incentive for employers to set up and maintain retirement plans, it is imperative that the laws and rules governing retirement plans are as simple and straightforward as possible.

Small businesses are especially burdened, by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. While most small businesses use advisors to determine the best plan for their needs and the needs of their employees, participants receiving distributions are often ill-equipped to deal with the variety of planning opportunities available to them. Our suggestions are designed to encourage the operation of qualified retirement plans by small business, expanding retirement savings for all employees.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate the opportunity to provide comments on these issues related to tax reform of savings and investments. If you have any questions, please contact me at (408) 924-3508 or annette.nellen@sjsu.edu; or Kristin Esposito, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com.

Sincerely,



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Chair, AICPA Tax Executive Committee