Testimony Submitted by Judy A. Miller on behalf of the American Society of Pension Professionals and Actuaries

Senate Finance Committee Hearing

Tax Reform Options: Promoting Retirement Security

September 15, 2011

Thank you Chairman Baucus, Ranking Member Hatch and members of the Committee for the opportunity to speak with you about how tax incentives for the employer-sponsored retirement system are working to promote retirement security. I am Judy Miller, Chief of Actuarial Issues and Director of Retirement Policy for the American Society of Pension Professionals and Actuaries ("ASPPA"). Before working for ASPPA, I had the honor of serving as Senior Benefits Advisor on the Committee staff from mid-2003 through November of 2007.

ASPPA is a national organization of more than 7,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines including consultants, administrators, actuaries, accountants, and attorneys. ASPPA is particularly focused on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-based retirement plan system.

The message I want to convey today is that the current tax incentives are working very well to promote retirement security for millions of working Americans. Modest changes can and should be made to expand coverage, but care should be taken to preserve and enhance the basic framework of the current incentives that motivate employers to sponsor retirement plans, and both employers and employees to contribute to these arrangements.

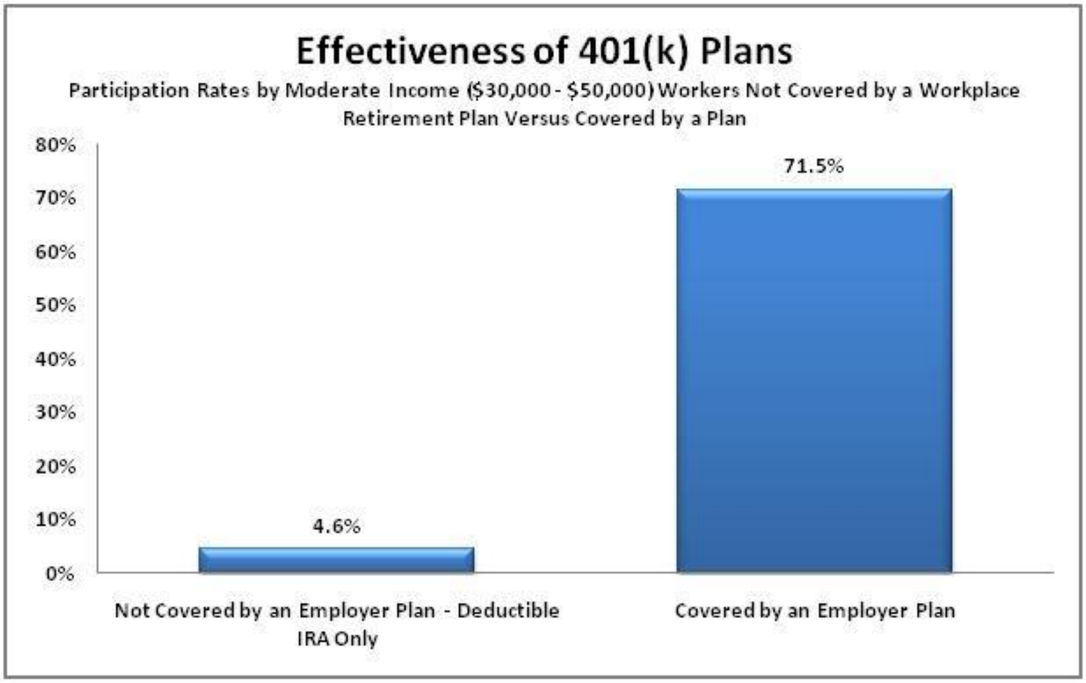
Background

The current system of tax incentives has been very successful at accumulating assets to improve the retirement security of millions of American households. Seventy percent of U.S. households now have an IRA or an employer-sponsored retirement plan. At the end of 2010, private employer-sponsored defined contribution plans held about $4.5 trillion in assets, private employer-sponsored defined benefit plans held $2.2 trillion and state and local retirement plans held $3.0 trillion. There was another $4.7 trillion held in IRA accounts. Although IRAs include contributions made by individuals to the IRA on their own behalf, a substantial portion of IRA assets are attributable to rollovers from employer-sponsored plans and direct employer contributions. Of the 49 million households that own IRAs, 55% report that their IRA accounts include a rollover from another retirement plan, and 9 million of the IRAs are employer-sponsored retirement savings arrangements such as SEPs and SIMPLE IRA plans.[1]

The past 20 years has seen a gradual shift in employer-sponsored arrangements from defined benefit plans to defined contribution plans. The number of participants (active, retired and deferred vested) reported as covered by defined benefit plans has been fairly stable - about 40 million in 1986, and 42 million in 2006, but an increasing proportion of those are retired participants. Over the same period, the reported number of participants in defined contribution plans increased from 37 million to 80 million. In 2009, about 61 million *active* workers participated in employer-sponsored retirement plans.[2]

Data shows that 401(k) and similar plans (such as 403(b) and 457(b) arrangements) have been very successful in getting workers to save for retirement. Contrary to the common assertion that only half of working Americans are covered by a retirement plan, a recent study from the Social Security Administration ("SSA") shows that about 70 percent of private sector workers have access to a retirement plan at work, and 80 percent of eligible workers with access to a plan participate in that plan. The success of saving through an employer-sponsored plan extends to low to moderate income workers. The chart below, based on data prepared by the Employee Benefit Research Institute (EBRI) updated to 2010, shows that over 70% of workers earning from $30,000 to $50,000 participated in employer-sponsored plans when a plan was available, whereas less than 5% of those without an employer plan contributed to an IRA.

[1] *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, Investment Company Institute, available at http://ici.org/pdf/2011_factbook.pdf.
[2] *EBRI Databook on Employee Benefits*, Employee Benefits Research Institute, available at http://ebri.org/publications/books/?fa=databook.



Source: Employee Benefit Research Institute (EBRI) (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan-IRA only)

ASPPA wishes to thank this Committee for its leadership in passing the Pension Protection Act of 2006 ("PPA"), which was supported by this Committee and the entire Congress overwhelmingly on a bi-partisan basis. By permanently extending previously enacted changes to various retirement plan rules, PPA greatly contributed to the continued maintenance and formation of workplace retirement plans by providing the certainty needed by both employers and employees.

Current Tax Incentives

<u>What are the incentives?</u>

Employer contributions made to qualified retirement plans are deductible to the employer when made. Income tax on investment earnings on those contributions is deferred until amounts are distributed from the plan. When a distribution is made to a plan participant, all amounts are subject to ordinary income tax. Employer contributions made on a participant's behalf are not subject to FICA. In addition, individuals with adjusted gross income ("AGI") of less than $27,750, and married couples with AGI of less than $55,500, may qualify for a Saver's Credit ranging from 10% to 50% of the first $2,000 the individual contributes to an IRA or employer-sponsored defined contribution plan.

Limits are placed on contributions to defined contribution plans, and on benefits payable from defined benefit plans:

- Certain defined contribution plans permit employees to contribute on their own behalf by electing to have a certain dollar amount or percentage of compensation withheld from pay and deposited to the plan. These "elective deferrals" are excludable from income for income tax purposes, but FICA is paid on the amounts by both the employer and the employee. For 2011, the maximum elective deferral to a 401(k) or similar plan is $16,500. Employees age 50 or over can also make a "catch-up contribution" of up to $5,500. Elective deferrals to a SIMPLE plan are limited to $11,500, plus a $2,500 catch-up contribution for those age 50 or over.

- If the employer also contributes to a defined contribution plan (such as a 401(k) plan), the maximum contribution for any employee is $49,000. This limit includes any elective deferrals other than catch-up contributions. This means a participant that is age 50 or over, and who makes the full $5,500 catch-up contribution, would have a total limit of $54,500.
- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year's pay or $195,000. If retirement is before age 62, the dollar limit is reduced. Employers can deduct the amount required to fund promised benefits.
- Annual IRA contributions are limited to $5,000, plus "catch-up" contributions of $1,000 for those age 50 or over.

Compensation in excess of $245,000 cannot be considered in calculating contributions or in applying nondiscrimination rules under either defined benefit or defined contribution plans. For example, if a business owner makes $400,000, and the plan provides a dollar for dollar match on the first 3% of pay the participant elects to contribute to the plan, the match for the owner is 3% of $245,000, not 3% of $400,000.

The higher contribution limits for qualified retirement plans – both defined contribution and defined benefit plans – come with coverage and non-discrimination requirements. For example, a small business owner with several employees cannot simply put in a defined contribution plan and only contribute $49,000 to his or her account. Other employees who have attained age 21 and completed 1 year of service with at least 1000 hours of work must be taken into consideration, and the employer must be able to demonstrate that benefits provided under the plan do not discriminate in favor of "Highly Compensated Employees" ("HCEs"), which would include the owner.

Safe harbors are available. For example, if all employees covered by a 401(k) plan are provided with a contribution of 3% of pay that is fully vested, the HCE can make the maximum elective deferral, regardless of how much other employees choose to contribute on their own behalf.

Age can also be considered when determining the amount of contributions that can be made on a participant's behalf. A larger contribution (as a percentage of pay) can be made for older employees because the contribution will have less time to earn investment income before the worker reaches retirement age (usually age 65).

How do retirement savings tax incentives differ from other incentives?

Unlike many tax incentives, the income tax incentives for retirement savings are not permanent deductions or exclusions from income. Taxes are *deferred* as long as the savings remains in the plan, but tax must be paid in later years when distributions are made from the plan. Furthermore, the distributions are subject to tax at *ordinary income* tax rates, even though lower capital gains and dividends rates may have applied if the investments had been made outside of the plan.

The tax incentives for qualified employer-sponsored retirement plans also come with stringent non-discrimination rules. These rules, coupled with the limit on compensation that can be considered under these arrangements, are designed to insure that qualified employer-sponsored retirement plans do not discriminate in favor of HCEs. Non-discrimination rules do not apply to other forms of tax-favored retirement savings. For example:

- IRAs share the incentive of tax deferral. However, if a small business owner makes a personal contribution to an IRA, there is no corresponding obligation to contribute to other employees' IRAs. However, under the current rules, the contribution limit for IRAs is set low enough (and the limit for employer-sponsored plans high enough) to make a qualified retirement plan attractive to a business owner who can afford it.
- Annuities purchased outside of a qualified plan share the benefit of "inside buildup" - the deferral of income tax on investment earnings until distributed from the arrangement – but have *no limit on contributions or benefits, and no non-discrimination requirements*. This means the attraction of a qualified retirement plan for a small business owner is heavily dependent on the interaction of non-discrimination rules and the contribution limits for a qualified retirement plan. [Note that at the end of 2010, there was $1.6 trillion in annuity reserves held *outside of* retirement plans.[3]]

How does tax deferral work to incent coverage?

The tax incentive for a small employer to sponsor a qualified retirement plan is a critical component to the establishment of a 401(k), defined benefit or other qualified retirement plan. The tax savings for the company's owner (or owners) can generate all or part of the cash flow needed to pay required contributions for other employees, which substantially reduces the cost of the plan to the owner (and transfers much of the apparent tax benefit to covered employees). Consider the following situation:

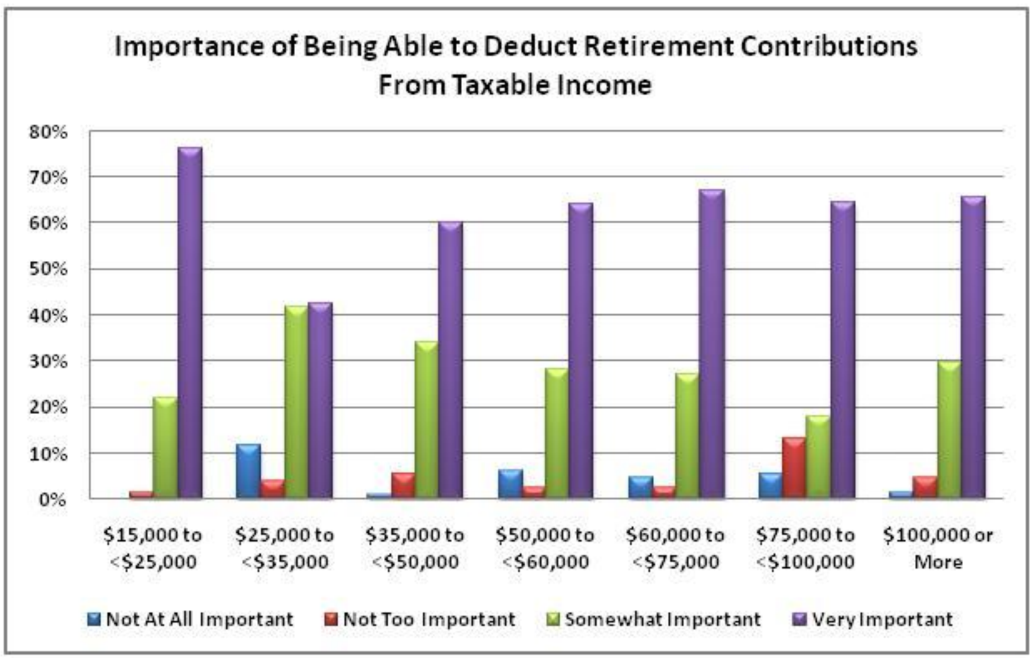
> ABC Company has been in operation for 5 years. The owner has some retirement savings in an IRA, but has never taken time to think about retirement. The business has 4 other employees earning from $35,000 to $70,000. The owner takes compensation of $10,000 per month during the year, then takes a year-end bonus of the amount of company profits. The owner pays individual income taxes on the full amount of the profits at a marginal rate of 28%.
>
> The owner meets with a retirement plan consultant. The owner is older than most of the other workers, so the consultant recommends a safe harbor 401(k) plan with an additional "cross-tested" contribution. Thanks to the

[3] *Retirement Assets Total $17.5 Trillion in Fourth Quarter 2010*, Investment Company Institute (Apr. 13, 2011), available at http://www.ici.org/pressroom/news/ret_10_q4.

nondiscrimination rules that apply to qualified retirement plans, putting $49,000 of the profits into the 401(k) plan for the owner means the owner must contribute at least 5% of pay for the employees. However, tax savings on the $49,000 will be more than enough to cover that 5% contribution, and the tax credit for the cost of setting up and operating a new plan helps defray any startup and initial operating costs. Setting up the plan becomes a simple question of "Do you want to give that money to your employees? Or add it to the check you are sending to IRS?"

The current tax incentives transform what would have been a bonus to the business owner, subject to income taxes, into a retirement savings contribution for the owner *and the employees*. Not only will the employees receive an employer contribution of 5% of pay, most will also make additional contributions on their own behalf.

The tax incentives are also used to encourage employees to join 401(k) plans and similar plans. Educational materials encouraging participants to enroll in, and contribute to, plans typically show the worker how tax savings will help them save more than they could through another savings arrangement. For example, materials will show how contributing $100 to your 401(k) account will only cost $85 (or $72 for higher income workers). As shown in the chart below, over 80% of workers in all income categories find this incentive somewhat or very important.



Source: Jack VanDerhei, *The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results From the 2011 Retirement Confidence Survey*, ebri.org Notes (Mar. 2011), available at http://ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=4785.

Who Benefits

<u>Who is participating?</u>

The Bureau of Labor Statistics ("BLS") found that 78 percent of all full time civilian workers had access to retirement benefits at work, with 84 percent of those workers participating in these arrangements. For private sector workers, BLS found the access and participation rates are 73 percent and 80 percent respectively. Availability and take up rates are substantially lower for part-time workers, so if part time workers are included, BLS found that 68 percent of civilian workers had access to retirement plans, and 80 percent of those actually participate in the offering. For the private sector only, the access and participation rates for all workers are 64 percent and 76 percent respectively.[4]However, alternative research suggests these estimates are less than what is actually happening in the workplace.

A report from SSA shows that 72 percent of *all* employees who worked at private companies in 2006 had the ability to participate in a retirement plan, and 80 percent of those participated.[5] The SSA used data from a Census survey merged with W-2 tax records to correct for respondents' reporting errors. SSA found "among private-sector wage and salary workers, both employer offer rates and employee participation rates in *any* type of pension plan considerably increase when W-2 records are used, an indication of substantial reporting error." [6] The SSA results indicate the BLS statistics on availability are likely understated.

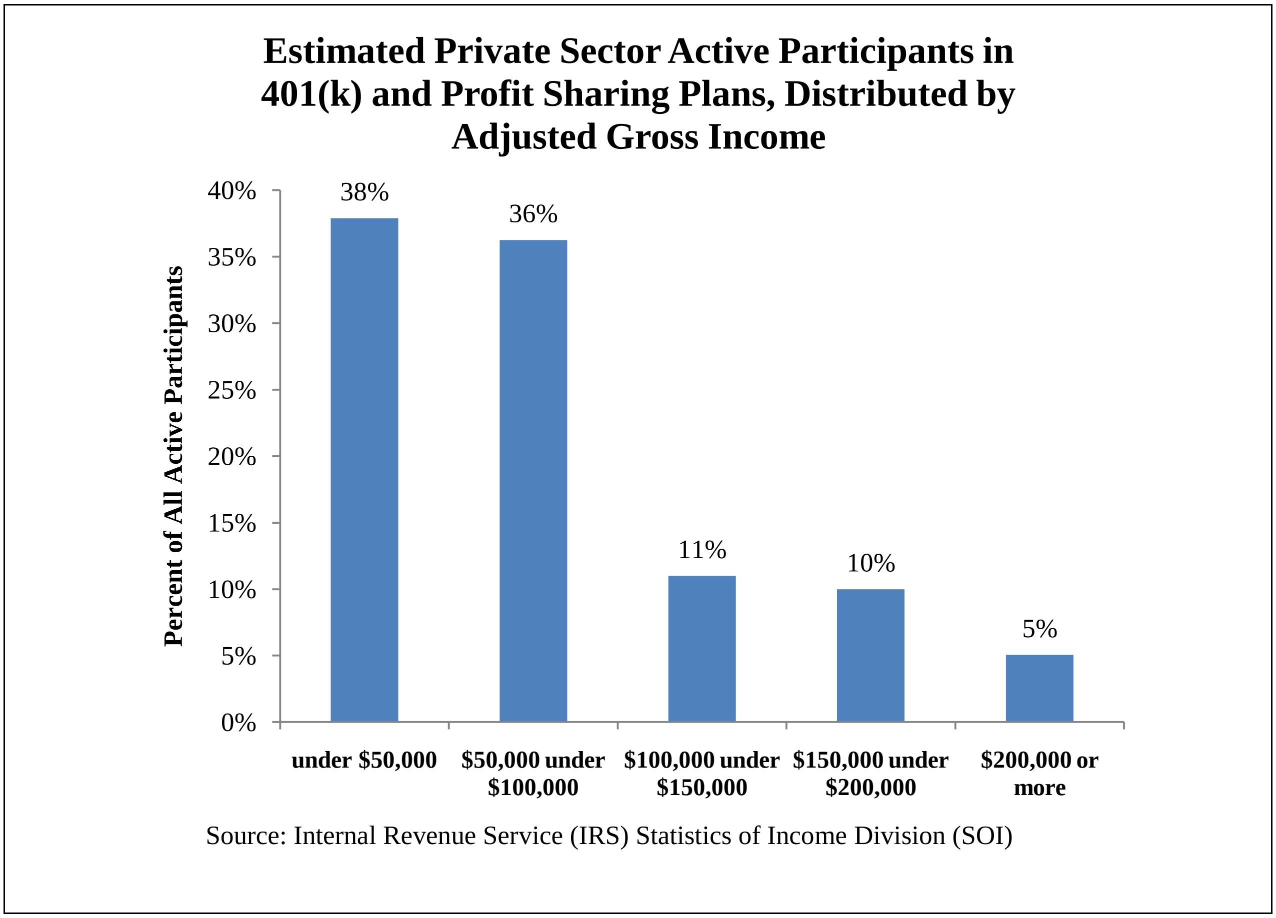
Part-time workers are far less likely to have a retirement plan available at work, and less likely to participate in a plan when it is available. BLS data shows only 37% of part-time private sector workers have a retirement plan available at work, and 54% of those participate in the plan. Similarly, employees that work for smaller employers are less likely to have a plan available. BLS data shows 49 percent of private sector employees who work for employers with less than 100 employees have a plan available at work. Sixty-nine percent of those workers do participate when a plan is offered, though. Employer surveys indicate business concerns are the primary driver of this low rate of sponsorship among smaller employers.

Participation in employer-sponsored defined contribution plans is heavily weighted toward middle class Americans. As the chart below shows, 38% of participants in defined contribution plans make less than $50,000 per year. Nearly three-quarters make less than $100,000.

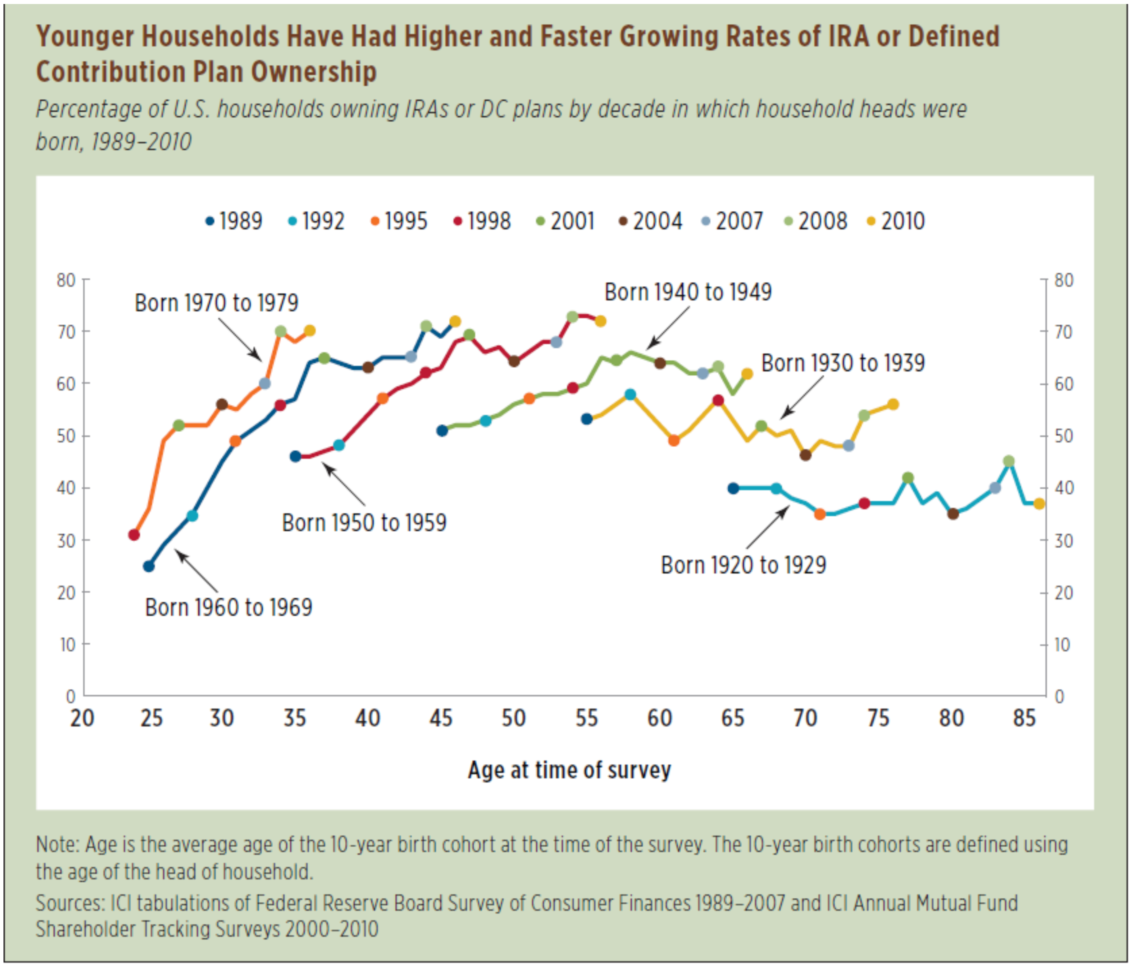
[4] Bureau of Labor Statistics, *Employee Benefits Survey: Retirement Benefits, March 2011: Retirement benefits: access, participation, and take-up rates: National Compensation Survey March 2011* available at http://www.bls.gov/ncs/ebs/sp/ebnr0017.pdf (hereinafter "BLS Survey").

[5] Irena Dushi, Howard M. Iams, and Jules Lichtenstein, *Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Records*, Social Security Bulletin (2011), available at http://www.ssa.gov/policy/docs/ssb/v71n2/v71n2p53.pdf.

[6] *Id*. at 1 (noting "We find substantial reporting error with respect to both offer and participation rates in a retirement plan. About 14 percent of workers who self-reported nonparticipation in a defined contribution (DC) plan had contributed as indicated by W-2 records, whereas 9 percent of workers self-reported participation in a DC plan when W-2 records indicated no contributions.").



There is reason for optimism that coverage will increase over time. The following chart shows that younger workers have shown dramatic gains in ownership of retirement savings accounts over the past decade. The increasing use of automatic enrollment is also expected to increase take-up rates. (Most plans only automatically enroll new hires, so recognition of participation gains will occur gradually).



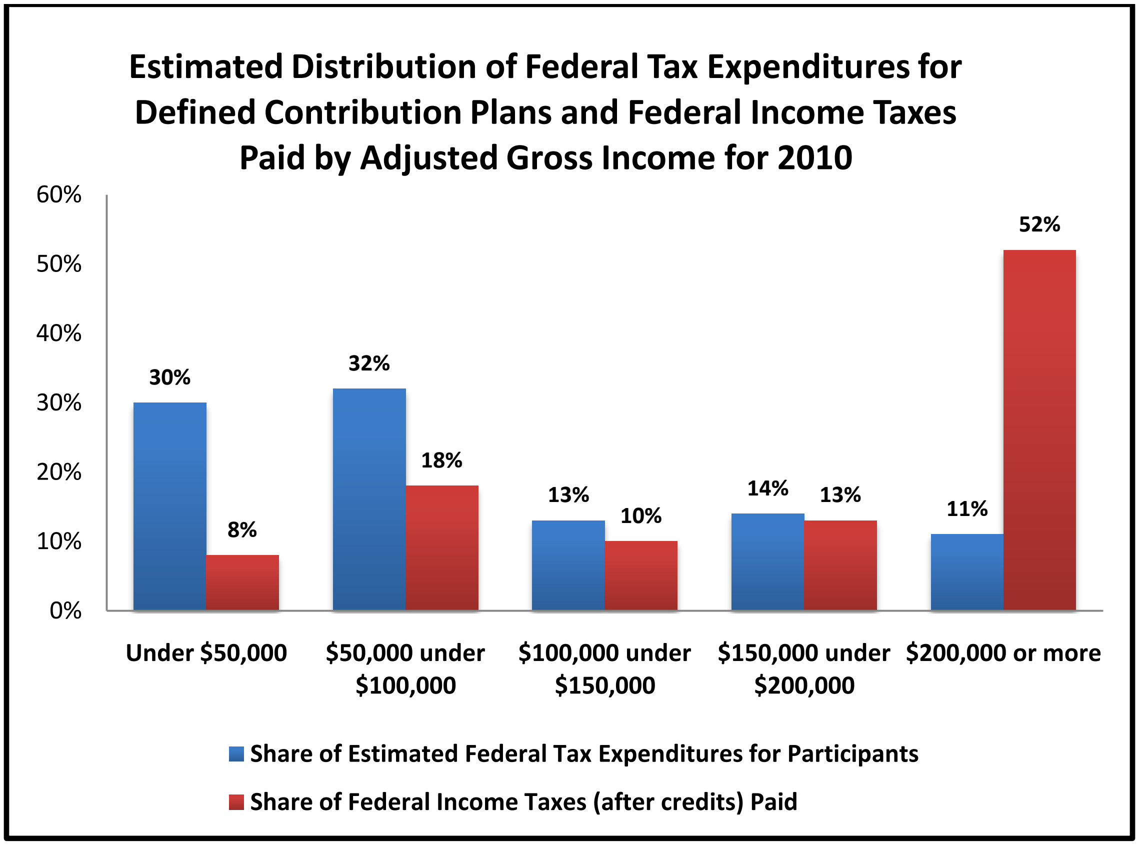
Source: 2011 Investment Company Factbook, Figure 7.4, page 103

<u>How is the tax benefit distributed?</u>

Distribution of the tax benefit is typically analyzed by applying the marginal tax rate to contributions allocated to an individual's account multiplied by the marginal tax rate.[7] Because the U.S. income tax system is progressive, the value of the tax incentive on a dollar of retirement savings *in the year of deferral* increases as the marginal tax rate increases. This progressive income tax structure, coupled with the assumption that the more income a worker has, the more he or she can afford to save, would lead one to expect the tax benefit for retirement savings would be more skewed than the incidence of income tax. However, the non-discrimination rules that apply to employer-sponsored retirement plans, coupled with the limit on compensation that may be considered for purposes of determining contribution allocations, leads to a very different result. The distribution of the tax incentive for retirement savings is *more progressive* than the current progressive income tax system. As the following chart shows, households with incomes of less than $50,000 pay only about 8% of all income taxes, but receive 30% of the defined

[7] For example, see Table 1 of the Hamilton Project paper "Improving Opportunities for Savings and Incentives for Middle- and Low-Income Households" by William Gale, Jonathan Gruber and Peter Orszag.

contribution plan tax incentives. Households with less than $100,000 in AGI pay about 26% of income taxes, but receive about 62% of the defined contribution plan tax incentives. [8]



What this clearly shows is that, contrary to one common myth, the tax incentives for retirement are *not* upside down at all. Thanks to the balance imposed by the current law contribution limits and stringent nondiscrimination rules, these tax incentives are *right side up* – even before properly considering other components of this incentive.

The standard methodology for measuring the benefit of the tax incentive (multiplying marginal rate times income deferred) shows that the tax incentives for employer-sponsored retirement savings are more progressive than the current income tax code. However, because of the unique nature of this tax incentive, this methodology actually *understates* how progressive the current tax incentives are:

- First, as illustrated in the "ABC Company" example on page 5, this measurement fails to consider that much, if not all, of this apparent tax savings to a small business owner is transferred to employees in the form of employer contributions. The standard methodology credits the small business owner contributing $49,000 on her

[8] *Estimated Benefits of Tax Expenditure Estimates for Defined Contribution Plan Participants and Retirees with Account Balances*, available at http://www.asppa.org/Main-Menu/govtaffairs/Testimony/2011/DistTaxExp_TaxesPaid_3-18-11.pdf.aspx.

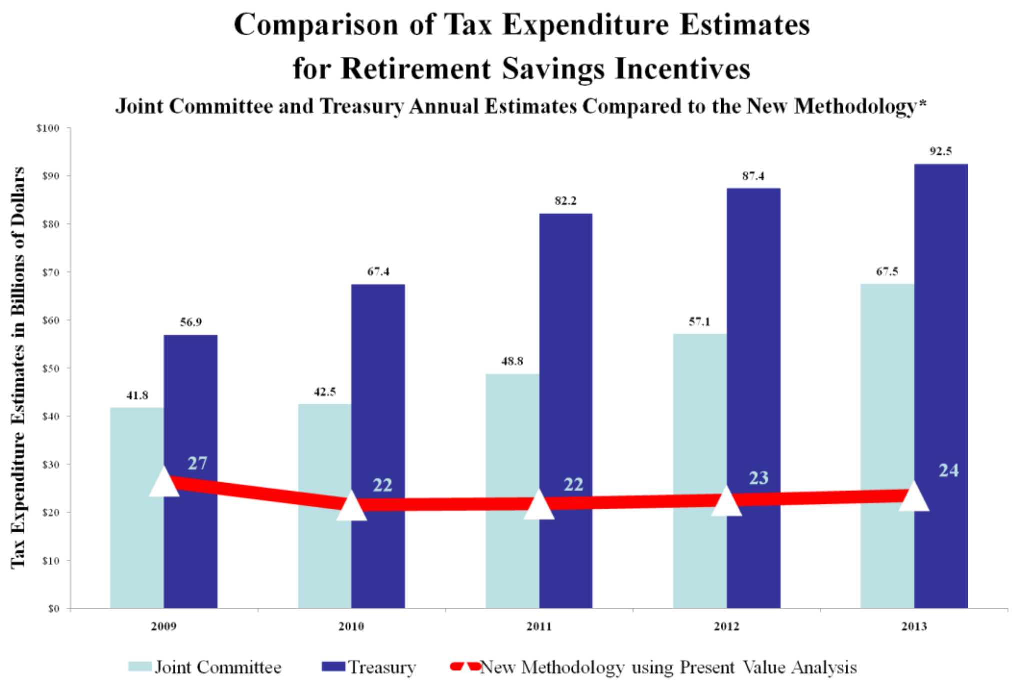
own behalf with $13,200 "tax savings" (28% marginal rate times $49,000). If payroll for other covered employees is $200,000, the nondiscrimination rules require the employer to contribute at least 5% of pay, or $10,000, to the accounts of these other employees. Assuming for the sake of simplicity that the business tax rate is the same as the owner's rate of 28%, the net cost of the $10,000 contribution is $7,200. The small business owner's net benefit for the current tax year is therefore only $6,000 ($13,200 - $7,200). Assume the average marginal rate for the other employees is 15%. The rate times contribution method results in an apparent tax benefit of $1,500 (15% of $10,000). In fact the benefit is the full $10,000. So, although standard methodology would measure the tax incentive in the current year as $13,200 for the owner and $1,500 for the other employees, the true allocation is $6,000 for the owner and $10,000 for employees.

- Part of the cost of the retirement savings tax incentive is the deferral of income taxes on investment income. However, if a small business owner elected not to set up a qualified plan, and had simply paid income taxes instead of making retirement contributions for herself and the other employees, she could have gained identical deferral of income tax on investment earnings by investing the $49,000 in an individual annuity, or benefitted from lower capital gains and dividend tax rates on investment income by purchasing investments outside of a retirement savings vehicle. Therefore, the cost of the qualified retirement plan tax incentive should only reflect the cost of excluding the deferral in the year the contribution is made, plus deferral of tax on investment income on contributions in excess of an after-tax contribution amount, *less* the difference between ordinary income tax and capital gains and dividend taxes on investment income. (Note that for this small business owner, the after-tax value of the *employee* contributions would be available for investment outside of the qualified retirement plan, not just the after-tax value of the $49,000 contribution for the owner.)
- Analyzing the benefit for any given year during an accumulation period also fails to recognize the deferral nature of the savings tax incentive. When an individual saving $49,000 per year reaches retirement and distributions begin, the marginal income tax rate of those distributions will be substantially higher than for those with a history of lower contributions. (The fact that the amount of Social Security benefits includible in income, if any, depends on the amount of other retirement income received during a year increases the rate differential for retirees). As a result, this failure to consider taxes to be paid at a later date tends to overstate the relative benefits offered by the current system to those who make higher levels of contributions to these plans.

An analysis of the distribution of the tax incentives that considers these factors would show the current tax incentives for retirement savings are extremely efficient at distributing benefits to low- and moderate- income workers.

True Cost Overstated

Current budget rules require that the cost of most tax incentives be determined on a cash flow basis. Because the tax incentive for retirement savings is a *deferral,* not a permanent exclusion, basing the cost on current cash flow analysis – taxes not paid on contributions and investment earnings for the current year less taxes paid on current year distributions – misrepresents the true cost of the retirement savings incentives. Using a present value method, which recognizes that taxes will eventually be paid on distributions, produces very different estimates – more than 50% lower than JCT or Treasury estimates for a 5-year budget window.[9] The following chart illustrates the results.



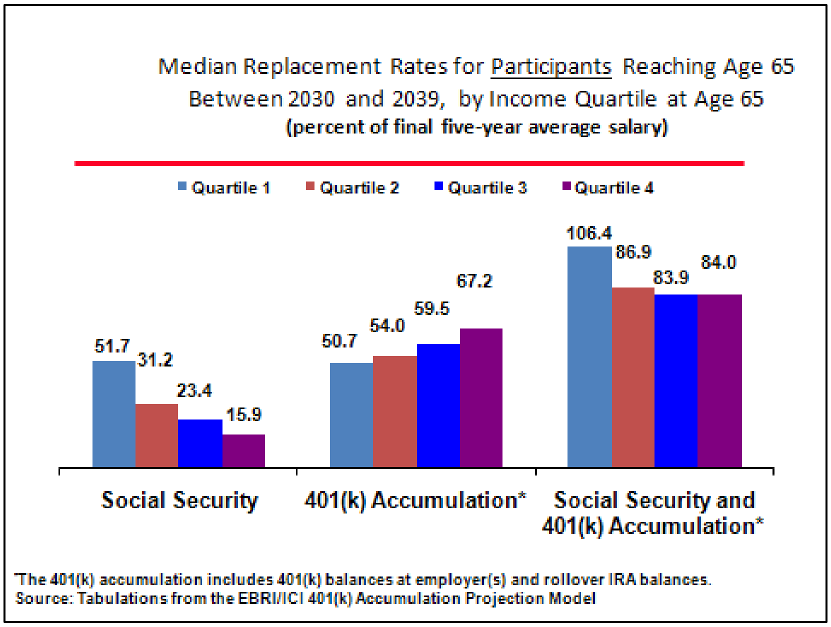
* The new methodology estimates the tax benefit of the deferral and inside buildup, in present value terms. The Joint Committee and Treasury estimates rely on cash-flow analysis.

The danger in using the cash flow measurement is not just that the current cost is overstated, but the long-term impact of modifying the incentives is also hidden. Reducing the limits will generate revenue in the budget window, but will also lead to reduced revenue – and more demand for low income benefits such as Medicaid and Supplemental Security Income ("SSI") - in later years.

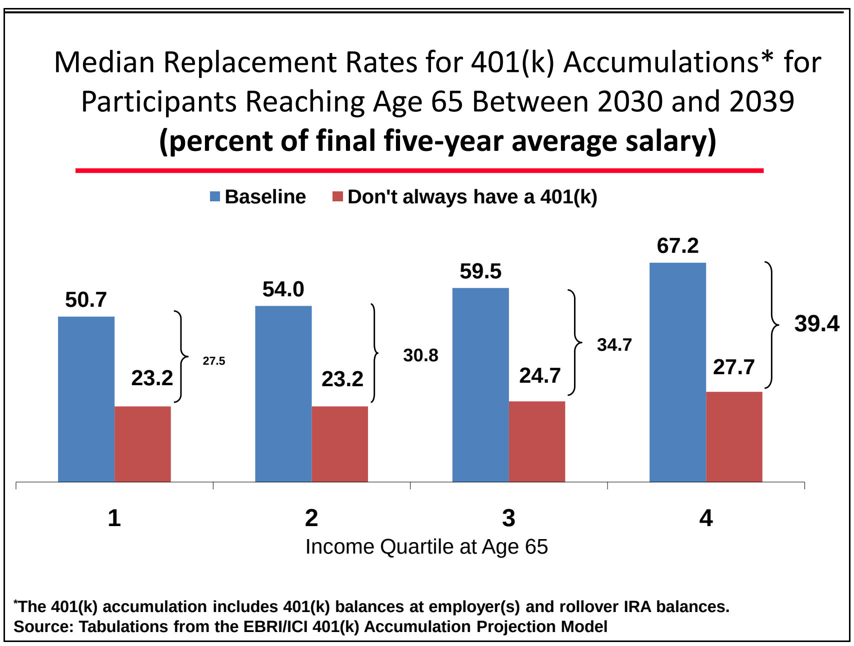
Adequacy of Benefits

The availability of a defined contribution plan at work is a key determinant in the likelihood for having a secure retirement. Benefits can be very meaningful ….

[9] Judy Xanthopoulos and Mary Schmidt, *Retirement Savings and Tax Expenditure Estimates* (May 2011), available at http://www.asppa.org/Main-Menu/govtaffairs/RET.aspx



if there is consistent availability of workplace savings.

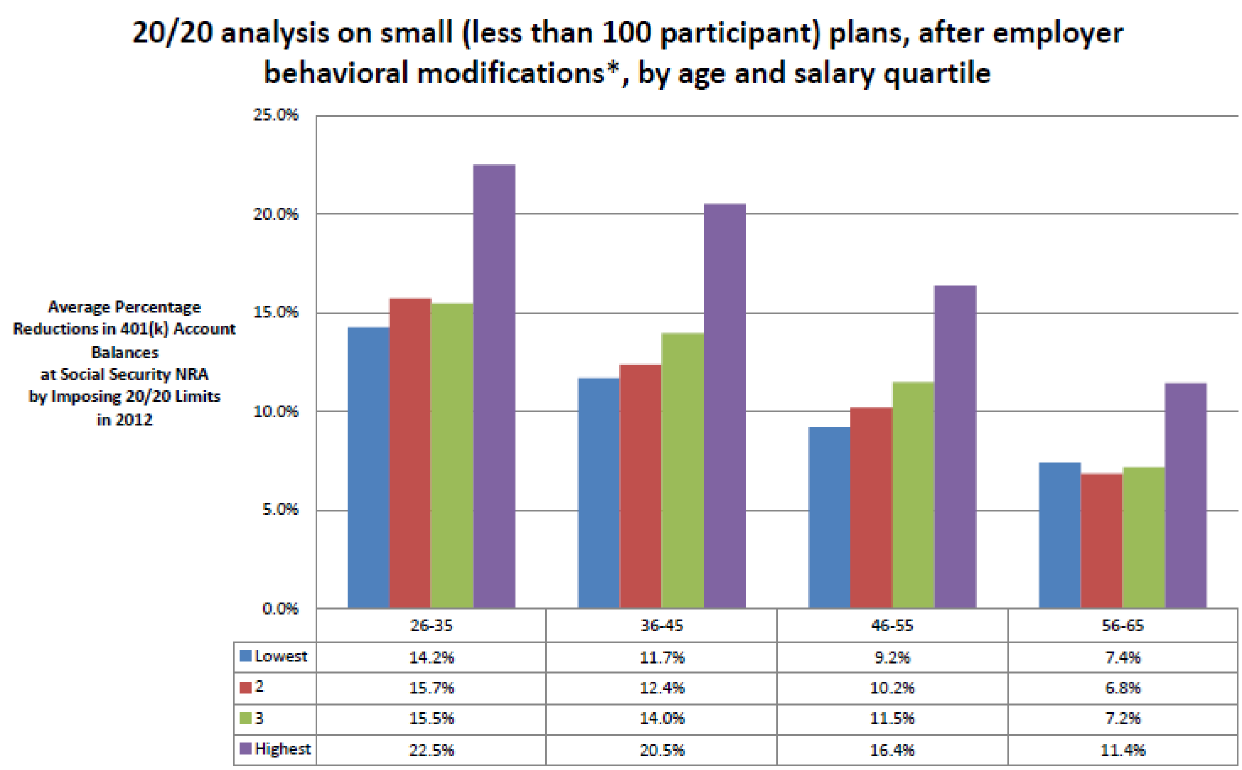


Impact of Proposed Changes

The Deficit Reduction Commission and the President's Economic Recovery Advisory Board ("PERAB") both floated the idea of reducing the current $49,000 maximum contribution for defined contribution plans to the lesser of 20% of pay or $20,000. Reducing the maximum contribution from the current $49,000 to $20,000 would mean the qualified retirement plan no longer makes financial sense for many small business owners. The result would be less access to retirement savings opportunities at work for rank and file employees. In a survey of ”cross-tested” plans conducted by the American Society of Pension Professionals and Actuaries (ASPPA), 65% of plan sponsors indicated they were likely to terminate the cross-tested plan if the plan design were no longer available. A dramatic reduction in the limit would effectively make not only a cross-tested plan, but most other qualified defined contribution plans, unattractive to small business owners.

Even if some plans survived, contribution rates, and so projected balances, would decline. Employer contributions are often based on the level of contribution required to meet the nondiscrimination rules. Lower maximum contributions will mean nondiscrimination testing passes with a lower level of employer contributions, which means lower employer contributions for employees. Nonetheless, the reality for many small business retirement plans is that the reduced limits will mean the end of the plan. For many small businesses, even after reducing the level of employer contributions made on behalf of non-owner employees, the reduced tax incentive due to the lower limits will simply not create enough cash flow to justify continuing the plan at all.

The following chart shows the decline in projected account balances for participants in small plans, considering both changes in employee behavior and employer behavior, including the termination of plans, if the maximum contributions for defined contribution plans were reduced to the lesser of 20% of pay or $20,000.



	26-35	36-45	46-55	56-65
Lowest	14.2%	11.7%	9.2%	7.4%
2	15.7%	12.4%	10.2%	6.8%
3	15.5%	14.0%	11.5%	7.2%
Highest	22.5%	20.5%	16.4%	11.4%

Source: EBRI RSPM, version 110906c.
* This includes both reduced employer contribuion behavior as well as the plan termination scenario when there is a negative "net benefit" as a result of the 20/20 constraints, even after adjustments to contribuion levels.

Another recurring proposal would convert the current-year contribution exclusion from income into a uniform tax credit. How a proposal such as this affects plan sponsors and participants depends, of course, on what the level of credit is, and whether or not it is deposited to a retirement savings account or directly offsets income tax liability. The current proposal from William Gale[10] offers both a 30 percent credit, which the paper says would be revenue neutral, and an eighteen percent credit. This proposal purports to create additional savings by providing more incentive for taxpayers below the 23 percent and 15 percent marginal tax brackets to save. There appear to be several basic flaws in this proposal:

- Data shows the primary problem to be addressed in improving retirement security is increasing *access to workplace savings*, not a lack of incentive for take-up by participants with access. The proposal itself indicates that the current tax incentive for many decision makers would be reduced under the proposal. In fact, for the business owner, the reduction in the incentive would be more than illustrated in the proposal because contributions made on behalf of employees would become subject to FICA. In other words, the "problem" being addressed by this proposal is not the problem, and the "solution" will only make the situation worse.

[10] William G. Gale, *A Proposal to Restructure Retirement Savings Incentives in a Weak Economy with Long-Term Deficits* (Sep. 8, 2011).

- If the credit is an offset from income tax liability, the size of the credit for a small business owner would determine if setting up or maintaining the plan is still worthwhile. If the credit were deposited to a retirement account, in many cases the resulting drain on cash would necessarily result in lower contributions for the small business owner and employees, or termination of the plan. (We note that for larger employers, the size of the credit will in no way offset additional FICA liability. They would have to take on the additional cost, or decrease contributions.)

- The paper notes that a 30 percent credit is equivalent to a 23 percent deduction. Similarly, an 18 percent credit would be equivalent to a 15 percent deduction. The equivalency is based on the theory that only the after-tax amount of income will receive the credit. For example, if an employee defers $1,000 under the current incentive system and is in the 15 percent bracket, under current rules, $150 of income tax liability is deferred. Under the proposal, the after tax deferral would be $850. Eighteen percent of $850 is $150, so this credit is equivalent to the exclusion for income tax purposes. This analysis makes sense in the case of IRA contributions or elective deferrals, where FICA is already paid on the contribution amounts. It does not hold up, however, for employer contributions where there is currently no FICA liability for either employees or employers.

  Consider an employee in the 15 percent bracket contributing $1,000 as an elective deferral and receiving a $1,000 employer contribution. *If the level of employer contribution does not change*, the employee will not only offset the $1,000 elective deferral by the $150 income tax liability on the elective deferral, but also by the $150 income tax liability for the employer contribution and the $76 in FICA contributions the employee owes on this employer contribution amount. Instead of $2,000 in total contributions, there will be $1,624 ($2000 - $150-$150-$76). An eighteen percent credit applied to $1,624 is only $292. So the employee has lost over $80 in this change to an "equivalent" eighteen percent credit. For this situation, the equivalent credit would be about 23 percent. Note, however, that the higher the level of the employer contribution relative to the elective deferral, the higher the credit must be for the individual to break even. If there were a $2,000 employer contribution, an 18 percent credit would result in a reduction of over $171, after FICA is considered, and the equivalent credit would be over 25 percent.

Considering the FICA implications, this proposal has the effect of penalizing both business owners (through increased FICA taxes) and employees when the plan provides for matching or profit-sharing contributions, with the penalty increasing as the employer contribution increases. Regardless of the size of the credit, this is an incentive for all employers, not just small business owners, to reduce company contributions.

Simplification Myth

There is a persistent myth that the variety of retirement savings arrangements confuses small employers from setting up plans, and employees from participating in them. This line of reasoning leads to proposals to consolidate all types of defined contribution plans into a single plan with a single, safe harbor, contribution testing methodology. This myth is not supported by the facts for the employer-sponsored retirement system.

- Small employers that do not sponsor a retirement plan consistently point to business concerns as the main reason they do not sponsor a plan. In fact, the primary reason is uncertainty about revenue. Flexibility in plan design gives practitioners the tools to design arrangements that are attractive to more employers than a "cookie cutter" approach.
- Different types of employer-sponsored plans do not discourage employee participation. Potential plan participants are NOT asked to choose between a 401(k) or SIMPLE, or a 401(k) or 403(b) arrangement. Employees are simply asked if they want to enroll in the plan being offered by the employer – or are automatically enrolled.

In short, less flexibility would reduce coverage, not enhance it.

What Should be Done?

The current system is working very well for millions of working Americans. Expanding *availability* of workplace savings is the key to improving the system. There is no need for dramatic changes, but measures should definitely be considered to make it easier for employers, particularly small businesses, to offer a workplace savings plan to their employees.

I would be pleased to discuss these issues further with the Committee or answer any questions that you may have.