

**Testimony to the United States Senate
Special Committee on Aging**

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The Small Business Council of America (SBCA) and the Small Business Legislative Council (SBLC) appreciate the opportunity to submit testimony to the Senate's Special Committee on Aging.

The SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Advisory Boards, many of whom are the leading experts in employee benefits law and how that law impacts small and family-owned businesses.

The SBLC is a 35 year old permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

Mr. Chairman and Members of the Committee, I am Paula Calimafde, Chair of the SBCA and a member of the Board of Directors and past Chair of the SBLC. I am also a practicing attorney who works extensively in retirement plan and employee benefits law. As Chair of the SBCA and a member of the Board of Directors of the SBLC, I am here to present our views as to how small business retirement plan coverage can be increased as well as how employees can be incentivized to increase their savings inside those plans so as to increase the retirement security of our country's employees.

Introduction:

Longer life expectancies are requiring increased retirement savings. Individuals of all economic levels are far more likely to properly save for their retirement if they participate in some form of retirement plan. According to research by the American Society of Pension Professionals and Actuaries (ASPPA), workers are **14** times more likely to save in a retirement plan offered by their employer than to save through an

IRA.¹ By using payroll deductions, these plans encourage savings because they automatically remove the money before it ever goes into the employee's pocket.

The retirement security of our nation's employees is intended to rest primarily upon three sources – often referred to as the three legged stool – Social Security, the voluntary private retirement system and individual savings. As we know, Social Security is basically a defined benefit system and payments are based upon an annuity type of framework – i.e., one cannot outlive payments from Social Security. The voluntary private retirement system is now primarily based on a defined contribution system and the methods of payments can include annuity, instalments (most often through an IRA), lump sum or a combination of one or more of these methods.

Today there is concern for the viability of the Social Security system, though most experts believe that with some relatively minor, but probably politically painful, shoring, it could be kept viable for the foreseeable future. The private retirement system is doing quite well, primarily because of a series of laws (sometimes referred to as the “Portman-Cardin” laws) which recognized that the system had become too complex and costly without providing enough upside for small and mid-size businesses to join it and largely corrected those problems. As reflected in the ASPPA statistic cited above, almost all of our individual savings are done inside a 401(k) plan, 403(b) plan or SIMPLE IRA. We also know that 71.5% of individuals who make between \$30,000 and \$50,000 contribute to an employer plan, whereas only 4.6% of individuals in the same income bracket contribute to an IRA.²

It would appear that there are at least three factors responsible for the success of employee saving in retirement plans. First, it is clear that payroll deduction is an “easy” or “painless” way to save. It is done automatically by the employer and thus, the employee does not have to do anything to get the money into the savings vehicle. Second, it is easier not to spend money or conversely to save it when one does not have it in his/her pocket. Third, with respect to the 401(k) and 403(b) plan, the employee does not have easy access to the saved money so that it continues to grow tax free.

Retirement plans are therefore central to helping employees prepare for their retirement. When an employer offers a retirement plan, most employees will participate. These high “take-up” rates are true regardless of the size of the employer. A recent study,³ which used actual data from employees' W-2 forms, found that 81% of employees working for employers with 100 or more employees take advantage of an

¹ The American Society of Pension Professionals and Actuaries, Tax Reform Shouldn't Harm Main Street's Retirement Plan (April 19, 2013), <http://www.asppanews.org/2013/04/19/tax-reform-should-not-harm-main-streets-retirement-plan/>

² The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, <http://asppa.org/savemy401kfactsheet>

³ Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol. 71 No.2 2011, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records.

offered retirement plan and that 79% of employees working for employers with less than 100 employees take advantage of being able to make employee contributions into the qualified retirement plan. Although these rates are good, maintaining and continuing to increase these numbers is still important. Auto-enrollment, which automatically enrolls an employee in the plan unless they opt out, and auto-escalation, which automatically increases an employee's contribution to the plan unless they opt out, are important options that an employer can utilize to increase employee participation in a plan. The success of auto enrollment and auto escalation is somewhat startling.⁴ Those of us in the trenches believe that inertia is the key to their success – i.e., an employee would rather stay enrolled in a retirement plan because it is easier to do so than to opt out and it is easier for employees to allow the amount of their contributions to increase over a number of years than to affirmatively take steps to decrease the amount. Additionally, educating the entire workforce, particularly the younger workers, of the importance of saving for retirement is key to maintaining the high take-up rates that we see today.

Because employees save better in a retirement plan, and because employees are likely to participate in a plan when given the option, encouraging employers to sponsor retirement plans is critical in creating retirement stability.

Small businesses face particular challenges when it comes to sponsoring retirement plans. Small businesses have long been at the heart of the American economy. However, it is important to remember that small business owners are focused on the challenges of maintaining their businesses and that the relative cost of sponsoring a plan is far greater for small businesses than it is for large companies. In 2012, the Small Business Administration reported that only about half of new businesses survive their first five years and only about a third of new businesses survive 10 years or more.⁵ No matter how much a small business owner cares about his or her employees, offering a retirement plan is often a secondary concern to the survival of the business and the decision of whether to offer a plan comes down to a cost benefit analysis. Once small businesses survive the initial period of uncertainty and become more established they are far more likely to sponsor a retirement plan.

Despite the challenges, many small businesses still offer plans and make meaningful contributions for their employees. Unfortunately, there is a problematic misconception that plan sponsorship among small businesses is very low. In fact, the small business qualified retirement plan system has been very successful in providing retirement security for its workers. In the study⁶ which used actual data from employees'

⁴ Jack VanDerhei and Lori Lucas, The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy, Employee Benefits Research Institute, Issue Brief No. 349 (November 2010), http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No349_EBRI_DCIIA.pdf

⁵ Frequently Asked Questions, Small Business Administration, Office of Advocacy (September 2012), available at http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

⁶ Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol. 71 No.2 2011, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records.

W-2 forms, the researchers found that 77% of all employees who work in companies with 10 or more employees are offered a retirement plan and that of these employees, 62% made 401(k) contributions.⁷ It is interesting to note that the reason why this study shows higher retirement plan coverage than is reflected in other studies is because this study relied upon actual W-2 data to determine if an employee was covered by a plan. Most other studies have relied upon surveying employees to find out if they were covered by a retirement plan. Once again, those of us in the trenches are not surprised by the marked discrepancy between employees who report they are not covered by a plan compared to the actual data. One would think that an employee would know if he/she were making employee contributions into the plan but this is not the case. Perhaps even more obscured for many employees is that their employer is making contributions for them whether through a match or by a nonelective employer contribution (aka profit sharing contribution).

In light of the cost to a small business of offering a plan and the large number of employees who are actually covered by the qualified small business retirement plan system, any changes that would make plan sponsorship more costly or burdensome, or otherwise motivate employers to freeze or eliminate the plans could have significant and detrimental long term repercussions. This is highlighted by considering the demographics of the employees who participate in retirement plans – nearly 80% of all plan participants make under \$100,000 per year and 43% of all participants make less than \$50,000 annually.⁸

What Motivates Small Businesses to Sponsor Plans?

There are a number of elements that small business owners weigh when deciding whether to sponsor a plan. Small businesses have a unique place in the qualified retirement plan system. Unlike large businesses, most small businesses are closely held and most small business owners do not anticipate being able to sell their businesses as a means of providing for their retirement. Also, the non-qualified deferred compensation plan heavily utilized for key management employees in larger businesses is not available to smaller businesses because of unfavorable tax treatment. **Because of this, one of the primary motivations for small business owners to sponsor a plan is that participating themselves is the best way to save for their own retirement. Most small business owners view the meaningful contributions that are made for the non-key employees as the price of admission to be able to save in a qualified retirement**

⁷ The size of the company makes a significant difference. W-2 data reflects that 46% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that 60% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 70% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 84% of businesses with more than 100 employees offer a retirement plan. There is no further breakdown given for over 100 employees so we do not know how many small to mid-size businesses – often defined as up to 500 employees offer plans compared to the larger businesses.

⁸ The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, <http://asppa.org/savemy401kfactsheet>

plan for themselves. Employee recruitment, retention and morale are also positive factors that the owners take into account when deciding whether or not to sponsor a plan.

There are, however, significant costs for a small business to sponsor a plan. Thus, a small business owner's decision of whether to sponsor or continue to sponsor a plan often comes down to a cost benefit calculation. Some of the factors taken into account by small business owners when deciding to sponsor a retirement plan include the employees' preference for cash or health care coverage (i.e., lack of appreciation by the employees for contributions made by the employer into the retirement plan for their benefit), the uncertainty of the business' revenue from year to year, the costs of setting up the plan and the ongoing costs of administering it and the amount of the required company contributions (i.e., the top-heavy rules). When asked what could break down these barriers, the following answers are often given by small businesses: repeal the top-heavy rules, reduce administration, and change the lack of employee demand by educating employees about the need to save for their retirement now. As mentioned above, some small business owners reported that until they were more profitable and stable nothing would induce them to join the system. Almost all reported that any decrease to the owners' and key employees' level of benefits would significantly affect their cost-benefit analysis.

Some small business owners engage in this calculus on their own, while many rely on accountants and other financial advisors to help them weigh the pros and cons of sponsoring a plan. As such, the success of the small business retirement system is largely dependent on federal tax laws. The contribution limits for both employees and employers and the tax deferrals are usually central to tipping the scale in favor of plan sponsorship.

A criticism sometimes aimed at the retirement plan system is that the contributions for the non-highly compensated are not significant. Practitioners who work with qualified retirement plans know better, at least as far as small businesses are concerned. The rules governing the qualified retirement system force significant company contributions for all non-highly compensated employees if the highly compensated employees are to receive benefits. Since a major goal of a retirement plan is to provide retirement security for the owners (and in most cases, is the only way they can save for retirement through their company), it is not at all unusual for small business contributions to range between 3% and 10% of compensation for the non-highly compensated employees. This means that it is not unusual for a small business employee to, in effect, receive a bonus, albeit one given to the retirement plan, in an amount of at least 3% of their annual compensation but often equal to 5% or even 7.5%.

In the recent discussions on how to raise revenue (and conceivably lower tax rates through tax reform), the deduction for retirement plan contributions has been treated the same as other tax expenditures in the tax code. This is a mischaracterization because retirement plan contributions are eventually brought into income, along with any

earnings.⁹ There are approximately 670,000 private-sector defined contribution plans covering approximately 67 million participants and over 48,000 private-sector defined benefit plans covering approximately 19 million participants. The U.S. private retirement plan system paid out over \$3.824 trillion in benefits from 2000 through 2009 and U.S. public sector plans paid out \$2.651 trillion during the same period. All of this money was brought into income and subject to regular income tax rates (the only exception would be money that was contributed on an after-tax basis). The only loss to the government with respect to the deduction for retirement plan contributions and tax free growth inside the plan is the time value of money. But the potential detrimental impact on savings by Americans due to a reduction on contributions to retirement plans could be huge.

Simplifying the Retirement Plan System to Motivate Plan Sponsorship:

A major disincentive for a small business owner to sponsor a plan is the heavy administrative requirements (such as notice requirements, top-heavy rules and discrimination testing) which can often be very burdensome on the employer and tip the scales against sponsoring a plan. Many of these administrative requirements could be eliminated or simplified without negatively impacting the participants.

Repeal or Revise Top-Heavy Rules

One of these areas which is ripe for simple and meaningful changes is the top-heavy rules for defined contribution plans. When first enacted the top-heavy rules imposed additional minimum contributions and accelerated vesting on small and mid-size retirement plans which were almost always top-heavy due to the mathematical tests used to determine such status. Over the years, the rules have changed so significantly that the top-heavy rules are now an archaic appendage similar to that of the appendix in the human body – they do nothing but cause problems.

Nevertheless those who are not immersed in the technicalities of retirement plan law insist that the top-heavy rules still operate so as to benefit non-highly compensated employees. This outdated view has resulted in inertia on the Hill when it comes to repealing these unnecessary and complicated rules. Because this is unlikely to change, the following proposals have been developed so as to try to ameliorate the more negative aspects of the top-heavy rules. However, these ideas would not accomplish the goal nearly as effectively as outright repeal of these obsolete rules for defined contribution plans.

One way to improve the system would be to eliminate top-heavy contributions for plan participants with less than one year of service so that employees are allowed to make

⁹ A study prepared for the American Society of Pension Professionals & Actuaries reflects the value of the retirement plan tax expenditure to be roughly 55 – 75% lower than estimates by the Joint Committee and the Treasury. This study assumes that people will enjoy lower income tax rates during retirement than when contributions are made to the retirement plan. This assumption, increases the value of the “tax expenditure.” Many experts believe, however, that tax rates are going to be higher for most taxpayers in the future and that the “real” cost of the retirement plan tax expenditure is even lower than that set forth in the ASPPA report. Xanthopoulos and Schmitt, Retirement Savings and Tax Expenditure Estimates, ASPPA May, 2011.

401(k) contributions during their first year. Because of the top-heavy rules, small and mid-size plans that are top-heavy cannot allow recent employees into the 401(k) portion of their profit sharing plan without these employees receiving an employer contribution even though they have not met the requirements for the regular “profit sharing contribution.” Thus, even though from a policy viewpoint we would want to encourage new hires to start saving for their retirement as soon as possible, the top-heavy rules do not allow this result. Enactment of the change above will result in more participation in the 401(k) plan sooner rather than requiring employees to be at the company for a year before being able to enter the 401(k) portion of the retirement plan. The one year wait is the “typical” wait for eligibility for entry into small retirement plans and this is because of the top-heavy rules. Eliminating the wait would allow more small business employees to start participating in the 401(k) portion of the plan sooner.

The topic of 401(k) plans is a tremendous success story. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much does the employer contribute. Employees meet with investment advisors to be guided as to which investments to select, employees have 800 numbers to call to see how their investments are doing and to determine whether they want to change investments. Employees discuss among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown. It is probably not an exaggeration to say that the 401(k) plan brought Wall Street to main street and that it has provided employees with the education needed to effectively invest.

The forced savings feature of the 401(k) plan cannot be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Some retirement plans allow savings to be removed by written plan loan which cannot exceed 50% of the account balance or \$50,000 whichever is less. Savings can be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency. This is in contrast to funds inside an IRA or a SIMPLE IRA (an employer sponsored IRA program) where the funds can be accessed at any time for any reason. True, funds removed will be subject to an early withdrawal penalty (which is also the case for a hardship distribution from a 401(k) plan), but anecdotal data suggests that individuals freely access IRAs and SEPs (also an employer sponsored IRA program) and that the early withdrawal penalty does not seem to represent a significant barrier. Nevertheless, there is a distinct difference between asking the employer for a loan or a hardship distribution and having to jump through some statutorily and well placed hoops versus simply removing money at whim from your own IRA.

Another change would be to allow small and mid-sized companies to sponsor employee pay-all 401(k) plans without the 401(k) contributions made by key employees triggering the top-heavy rules. Under current IRS regulations, when a key employee makes a 401(k) contribution, that employee contribution is deemed to have been made by the company and the company is then required to make top-heavy contributions for the

non-key employees. Because of this rule, small to mid-size employers who would like to offer 401(k) plans must either commit to make company contributions to non-key employees or to exclude key employees from participation in the 401(k) plan. Many companies cannot afford to make company contributions and most owners will be unmotivated to offer plans in which they, and other key employees, cannot participate. Thus, from a policy viewpoint, employees who might have made 401(k) contributions are not given the opportunity because of the significant barriers that stand before small to mid-size company offering this type of plan. Many members of Congress seem to not understand that most small business owners are not interested in incurring additional expense and administrative burdens if there is no upside for them. Employees of small or mid-sized employers would certainly be far better off having an employee pay-all plan, in which both key and non-key employees could contribute without creating a required contribution for the company, than having no plan at all. Under such a scenario, the regular anti-discrimination tests would still apply to offer protection for non-key employees. Larger companies (which because of the mathematical tests are never top-heavy) can sponsor employee pay-all 401(k) plans. This rule unfairly discriminates against small businesses and their employees. A change to this rule would allow more small business employees access to a 401(k) plan and level the playing field between larger and smaller business entities.

Simplify ADP Testing

Another area ripe for simplification is the 401(k) discrimination testing, known as the “ADP” tests. The anti-discrimination rules for 401(k) plans (the ADP tests) are more complicated than needed. For instance, the tests set forth in the proposal referred to as the “ERSA” (Employer Retirement Savings Accounts) would satisfy the policy goals of the ADP while reducing some of the complexity currently inherent in these tests. This could be an optional ADP test so that companies who are able to deal with the current ADP tests are not required to change retirement plan documents, software and procedures.

The ERSA proposal calls for the contribution percentage for eligible highly compensated employees (HCEs) for the plan year not to exceed 200% of such percentage for the non-highly compensated employees (NHCEs) if the contribution percentage of the NHCEs does not exceed 6%. If the contribution percentage of the NHCEs exceeds 6%, then no testing would be required. The proposal also has two safe harbors to avoid the simplified nondiscrimination test which are similar to the current 401(k) safe harbors.

Eliminate Safe Harbor Notices for 401(k) Safe Harbor Match and 3% Non-Elective Safe Harbor Notices

These notices, both required by statute, are costly and burdensome. The match safe harbor notice does serve a policy purpose in that it can affect the amount of 401(k) deferrals an employee may choose to make in order to receive the match. However, rather than yearly notices, the notice could stay in effect unless and until revoked. The notice could be part of the Summary Plan Description.

The safe harbor notice for the 3% non-elective safe harbor serves no policy purpose at all and should be eliminated as soon as possible. Eliminating these unnecessary notice requirements would reduce the burdensome paperwork that pose a barrier to small businesses sponsoring a plan.

Eliminate Required Minimum Distributions (RMDs)

It makes no sense to require individuals to remove funds from an IRA or retirement plan prior to their retirement or when not needed. **Presently the law requires small business owners (and only small business owners) to start receiving RMDs while they are working.** The demographics of the group comprised of small business owners are such that money saved in a plan or an IRA will be crucial to their retirement security.

Further, all IRA owners must start removing money from their IRAs whether needed or not by the April 1st following the calendar year in which they attain the age of 70 ½. Life expectancy appears to be increasing dramatically, particularly for the oldest sectors of our population. There is no reason why the tax code should be forcing people to remove money that is intended to provide retirement security before it is needed. Worse, it is likely that the withdrawn money will be spent rather than growing tax deferred inside the IRA. It is essential that the money be available to the IRA owners when they reach the ages of 85, 90 or beyond.

Eliminating required minimum distributions and allowing participants more control after the age of 59 ½ will also help to simplify the tax code. At a minimum, the 70 ½ beginning date should be pushed back to 75. Doing so would help to ensure that individuals will have enough savings for their retirement taking into account increasing longevity so they will not have to rely upon the government for their welfare.

Modify the QPSA Rules so that the Age 35 Requirement is Eliminated

The law now provides that a plan participant subject to the survivor annuity requirements of section 401(a)(11) generally may only waive the Qualified Pre-retirement Survivor Annuity (QPSA) benefit (with spousal consent) on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver (with spousal consent), provided that a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th birthday occurs. If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death. This provision does not promote any particular policy goals and is exactly the type of unnecessary provision that should be eliminated.

Bring Interim Amendments Under Control

Small plans (actually all plans) have in the last five to six years been getting hit with almost yearly amendments that are costly, and by and large unnecessary. This has placed a huge burden on the small business retirement plan system. When making any changes in the retirement plan area Congress should include a direction to the IRS that no amendments are to be required on the new law, including regulations on the new law, for

a period of at least 3 years, or better until the next required restatement of the plan document. Summary of material modifications would still be required for changes requiring such notice to the plan participants. This change would make plans less expensive and burdensome to maintain while imposing no hardship on the plan participants.

Conclusion:

The sine qua non of small businesses is private ownership with any year end surplus revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and “grow” the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the top-heavy and anti-discrimination rules set forth in the Internal Revenue Code and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners are likely to forgo the retirement plan option.

Employer sponsored retirement plans are critical to ensuring widespread retirement security. Although small businesses face greater costs and barriers to sponsoring a retirement plan, the small business retirement system has been largely successful at helping employees save. This trend should be encouraged by promoting laws which simplify the system and cut down the costs on small businesses and rejecting proposals to eliminate the tax deductions and other benefits that motivate small businesses to sponsor plans.