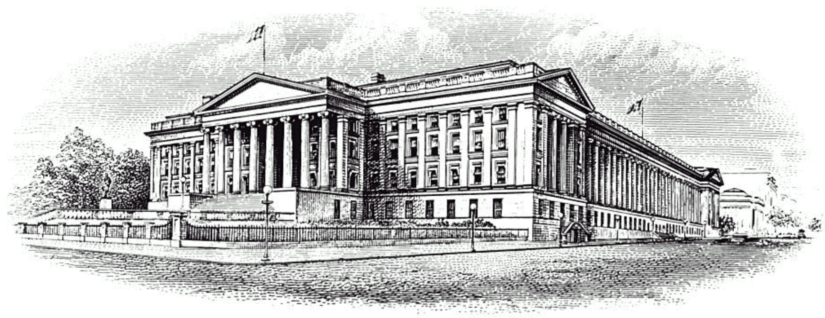

TESTIMONY OF
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FOR THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
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Mr. Chairman, Senator Grassley and distinguished Members of the Committee, I thank you for the opportunity to testify before the Finance Committee on the important issue of retirement security -- specifically, employer sponsored tax-qualified retirement savings plans, such as 401(k) plans.

My testimony this afternoon will address the President's Retirement Security Plan. As background, I will also address the current structure of the employer-provided retirement system as it is reflected in the Internal Revenue Code (the Code), especially plans that invest in company stock, and the expansions brought about by last year's Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The members of this Committee have always been serious proponents of the expansion of the retirement system. You, Mr. Chairman, Senator Grassley and Senator Graham have lead the way in promoting retirement legislation. Their efforts over the last few years resulted in retirement legislation that had overwhelming bipartisan support. Most of the provisions in their retirement bill were enacted last year as part of EGTRRA and we, at Treasury and the IRS, are working hard to make sure that these provisions have been implemented. There are many more members of this Committee who lead the way when it comes to expanding and protecting American retirement security. Senator Bingaman is one of those leaders by using his position on both this Committee and the Health, Education, labor and Pensions Committee. Senator Hatch is a long time advocate of increasing the number of pension plans for small businesses, especially by eliminating administrative complexity. Senator Breaux has been a great friend of employee stock ownership plans. And Senator Jeffords has always shown a great interest in retirement savings over the years.

The issues relating to promoting and protecting retirement savings can be difficult and the proper balances hard to strike. The substantial experience of this Committee will be a valuable asset.

In talking about retirement security and the defined contribution system, let us follow the path of bipartisanship that the Senate has been following when dealing with retirement issues. When looking at how to further improve the system, both sides having common goals. They include the promotion of the use of the voluntary, employer-based retirement system to provide retirement benefits to Americans and to protect participants' savings and retirement income. These laudable goals are reflected in all the various legislative proposals that have been introduced. Let us remember that we have the same goals when commencing this debate.

While the universal goal of the system is to provide for retirement security, each individual's personal goals for retirement savings differ. All agree that we must equip participants with tools to accomplish individual goals in a rational manner. Artificial restrictions may not be appropriate for all employees who are making personal decisions on how much to contribute to a plan and how to invest their contributions. Employees who determine their own investment goals do not want a government to restrict the amount of their investment that can be invested in specific funds.

Last month, President Bush formed a task force on retirement security. He asked Treasury Secretary O'Neill, Labor Secretary Chao and Commerce Secretary Evans to analyze our current pension rules and regulations and make recommendations to create new safeguards that protect the pensions of millions of American workers. In his State of the Union speech, the President reiterated this commitment when he said:

> "A good job should lead to security in retirement. I ask Congress to enact new safeguards for 401(k) and pension plans. Employees who have worked hard and saved all their lives should not have to risk losing everything if their company fails."

The President's Retirement Security Plan, announced on February 1, 2002, would strengthen workers' ability to manage their retirement funds by giving them freedom to diversify their investments and better information for making savings and investment decisions, including access to professional investment advice. It would ensure that senior executives are subject to the same restrictions as American workers during temporary blackout periods and that employers assume full fiduciary responsibility during such times. I will talk more about the specifics of his proposal later in my testimony.

Under our retirement system, no employer is obligated to provide a retirement plan for employees; the private retirement plan system is completely voluntary. There are clear benefits to employers who provide retirement plans – not only tax benefits but also the benefits of hiring and retaining qualified employees who help the business prosper. Because of these benefits, we must be careful not to overburden the system. If costs and complexities of sponsoring a plan begin to outweigh advantages, employers will stop sponsoring plans. What benefit does an elaborate protection mechanism provide for retirement savings if the employer ceases sponsoring a plan? We should join together in a bipartisan fashion to ensure that the legislative proposals we advance will not result in a reduction in the number of employers' sponsoring plans.

An important point I would like to make is that the retirement system is thriving. Some statistics illustrate the strengths of the system.

- In 1998 (the most recent data available from the Department of Labor), qualified retirement plans for private employers covered a total of 41 million defined benefit plan participants and 58 million defined contribution plan participants. These plans held assets of $4 trillion. Contributions of $202 billion were made and benefits of $273 billion were paid.

- Currently, it is estimated that 42 million workers participate in 401(k) plans, which hold $2 trillion in assets (of which 19 percent are invested in employer securities). Employees contribute about $100 billion per year to 401(k) plans, and employers contribute another $50 billion per year. About half of 401(k) participants are also covered by another pension plan.

These statistics underscore the breadth of coverage of employer-sponsored plans and the strength and vitality of the 401(k) plan system. Other statistics, however, point out the lack of coverage in small business – something that EGTRRA was designed to remedy.[1] In 1998, 86 percent of the employers with 500 or more employees sponsored a retirement plan. Fewer than 14 percent of the smallest employers sponsored a plan.

Tax Principles Regarding Retirement Plans and Company Stock

The importance of the retirement system under the tax code is long-standing. In the Revenue Act of 1921, Congress provided that contributions by an employer to a stock bonus or profit sharing plan[2] are deductible by the employer and not taxable until the amounts contributed are distributed or made available to the employee. Five years later, in the Revenue Act of 1926, the Congress extended this tax treatment to pension plans. The concepts of profit-sharing and stock bonus plans date back to the 1920's, and some of the oldest defined contribution plans now maintained by well-known and well-run companies began as stock bonus plans. Many companies that contribute stock to their retirement plans have employees who end up with very comfortable retirements. For example, the average rate of return from 1990 to 1997 for employee stock ownership plans was 13.3 percent, while for 401(k) plans it was 11.9 percent.

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[1] For example, EGTRRA provided a small business tax credit for new plan expenses for small businesses.
[2] A "profit sharing" plan is a tax qualified plan under which employer's contributions on behalf of covered employees are allocated according to a definite predetermined formula and distributed after a fixed number of years, the attainment of a stated age, or upon the occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. An employer does not have to have profits to make contributions to a profit sharing plan. A "stock bonus" plan is similar to a profit sharing plan, except that the contributions by the employer are distributable in stock of the employer.

Some assert that having company stock in a retirement plan is a gamble that employees should not take. We believe that company stock, as part of one's overall retirement nest egg, has generally proven to be a favorable for employees. We all know examples of employees who did not fare well. While appropriate steps should be taken to enable employees to better protect themselves, we should not abandon the long-standing and successful employer-provided plan retirement system. Rather we should give employees more flexibility and more information so that they can better manage their retirement nest egg.

Tax qualified plans are accorded favorable tax treatment. A sponsoring employer is allowed a current tax deduction for plan contributions, subject to limits, and employees do not include contributions or earnings in gross income until distributed from the plan. Trust earnings accumulate tax-free.

Qualified plans are also subject to rules protecting participants and restricting the use of plan assets, including the following:

- Plan funds must be used only for the exclusive benefit of employees or their beneficiaries.

- To ensure that employers provide benefits under these plans to moderate and lower-paid employees, qualified plans are subject to rules that prohibit discrimination in favor of highly compensated employees (the nondiscrimination rules).

- To encourage participants to keep amounts in plans to satisfy retirement needs, sanctions are imposed if funds are withdrawn from a qualified retirement plan prior to retirement.

- To ensure that plan assets are accumulated for retirement purposes and not accumulated as a death benefit, sanctions are imposed for not taking distributions during a participant's retirement years.

Since 1974, many of the tax qualification rules have also been addressed in provisions of the Employee Retirement Income Security Act of 1974 (ERISA).[3]

Types of Retirement Plans.

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[3] For example, most of parts 2 and 3 of Title I of ERISA (the vesting, participation, and funding rules) are virtually identical to tax qualification rules in the Internal Revenue Code. The Internal Revenue Service makes determinations as to the qualified status of the form of a plan and audits whether plans operate in accordance with their terms. Generally, an employee cannot bring an action to enforce tax qualification requirements, which are enforced by the Internal Revenue Service. If a tax qualification requirement is also contained in ERISA, however, it can also be enforced by a plan participant or by the Department of Labor. The Reorganization Plan No. 4 of 1978 provides that, in general, the Secretary of the Treasury has the regulatory authority for those provisions that are contained in both the Internal Revenue Code and ERISA.

There are two broad categories of tax qualified retirement plans: defined benefit plans and defined contribution plans. While many of the tax rules regarding these types of plans are similar, there are important differences.

A defined benefit plan provides a participant with a benefit defined by the plan. The employer makes plan contributions that are actuarially determined to fund the benefit over the working life of the employee. The employee has no risk that his or her entire pension benefit will be lost. If the funds of the plan are insufficient to pay the benefits promised and the company is bankrupt, the Pension Benefit Guaranty Corporation provides a guarantee of benefits up to a statutory maximum, which in most cases exceeds the promised benefits. Conversely, if the investment experience of the underlying fund outpaces the promised benefits, the employer benefits through a lower contribution obligation. While excess funds are held for employees, they are not required to be used to increase pension benefits.

In a defined contribution plan, the employer makes a contribution that is allocated to participants' accounts under an allocation formula specified by the plan. Investment gains or losses increase or decrease the participant's account, without obligating the employer to make further contributions. Earnings increase the participant's ultimate retirement benefit; losses will decrease that ultimate benefit. Under a defined contribution plan the plan sponsor may, but is not required to, give participants the ability to allocate assets in their accounts among a number of investment alternatives. If a participant has the ability to direct plan investments, his or her investment decisions will determine the ultimate retirement benefit.

Due to a number of factors, there is a recent trend among employers to shift toward defined contribution plans. One of these factors has been the increasing mobility of the American workforce and demands by employees for a portable benefit. It is difficult for an employee who changes jobs frequently to vest in a significant defined benefit. From 1985 to 1998, the number of defined benefit plans fell by 67 percent and the number of active defined benefit participants fell by 21 percent. Over the same period, the number of defined contribution plans rose by 46 percent and the number of active defined contribution plan participants rose by 52 percent. In particular, the growth in the number of defined contribution plans and participants is due to an explosion in the number of 401(k) plans and participants.

Employees and employers both appreciate many of the advantages of defined contribution plans. Employees have become more mobile and defined contribution benefits are more valuable than defined benefits for employees who change employers during their working life. Employees also appreciate the ability to control the allocation of the assets in their accounts. Employers appreciate the more predictable funding obligations of defined contribution plans.

401(k) Plans.

A very popular feature in defined contribution plans is the cash or deferred arrangement, codified under section 401(k) of the Code (hence, the term "401(k) plan"). Section 401(k) of the Code permits a participant to elect to contribute, on a pre-tax basis, to a defined contribution plan instead of receiving cash compensation.

There are restrictions on these elective contributions, including a requirement that the average amount of elective contributions made by highly compensated employees (as a percentage of compensation) may not be greater than a certain percentage of the average amount of contributions made by non-highly compensated employees. This test is referred to as the Actual Deferral Percentage (ADP) test and must be satisfied annually. One result of the ADP test is that employers encourage participation by lower-paid employees. Employer matching contributions give an incentive to lower-paid employees to contribute to the plan. A new EGTRRA provision requires that matching contributions be 100 percent vested after three years of service or vested ratably over six years. Another important provision of EGTRRA, the Saver's Credit, provides a tax credit equal to 50 percent of the retirement savings (up to $2,000) of many lower paid employees. The more lower-paid employees save for retirement the more higher-paid employees can save.

Matching contributions are subject to a nondiscrimination test similar to the ADP test. This test, the Actual Contribution Percentage (ACP) test, is used to make sure that matching contributions do not disproportionately favor the highly compensated (as a percentage of compensation) relative to non-highly compensated employees. Prior to EGTRRA, an additional nondiscrimination test – called the Multiple Use Test –had to be passed. EGTRRA eliminated this third nondiscrimination test because it unnecessarily complicated 401(k) plan testing. Congress and the Administration agreed that the ADP and ACP tests are adequate to prevent discrimination in favor of highly compensated employees.

The ADP and ACP tests can be avoided through the use of one of two statutory safe harbors. Under one of the safe harbors, the employer matches 100 percent of an employee's contributions, up to 3 percent of compensation, and 50 percent of the employee's contributions between 3 percent and 5 percent of compensation. The other safe harbor requires the employer to make a contribution on behalf of all eligible employees (regardless of whether the employee actually makes a 401(k) contribution) equal to 3 percent of compensation.

Employee Stock Ownership Plans.

A stock bonus plan may be designated in whole or in part as an employee stock ownership plan, or ESOP. An ESOP is a plan that is designed to invest primarily in company stock. Currently, it is estimated that there are about 11,500 ESOPs, covering about 8.5 million workers. Only about nine percent of ESOPs are in publicly traded companies. However, these tend to be large companies and hence account for about half of ESOP-covered workers. In 1999, ESOPs held about $500 billion in assets and received $20 billion in contributions.

If a plan or a portion of a plan is an ESOP, the ESOP generally must pass voting rights on publicly traded stock held in participants' accounts to participants. An ESOP must give participants the right to request the distribution in stock, and, if the distribution is made in stock, the right to "put" (i.e., sell) the stock back to the company or the plan. In addition, participants who are age 55 and have at least 10 years of participation in the plan must be given the opportunity to diversify a portion of the stock held in their ESOP account.

Employers establish ESOPs for many reasons. In addition to providing retirement benefits to employees, an ESOP transfers employer stock to employees, thereby encouraging employee ownership and aligning employees' interests with the success of the company. An ESOP can be used to transfer ownership from a company founder to employees by having the ESOP borrow funds to purchase company stock as the owner retires or to provide additional capital for employer expansion. Tax-deductible ESOP contributions can be used by the ESOP to repay a loan. As the loan is repaid, the stock purchased with loan proceeds is allocated to participants. About three-quarters of ESOPs have used borrowed funds to acquire employer securities.

Another advantage to establishing an ESOP is the ability of the employer to deduct dividends paid on employer stock held in the plan. EGTRRA made this feature even more attractive by extending this deductibility feature to all ESOP dividends provided that participants are given the opportunity to elect to receive the dividend in cash. Because of the value of this expanded deduction for ESOP dividends, we understand that most publicly traded companies that have a non-ESOP employer stock fund will convert that stock fund to an ESOP and offer participants the opportunity to take a distribution of the dividend in cash.

When talking about ESOPs, many people refer to K-SOPs and M-SOPS. A K-SOP is an ESOP that uses an employee's 401(k) contributions to purchase employer stock or repay a loan whose proceeds had been used to purchase employer stock for the plan. Likewise, an M-SOP is an ESOP that uses the employer's matching contributions to purchase employer stock or repay an ESOP loan.

The President's Retirement Security Plan.

The President's plan puts employees in better control of amounts that they contribute to a 401(k) plan and improves employees' ability to make good individual investment decisions and reach their retirement goals. The President's plan focuses on the following four areas:

1. Giving Employees Investment Choice

The President believes that federal retirement policy should expand, not limit employee ability to invest their contributions or matching contributions as they see fit. Under the President's plan, employers cannot require that accounts of employees who have three or more years of participation in the plan be invested in employer stock. However, the employee is not required to diversify these amounts; it is the employee's choice. The three-year rule provides a balance between the employer's desire to have employees invested in employer stock and the employee's interests in diversification. The three-year period is consistent with the shorter vesting rule for employer matching contributions.

ESOPs are intended to be invested primarily in employer securities and are an accepted method of transferring ownership of a company to employees. Requiring diversification in all ESOPs would make it virtually impossible to accomplish the well-accepted purposes of an ESOP, including the encouragement of employee ownership and a source of financing to the employer. Moreover, ESOPs are subject to special diversification rules already in the Code. Therefore, the President's plan provides that a stand-alone ESOP (i.e., an ESOP that holds no 401(k) contributions, matching contributions, or other contributions used to satisfy the Code's nondiscrimination tests) will not be subject to these diversification requirements. K-SOPs and M-SOPs will be required to offer diversification rights to plan participants.

This new diversification requirement will be an addition to the overall tax qualification requirements under the Code. Since the diversification rule will be a tax qualification requirement, the plan document must specifically provide for the diversification right. If the diversification right is not contained in the plan, the IRS will refuse to issue a favorable determination letter stating that the plan meets the qualification requirements.[4] **The diversification requirement would also be added to Title I of ERISA, thereby giving participants and the Department of Labor the ability to enforce the diversification right.**

2. Clarifying Employers' Responsibilities During Blackout Periods and Creating Parity Between Senior Corporate Executive and Rank-and-File Workers

The President's plan provides fairness by eliminating double standards with respect to the ability to sell employer stock during the time plan recordkeepers or plan

[4] The IRS estimates that it will review approximately 120,000 plans during this year's filing season to determine whether they meet the qualification rules of the Code.

investments change – the so-called blackout period. This is accomplished by placing restrictions on corporate executives trading employer stock outside of a plan that parallel restrictions on employer stock transactions inside the plan during a blackout period. In addition to being fair to employees, this rule would create a strong incentive for corporate management to shorten the blackout period to the minimum time required to make changes.

Section 404(c) of ERISA provides employers with a defense against lawsuits when employers give workers control of their individual account investments. The President's plan would clarify ERISA to disallow employers from utilizing this 404(c) defense for fiduciary breaches that occur during a blackout period. Because the 404(c) defense is based on the premise that employers have given investment control to their workers, the defense logically is inappropriate during blackout periods when employers have suspended investment control from their workers.

3. <u>Giving Employees Better Information about Their Pensions</u>

To make sure that employees have maximum control over the investment of their retirement savings, the President's plan requires that notice be given to employees 30 days before the blackout period begins. With this notice, employees will be able to adjust investment selections in anticipation of the blackout period. Failure to provide this notice will result in a penalty on the plan sponsor of $100 per day per employee for every day that an employee did not get the notice.

The President also wants to make sure that employees get up-to-date information on plan investments and reminders of sound investment principles. The President's plan expands the current reporting requirements for 401(k)-type plans so that quarterly statements are required. In addition, the quarterly statement should address appropriate investment diversification. We believe that the more employees hear about diversification, the more they can decide for themselves whether their overall retirement savings are secure.

4. <u>Expanding Workers' Access to Investment Advice</u>

In order for employees to get the investment advice they need, the President advocates the enactment of the Retirement Security Advice Act – which passed the House with overwhelming bipartisan support. Currently, ERISA impedes employers from obtaining investment advice for their employees from the financial institutions that often are in the best position to provide advice. The Retirement Security Advice Act would address this by providing employees with access to advice from fiduciary advisers that are regulated by Federal or State authorities. As fiduciaries, these advisers would be held to the standard of conduct currently required by ERISA. This legislation encourages employers to make investment advice more widely available to workers and only allows qualified financial advisors to offer advice if they agree to act solely in the interests of employees. The Retirement Security Advice Act would also add important protections by requiring information about fees, relationships that may raise potential conflicts of interest, and limitations on the scope of advice to be provided. The legislation also would place advisers who have affiliations with investment products on a more equal footing with non-affiliated advisers, foster competition among firms, and promote lower costs to participants.

I reiterate the Administration's desire to achieve consensus on both the problems and solutions surrounding the retirement security of all Americans. I hope that we can work together to improve the employer-based retirement system and provide more retirement security for all Americans by providing more investment choice, plan information, and investment education to employees.

I appreciate the opportunity to discuss these important issues with the Members of this Committee, and would be pleased to explore these issues further.

Mr. Chairman, this concludes my formal statement. I will be pleased to answer any questions you or other Members may wish to ask.