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Comment Letter on Simple Plans to Treasury Department, May 1997

By Hand

May 16, 1997

Mr. J. Mark Iwry
Benefits Tax Counsel, U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20020

Re: Issues Concerning the SIMPLE Plan

Dear Mark:

As you know, the Investment Company Institute[1] and its members have been quite interested in assuring the successful implementation of the new Savings Incentive Match Plan for Employees (SIMPLE), established by Congress in the Small Business Job Protection Act of 1996. We write, first, to inform you that, based on an informal survey of our members, small employers are establishing SIMPLE plans in significant numbers, particularly the SIMPLE IRA. Second, we seek additional guidance necessary to assure the program's continued success.

Of primary concern to our members is the treatment of self-employed participants in the SIMPLE program. The Institute believes that the ultimate success of the program amongst the smallest employers (those with 25 or fewer employees) will depend, in large part, on the nature of guidance for the self-employed.

I. The SIMPLE Plan: Small Employer Response in the First Quarter, 1997

Recently, the Institute informally surveyed members of its pension committees. We asked them to report the number of SIMPLE plans and accounts that had been established with their firms between January 1 and March 31, 1997. In particular, we sought to identify the aggregate number of plans and accounts; compute average plan size (as a proxy for the size of the employer); identify the types of employers establishing plans (incorporated or unincorporated entities, such as partnerships and sole proprietorships); determine whether the IRA or 401(k) version of the product was being used; and determine the extent to which the "Designated Financial Institution" concept was in use. A sample of the survey instrument is below.

The survey was sent to 141 firms, and results are based on responses from 19 members. Thus, the survey is neither a comprehensive, nor a scientifically representative sampling. We believe, however, that members with the most active SIMPLE programs, have provided us with data. Finally, we note that many of our members did not fully launch their SIMPLE marketing programs until well into February and in some cases as late as mid-March. The significance of the survey, therefore, is not in its numerical precision, but in the clear trends it indicates. We conclude as follows:

(1) Almost universally, the SIMPLE IRA, not the SIMPLE 401(k), is being established. As of March 31, 1997, respondents indicated that 5,174 SIMPLE IRA plans, including 24,081 IRA accounts, had been established. By contrast, we received reports of only 10 SIMPLE 401(k) plans with 186 participants. Only two of the nineteen respondent firms reported SIMPLE 401(k) plans. 5,174 of the 5,184 SIMPLE plans reported are SIMPLE IRAs.

(2) Only 6 of the 19 respondents indicated they presently are serving as Designated Financial Institutions for SIMPLE plans.[2] Of a total of 5,174 SIMPLE IRA plans, 1,250 plans—or about 24%—are DFI-styled plans.

(3) The survey clearly indicates that SIMPLE plan establishment is concentrated among the smallest employers, that is, those with 10 or fewer employees. A few firms could not report by size of employer. Removing their plans from the data set, we find that 3,163 of 3,682 SIMPLE IRA plans report 10 or fewer SIMPLE accounts per plan. About 86% of established SIMPLE IRA plans have 10 or

fewer participants and almost 98% of SIMPLE IRA plans have 25 or fewer participants.[3]

(4) Although many members could not determine whether employers establishing plans were unincorporated entities, such as partnerships and sole proprietorships, based on those able to report, more than half of SIMPLE plan formation (1,205 of 2,108 SIMPLE IRA plans) is attributed to these unincorporated entities. On the basis of respondents that could identify self-employed sponsors, our statistics indicate the following: About 57% of SIMPLE IRAs currently established were established by unincorporated entities, such as partnerships and sole proprietorships.

II. Request for Regulatory Clarification

In the months following the passage of the Small Business Job Protection Act of 1996, Treasury and the Internal Revenue Service issued timely guidance that was very useful to our members as they developed the marketing materials and administrative infrastructure necessary to offer the SIMPLE program to employers. Certain questions, however, remain unanswered. Additionally, as the program gets underway, new questions have arisen. Clearly, the most significant issue yet unanswered regards the treatment of the self-employed in the SIMPLE program.

The Institute urges the Department and the Internal Revenue Service to issue regulatory guidance that affirms, rather than inhibits, the ability of such individuals to fully participating in the SIMPLE program. We believe, based on our recently collected data, that any guidance that inhibits such participation will undermine the SIMPLE’s viability. It will lead to significantly less SIMPLE plan formation and the possible termination of plans already established this year.

A. SIMPLE IRAs for Unincorporated Partners and Sole Proprietors

Partnerships, sole proprietorships and other unincorporated entities make up a substantial portion of the small employer community. As discussed above, Institute data indicates that such entities constitute more than half of all employers establishing SIMPLE plans. Recently, there has been significant concern that self-employed individuals participating in the SIMPLE IRA program will be required to treat matching or non-elective contributions as "elective employer contributions" applied against the annual $6,000 limitation, set forth at Section 408(p)(2)(A). Under such a rule, a self-employed individual would be able to receive only one-half the annual contributions to a plan that other employees are able to receive. It is quite clear from the statute that Congress did not intend such a result.

1. The Statute Contemplates Full Participation Of The Self-Employed In SIMPLE IRAs

Generally, Code Sections 408(p)(2)(A)(i) and (ii) permit an "eligible employee" to enter into a qualified salary reduction arrangement under which "elective employer contributions" in amounts up to $6,000 annually are made to a SIMPLE IRA on the employee’s behalf. The employer is then required to make a matching contribution to the SIMPLE IRA in an amount not to exceed 3 percent of "compensation" (or, alternatively, a non-elective contribution of 2% of compensation) for the year. Code Sections 408(p)(2)(A)(iii) and (B)(i).

The "self-employed" are explicitly permitted to participate in SIMPLE IRA plans, because the definition of "employee," by reference to Code Section 401(c)(1), includes "self-employed individuals"—who are treated "as employees." Code Section 408(p)(6)(B). Furthermore, the SIMPLE legislation explicitly recognizes the self-employed by providing a separate definition of "compensation" for them, which must be applied when determining salary reduction amounts and employer matching or non-elective contributions. Code Section 408(p)(6)(A)(ii).

Finally, the legislative history supports a reading of the statute that would permit participation by self-employed individuals to the same extent as common law employees. Both the Senate Finance Committee report accompanying the legislation and the Joint Committee on Taxation’s "blue book" state without qualification that "[s]elf-employed individuals can participate in a SIMPLE plan."

On its face, therefore, the statute contemplates that the self-employed may participate in SIMPLE IRAs without qualification or special limitation.

2. The Statute Does Not Support The Application Of Existing Tax Rules That, If Applied, Would Limit Self-Employed’s Contributions To A SIMPLE IRA

Under current IRS regulations for 401(k) plans, unincorporated partners must aggregate matching or nonelective contributions with "elective employer contributions." See IRS regulation 1.401(k)-1(a)(6)(iii). The SIMPLE legislation does not suggest that this rule is to apply to SIMPLE IRA plans. As a matter of statutory drafting, there is no reason why Congress would have needed to state explicitly that regulations implementing Section 401(k) are inapplicable to SIMPLE IRAs.

Moreover, the regulation applies only by analogizing the SIMPLE IRA to the 401(k) plan. The analogy is ill-founded. First, the

SIMPLE IRA replaces the SARSEP—the more aptly analogous plan design—which was not subject to such restrictions. Second, Congress clearly distinguished between SIMPLE 401(k)s and SIMPLE IRAs—one is required to meet certain existing tax rules for 401(k) plans, the other is not. Applying this rule to SIMPLE IRAs is contrary to the unrestrictive statutory language and was not contemplated by Congress.

3. Congress intended to encourage small employers, many of which are organized as unincorporated partnerships and sole proprietors, to establish SIMPLE IRAs

Simply put, Congress clearly intended that the SIMPLE IRA be available to small employers, a substantial number of which are organized as unincorporated partnerships or sole proprietorships. If merely by virtue of their business form, certain small employers may establish SIMPLE IRAs for their employees, but contribute significantly less to SIMPLE IRAs on their own behalf, few, if any, will establish them, thus undermining the purpose of the statute.

B. Correction Mechanisms

The Institute and its members urge the Department and Service to clarify that self-employed individuals may fully participate in the SIMPLE IRA program. In the event that guidance clarifies otherwise, however, it is likely that a substantial number of self-employed individuals will find themselves out of compliance. We urge, therefore, that any such guidance, if issued, be applicable only prospectively. Preferably, the self-employed will be permitted to operate for the entire first plan year without correction. Second, it will be necessary to provide an easy, uncomplicated corrective rule. Guidance on how to correct excess contributions to SIMPLE accounts, particularly in the case of SIMPLE IRAs, would be needed.

C. Other Concerns

Our members have other questions concerning the SIMPLE program that the Department and Service should consider addressing in guidance. We enumerate these below.

1. Designated Financial Institution Responsibility.

The Department and Service should clarify the obligations of a Designated Financial Institution with regard to the timely submission and transfer of contributions to secondary financial institutions selected by a plan participant. Under current guidance, transfers of assets must occur on a "reasonably frequent basis," and monthly transfers are deemed to satisfy this standard. IRS Notice 97-6, Q&A J-3.

In the event an employer fails to make timely contributions to the DFI pursuant to the standards set forth at Section 408(p)(5)(A)(i), how is the "reasonably frequent basis" standard applied?[4] In order to assure trustees and custodians that their liability is not contingent on employer behavior, over which they have no control, guidance should clarify that the "reasonably frequent basis" standard and the 30-day transfer period are to be applied only from the time the DFI actually receives contributions from an employer.

2. Annual Account Fees.

IRS Notice 97-6, Q&A J-4 and J-5, states that financial institutions may assess SIMPLE IRAs a "reasonable annual administrative fee." Guidance should clarify that this fee may be different than the fee an institution assesses traditional IRA accounts to reflect the additional costs associated with SIMPLE accounts. SIMPLE IRA trustees and custodians must perform administrative services not required of a traditional IRA trustee or custodian, including, for instance, the preparation and distribution of plan summary descriptions and other plan program and educational materials. Financial institutions may also provide plan level statements to employer sponsors, another item not produced for the traditional IRA market. Moreover, SIMPLE plans require significantly more processing, because contributions are in the form of smaller contribution amounts received periodically, usually in accordance with each employer's payroll schedule. Additional infrastructure is required to process these periodic contributions, which may be received as a single, lump sum payment from an employer on a weekly, biweekly or monthly basis. Such processing is not necessary in the traditional IRA market, where contributions typically are made once annually and need not be broken out into separate individual accounts. Institutions should be permitted to set SIMPLE IRA account fees to reflect these services and associated costs.

Furthermore, guidance should clarify that to the extent a SIMPLE plan trustee or custodian assesses a charge for the DFI transfer function to the employer sponsoring the plan, the trustee or custodian is not responsible for monitoring whether the employer is violating the "without cost or penalty" clause by passing through such charges to plan participants who request transfers. See IRS Notice 97-6, Q&A J-5.

3. Reporting Issues.

The Institute and its members appreciate the timely issuance of guidance and forms with respect to reporting obligations. Some issues, however, remain.

a. Form 5498 reporting.
Boxes 6 and 7 of Form 5498 require the reporting of contributions to SEPs and SIMPLEs respectively. Guidance should clarify that the trustee is required to report the total aggregate amount of employer and employee contributions in the case of SARSEPs and SIMPLEs. A requirement to report only employee salary deferrals in each case would require additional, costly subaccounting not presently being performed by IRA trustees and custodians.

b. Transfers from SIMPLE IRA to non-SIMPLE IRAs.
Transfers from a SIMPLE IRA to a non-SIMPLE IRA within the two-year holding period are treated as distributions from the SIMPLE account. The transfer, therefore, is apparently reported as a distribution on Form 1099-R. Guidance is needed to clarify how the receiving institution records such a transfer on Form 5498. Because the receiving institution will not know whether the two-year holding period was satisfied prior to the rollover/transfer, it is unclear whether the transfer is treated as a rollover or a contribution to the IRA.

4. Multiple Employers.

a. Simultaneous employment.
What limitations apply to an individual employed by two separate, unrelated employers, each of which offers a SIMPLE plan in which the individual is eligible to participate? According to IRS Notice 97-6, Q&A C-3, the Section 402(g) limit applies where an individual participates in a SIMPLE plan and the retirement plan of another employer. Does the Section 402(g) limit apply where each plan is a SIMPLE plan?

b. SIMPLE two-year holding period and two employers.
Is the two-year holding period assessed on a per plan basis or on an individual basis? For instance, assume an individual works with two employers, each offering a SIMPLE plan. The individual initiates participation in one employer's plan in 1997 and initiates participation in the second employer's plan in 1998. Does the individual's participation in the first plan count toward the two-year holding period as applied to the second plan's account?

Similarly, what if an employee who was participating in a SIMPLE plan separates from service with an employer and then begins a second SIMPLE account with a new employer? The individual transfers balances from the first SIMPLE into the second account. How does the two-year holding period rule apply?

5. The 60-day Election Period And The Ability to Modify Salary Reduction Agreements "Without Restrictions."

IRS Notice 97-6, Q&A E-1 states that employees have the right to modify their salary reduction agreements during the applicable 60-day period "without restrictions." Further guidance is needed with regard to the meaning of this phrase.

For the year in which an employee becomes eligible to enter a salary reduction agreement, the employee must be able to commence contributions as soon as eligible, regardless of whether the 60-day period has ended. This situation will occur where a plan has generous entry dates, or where a plan's first plan year begins on a date other than January 1. The result is that an employee may make a salary deferral election within the 60-day period, begin salary deferrals and then decide to modify the agreement. Guidance should clarify that such modification applies prospectively and, therefore, does not result in a return of assets already contributed to a SIMPLE account.

For instance, the modification of a 10% salary deferral election to a 1% election would not require the employer sponsor or trustee/custodian to recalculate the appropriate election amount retrospectively and return contributions to the employee. Permitting such a return of assets would be administratively cumbersome and give rise to numerous valuation problems, dependent on intervening market performance. In fact, permitting an individual to "back out" of an investment, could lead to individuals changing deferral elections based on market performance during the 60-day period.

The Institute appreciates the opportunity to present its views concerning this important piece of legislation, and requests a meeting to discuss further the issues detailed above. We are particularly anxious to discuss the issue of self-employed SIMPLE participation. Please call either me at (202) 326-5835 or Cathy Heron at (202) 326-5830 at your earliest convenience in order to schedule such a meeting. If you or your staff have any questions prior to that time, please feel free to contact either one of us to discuss them.

Sincerely,

Russell G. Galer
Assistant Counsel - Pension

cc: Bill Bortz, Treasury
Carol Gold, IRS
Mark Hamelburg, Treasury
Marjorie Hoffman, IRS
Vicki Judson, Treasury
Roger Kuehnle, IRS
Kevin Knopf, Treasury
Nan Marks, IRS
Mary Oppenheimer, IRS
Alan Tawshunsky, IRS
Harlan Weller, Treasury
Don Wellington, Treasury
Dick Wickersham, IRS

Sample Simple Plans Questionnaire

* Please Respond By MAY 9, 1997. Please base responses on data for SIMPLEs established on or before March 31, 1997.

** Please respond by facsimile to Russ Galer, ICI, at (202) 326-5839. If you have questions regarding the survey, please call Mr. Galer at (202) 326-5835.

Firm: _______________Contact Person: _______________Telephone: ____________

A. SIMPLE-IRAs

1. Number of SIMPLE-IRA plans established from January 1 - March 31, 1997 =

2. Number of SIMPLE-IRA plans established by unincorporated entities, such as sole proprietorships and partnerships =

3. Number of SIMPLE-IRA accounts (i.e. number of plan participants) =

4. Specify number of SIMPLE-IRA plans in the following ranges of size:

a. 0-10 participants =
b. 11-25 participants =
c. 26-50 participants =
d. 51-100 participants =

5. Number of SIMPLE-IRA plans for which institution serves as a "Designated Financial Institution" =

B. SIMPLE-401(K) PLANS

1. Number of SIMPLE-401(k) plans established from January 1 - March 31, 1997 =

2. Number of SIMPLE-401(k) plans established by unincorporated entities, such as sole proprietorships and partnerships =

3. Number of SIMPLE-401(k) plan participants =

4. Specify number of SIMPLE-401(k) plans in the following ranges of size:

a. 0-10 participants =
b. 11-25 participants =
c. 26-50 participants =
d. 51-100 participants =

5. Number of SIMPLE-401(k) plans for which institution serves as a "Designated Financial Institution" =

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,368 open-end investment companies ("mutual funds"), 447 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $3.611 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

[2] The survey did not ask whether firms offered only the DFI or non-DFI version of the product. Many firms offering the DFI appear to offer only SIMPLEs with the DFI function, and thus reported 100% DFI plans. In the four cases where firms appeared to be offering a choice of a DFI or non-DFI SIMPLE plan, about 72% of employers elected the DFI version.

[3] We note that "accounts established per employer plan" may understate the average size of each employer. First, many of these plans are new and, thus, the 60-day election period, in many cases, has not yet concluded. Second, participation rates are not known, and it is likely that employers are somewhat larger than the participant count reflects. Nonetheless, the data clearly reflects the SIMPLE's concentration among the smallest employer groups.

[4] Under Section 408(p)(5)(A)(i), employers are required to make contributions to the SIMPLE plan no later than the close of the 30-day period following the last day of the month with respect to which the contributions are to be made. See also IRS Notice 97-6, Q&A G-5 and proposed Department of Labor regulations at 29 CFR Part 2510.3-102(b)(2).
