SMALL BUSINESS COUNCIL OF AMERICA

STATEMENT OF PAULA A. CALIMAFDE ON BEHALF OF THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

"SMALL BUSINESS PENSION PLANS: HOW CAN WE INCREASE WORKER COVERAGE?"

June 29, 2006

The Small Business Council of America (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 sponsor retirement plans or advise small businesses which sponsor private retirement plans. These enterprises represent or sponsor well over two hundred thousand qualified retirement plans and welfare plans.

Mr. Chairman and Members of the Committee, I am Paula Calimafde, Chair of the Small Business Council of America (SBCA). I am also a practicing attorney who specializes in retirement plan and employee benefits law. As Chair of the SBCA, I am here to present our view as to how worker coverage can be increased in the small business arena. At the outset, we would like to thank Chairman Gordon Smith and Ranking member John Kerry of the Senate Committee on Finance, Subcommittee on Long-Term Growth and Debt Reduction for examining these important issues.

VOLUNTARY QUALIFIED RETIREMENT PLAN SYSTEM - A MAJOR SUCCESS

More than *19 million* American workers are covered by the small business retirement plan system.[1] Most of these small business employees enjoy generous annual retirement plan contributions from their employers, often in the range of three to ten percent of compensation. The small business qualified retirement plan system is successful in delivering meaningful retirement benefits for its employees.

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[1] Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 2. Employee Characteristics by Employer Retirement Plan Sponsorship, 2003 at CRS-5. This Table shows that there are approximately 5.4 million employees who work for businesses that sponsor a retirement plan and employ fewer than 10 employees, approximately 4.8 million employees who work for businesses that sponsor a retirement plan and employ between 10 and 24 employees, approximately 9.6 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees and approximately 12.6 million employees who work for businesses that sponsor a retirement plan and employ between 100 and 499 employees. Small business retirement plans are sometimes considered as those with fewer than 500 participants while others use a cut off number of 250 or 100. Obviously, if the cut off number is higher than 100 participants, then the small business retirement plan system covers more than 19 million employees. The actual participation rates in these plans is somewhat lower since not all employees are eligible to participate. Many plans require employees to work a year before becoming eligible and many require employees to work at least 1000 hours a year to be eligible to receive contributions. These numbers are different from those presented in an earlier CRS report. See Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Pension Sponsorship and Participation: Summary of Recent Trends, September 10, 2004, Table 4. Participation in Retirement Plans by Size of Firm at CRS-10. This Table shows that there are approximately 5.8 million employees who work for businesses that sponsor a retirement plan and employ fewer than 25 employees and approximately 6.1 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees. There are approximately 31.5 million employees in companies that sponsor a retirement plan and employ more than 100 workers.

This was not always the case. Due to a constant onslaught of legislation and regulation throughout the 80’s which cut benefits for owners while simultaneously imposing additional costs and burdens to the company, the small business retirement plan system was stagnant at best. Terminations were up and new plan formation was down. By the beginning of the 90's, it became evident to Congress that if retirement plan coverage was to be increased, it was imperative to return stability and clarity to the voluntary qualified retirement plan system. Costs for administration had to once again become reasonable. Once again companies would have to be able to rely on the assurances of their advisors so that they could take actions knowing what the results would be. Due to a series of laws passed throughout the 90’s and continuing through the major tax bill in 2001 which included significant reforms for small business, Congress was able to put the system back into balance and small business formation has been increasing significantly. It is not an exaggeration to say that Congressional action in the retirement plan area over the last 15 years has saved the small business retirement system which in turn has provided retirement security for millions of small business employees.

IMPORTANCE OF TAX INCENTIVES IN THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

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 will forgo the retirement plan option.

SMALL BUSINESS PLANS ALSO ALLOW EMPLOYEES TO SAVE VIA PAYROLL DEDUCTION

Not only do many small business retirement plans have a generous employer contribution (generally a profit sharing contribution) and/or an employer matching contribution, but they also often provide an attractive way for all employees to save for their retirement. 401(k) plans and SIMPLEs are so effective because employees are able to save for their retirement by having automatic deductions taken from their paychecks which reduces the amount of their taxable income. The money saved by the employees inside the plan grows tax free and the 401(k) plan prevents easy access to the money by the employees so that the funds are able to grow and accumulate for retirement (not true for the SIMPLE see below). Intuitively, one anticipates that if an employee can reduce his or her paycheck by the amount of desired savings prior to receiving the cash in hand, the odds are the money will, in fact, be saved rather than spent. The SBCA has heard countless small business employees state how much easier it is to save by payroll deduction than by any other method.

Employer sponsored retirement plans are the most effective method for encouraging savings by low to moderate income workers. According to data collected by the Employee Benefits Research Institute (EBRI), 77.9 percent of workers earning between $30,000 to $50,000 who were covered by an employer sponsored 401(k) type plan actually participated in the plan, while only 7.1 percent of "non-covered" workers in the same income level, saved in an individual retirement account. In other words, low to moderate income workers are almost 11 times more likely to save when covered by a workplace retirement plan.[2] Reasons for this striking disparity include the convenience of payroll deductions since it is much easier to save money that one has never had in hand, the convenience of having investments preselected, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer. Unlike the success of the 401(k) plan and other employer-sponsored retirement plans, the rate of personal savings in this country outside of the retirement plan area (and outside IRAs) is quite low – less than two percent.

IMPORTANCE OF AUTOMATIC ENROLLMENT – LET'S NOT MISS THE OPPORTUNITY

In a number of studies, behavioral economists have found that the easier it is for an employee to save, the more likely it is for that employee to do so. While this seems to be axiomatic, it is surprising the extent to which employees do whatever is easiest. For instance, an analysis conducted in 2000 found that workers, particularly low income workers, were far more likely to participate in a 401(k) plan if they were automatically enrolled than when they had to sign up for the plan. The numbers are rather startling: when enrollment was not automatic, 37.4% of all workers overall would sign up for the 401(k) plan, but when enrollment was automatic, the number jumped up to 85.9%. This trend was even more pronounced in workers making less than $20,000 a year. Without automatic enrollment, 12.5% opted to join the plan, with automatic enrollment, 79.5% chose to participate in the plan.[3] This makes it clear that the way to encourage and increase savings, particularly for the low and mid-income worker, is to have an employer-sponsored plan, preferably with automatic enrollment and a preselected investment feature.[4] Interestingly, when these factors are present, employees are willing to save

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[2] ASPPA, based on the EBRI data, developed a chart setting this statistic out in graph format which demonstrates far more ably than words how effective the employer-sponsored retirement plan is at promoting savings for all workers.

[3] Washington Post, April 18, 2005, Private Accounts Make for Hard Sell at A8.

[4] Id., This article also states that in the same analysis conducted in 2000 that overall 71.2% of all workers kept the default investment option offered by the plan and that 24.8% switched to their own choice. Among workers who made below $20,000 a year, 89.3% stayed with the default investment option and 8.5% chose to select their own choice.

in these plans which effectively "lock up" the funds for long term growth since they are designed to have contributions accumulate and grow tax free until retirement. [As an aside, it is important to note that the funding problems seen in some of the very large defined benefit plans are highly unusual in the small business retirement plan system – this is likely due to the fact that the owners' retirement savings are also inside the plan so that the funding is adequate and the assets are carefully invested. Thus, not only are the plans highly effective as savings vehicles for the employees and for providing significant employer contributions for the employees, they are also by and large properly funded with the assets prudently invested.]

WORKABLE AUTOMATIC ENROLLMENT 401(K) SAFE HARBOR NEEDED

In the House version of the Pension Bill currently in conference, there is an automatic enrollment 401(k) safe harbor provision which, with one major change, could work in the small business retirement plan context. It offers an incentive to the small business to take on the extra administration inherent in automatic enrollment by reducing slightly the costs of the current 401(k) safe harbors – not by much, but in the SBCA's opinion, enough so that a small business would be willing to consider adopting it. Unfortunately, the proposed safe harbor is totally destroyed by a requirement that the safe harbor will only be operative if 70% of the employees who were automatically enrolled actually stay enrolled. This type of provision is what we refer to as an "ivory tower" provision – it sounds good but simply will not work in actual practice. Why? Because small business owners will simply not spend the money to amend the retirement plan and the summary plan description, provide written communication material explaining the new procedure, add an extra burden to their internal payroll system and add to the external administrative costs of running the plan if they are not assured that it will work. Because small business owners cannot force their employees to stay enrolled, they will not take on all of this extra expense when not assured of the outcome particularly because it is totally out of their control. The House version of the automatic enrollment 401(k) safe harbor should be adopted in the final compromise but without this provision which renders the entire safe harbor meaningless. If there is no incentive for the small business to adopt the automatic enrollment they will stay away from it because of the considerable additional administrative burden and expense imposed.

HOW MUCH IS COVERAGE LAGGING IN THE SMALL BUSINESS WORLD?

Many small businesses would like to provide retirement plans for their employees and believe that retirement plans aid in attracting and retaining top employees. As we know, however, the retirement plan coverage rate for small businesses lags behind the retirement plan coverage rate of their larger counterparts.

The actual retirement plan coverage picture may not be as bleak as reported, since qualified retirement plans are not required to cover part-time employees, employees under age 21 or transient employees. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the entire workforce and that percentage of the workforce that is actually eligible to participate in a retirement plan. When these ineligible employees are excluded, the coverage numbers improve. Further, these numbers do not distinguish between start up small businesses and those that are established. Data shows that *one third* of all new small businesses fail within the first two years and *fewer than half* survive more than the first four years.[5] This is a significant number of businesses which in all likelihood do not offer any retirement plan coverage (because they are struggling merely to exist) and yet are included in the statistics on low small business plan coverage. Once again, this high death rate of small businesses is a factor that could skew the data dramatically.

Interestingly, unlike coverage, participation in a retirement plan is fairly constant regardless of the size of the employer. In 1997, 88.2% of employees who worked for companies that employed 100 or more employees and sponsored a pension or retirement savings plan actually participated in the plan. 85.5% of employees in companies with 25 to 99 employees which sponsored such a plan participated and 84.8% of employees in firms with fewer than 25 employees participated. [6] These data illustrate that when a small business sponsors a retirement plan, the employees participate at close to the same levels as in larger companies. Thus, once a small business has chosen to sponsor a retirement plan, meaningful participation results. To achieve greater coverage, therefore, the system must be made attractive to small business.

TAX CODE REQUIRES MEANINGFUL BENEFITS FOR ALL SMALL BUSINESS EMPLOYEES

As mentioned above, once a small business sponsors a qualified retirement plan, employees frequently receive excellent benefits. In fact, employer contribution levels in small business plans are often higher than those offered by larger entities. For instance, small business plans typically provide contributions for staff employees at levels of three, five, six, seven or even higher percentages of compensation. These high levels of contributions are driven by the desire of the business owners and key employees to receive sufficient contributions for their own retirement benefits. Present laws require that significant contributions be given to the non-key employees in order for the key employees to benefit to any meaningful degree.[7] These significant contributions for the staff employees result from the anti-discrimination rules under I.R.C. § 401 and not the top-heavy rules found under I.R.C. § 416. The top-heavy rules today are largely duplicative of the existing non-discrimination rules governing the qualified retirement plan system.

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5 The Kiplinger Letter, January 20, 2006, Volume 83, No. 3

6 Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 3, Panel B, entitled "Percentage of Employees in Firms that Sponsored a Plan who Participated in the Plan" at 13.

7 The terms "key" and "non-key" as used here are not referring to the definition set forth in the top-heavy rules in I.R.C. § 416(i). Rather we are referring to "key" employees as those employees that the owners of a small business would deem key to running the business and "non-key" employees as those not essential to the operation of the business. As in all other businesses, the small business owners want to provide sufficient benefits and incentives to keep the key employees satisfied with their current employment so they will not move elsewhere. This problem is particularly acute in that small businesses often serve as the training ground for employees who move on to jobs with larger business entities where they perceive there is greater job security and better benefits.

SINGLE MOST ACTION NEEDED NOW – MAKE EGTRRA PENSION PROVISIONS PERMANENT

The 2001 Economic Growth and Tax Relief Reconciliation Act (referred to as EGTRRA) made many significant improvements to the small business retirement plan system. Among many other important changes, it increased and updated the limits on retirement plan contributions to levels which make sense for today's critical need to save for retirement. It allowed individuals who have attained age 50 to make additional "catch-up" contributions as they near retirement. It established the "saver's credit", which provides a savings incentive for low and middle-income individuals. It eliminated IRS user fees for small businesses that adopt or amend a retirement plan with respect to the first five years the plan is in existence. By increasing the deduction limit available to profit sharing plans, as well as not including employees' 401(k) contributions in the deduction limit, it allowed small businesses to set up one plan instead of two in order to provide desired contributions for their employees.

All of these changes have worked together to increase small business retirement plan coverage. This is not surprising inasmuch as they were the culmination of work done by Congress over a number of years in which the ideas and opinions of virtually all affected – employers, large, small, governmental, and non-profit, unions and employee groups – were requested and taken into account in putting the law together. This is why the EGTRRA pension provisions met with approval by almost all groups affected. [As an aside, this process did not take place with many of the provisions in the Pension Bill currently in conference. For instance, one of the provisions in this bill is to use a yield curve for defined benefit plans rather than to designate a single interest rate. Aside from some ivory tower thinkers who are intent on showing that perfection can be the enemy of the good, almost every ERISA pension practitioner, whether lawyer, actuary, plan administrator, in-house pension expert or accountant, believes that this will unnecessarily complicate an already complicated system for virtually no gain to anyone in the system, including and most importantly the plan participants. If the advice of the experts had been obtained first, we would have a single interest rate rather than this complicated structure which achieves little if anything and which cannot be justified in terms of increased burdens and costs.]

Unfortunately, all of these important EGTRRA pension provisions which have strengthened the small business retirement plan system expire after 2010. The House version of the Pension Bill in conference would make these provisions permanent. *We believe it is critical to make the EGTRRA pension provisions permanent now*.

We know that uncertainty in the retirement plan area is one of the leading reasons for plan terminations and lower new plan formation. Small business owners are not willing to expend their own hard earned dollars in the employee benefits area when they are not assured of the outcome. The nightmare situation would be to have these important provisions subject to a continuous state of short term extensions, perhaps even effective retroactively to cover a lapsed period. Without certainty in the system, small business owners would be unlikely to establish retirement plans when it is perceived that the pension rules cannot be relied upon from year to year. *We believe that this is perhaps the single most important issue with respect to small business coverage today*.

POLICY CHALLENGE – EASE OF ADMINISTRATION VERSUS RETENTION OF RETIREMENT PLAN MONEY

Small business has made it clear to Congress time and time again that it cannot easily accommodate additional administrative burdens. Unfortunately, qualified retirement plans impose additional burdens by way of required forms and governmental regulations. To deal with this problem, Congress has, over the last several years, developed an IRA based "retirement" plan known as the SIMPLE. Unfortunately, the very structure which makes the SIMPLE desirable from the viewpoint of the small business owners also makes it a "lesser" plan from the viewpoint of ensuring retirement income security for retired small business employees.

Congress understands the tension between the simplicity of the SEP or SIMPLE (both of which are IRA based plans) and the advantages afforded by a qualified retirement plan (a trust based plan). Small businesses operate lean and mean. They do not accept additional administrative burdens easily. The IRA based plans are almost maintenance-free. The small business simply goes to a bank or a brokerage house and sets up separate IRAs for each eligible employee. The company makes the correct contribution into each separate IRA and then walks away from the accounts. Unfortunately, this low administrative burden comes at a price.

The forced savings feature of a "regular " qualified retirement plan, such as the 401(k) plan, should not 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. Retirement plan money can be removed by written plan loan which cannot exceed the lesser of 50% of the account balance or $50,000. Retirement plan money can also 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, a SIMPLE or a SEP (both of which are employer sponsored IRA programs) where the funds can be accessed at any time for any reason. True, funds removed will be subject to a 10% penalty if the employee has not reached age 59 ½ (which is also the case for a hardship distribution from a 401(k) plan), but unfortunately it does not appear that the 10% penalty represents a significant barrier. This is why the SIMPLE IRA starts off with a 25% penalty for the first two years an individual participates in hopes that if a participant can accumulate a little bit he or she will be tempted to leave it alone and watch it grow. There is a distinct difference between complying with the statutory requirements for a loan or hardship distribution, including the need expressly to ask the employer for the loan or distribution, and having the power, independent of others, to remove money at whim from one's own IRA.

Thus, from a national policy viewpoint of preserving retirement assets for retirement, the SIMPLE plan should only be viewed as a starter plan. It is important, therefore, that all businesses, including the very small, be given incentives to enter the qualified retirement plan system as quickly as possible. The SIMPLE is an IRA program, as is the old SEP plan, and in the long run true retirement security for employees is better served by strengthening qualified retirement plans system rather than SIMPLEs and SEPs. This is simply because as mentioned above, employees have a far greater opportunity to remove the money from IRAs and SEPs and spend it - the forced savings feature of a qualified retirement plan is not present. It is also because the employees have no investment guidance or preselection of investment vehicles that have been determined to be prudent. Certainly, for start-up companies or micro businesses, a SIMPLE is the best first step into the retirement plan system. Thus, we believe that the "gap" between the 401(k) limit and the SIMPLE limit should be carefully preserved so that the system does not tilt in the wrong direction.

We are aware that many small business groups are asking Congress to change the law so that the IRA based plans mirror the higher contribution limits available in the 401(k) plan arena. We understand that they are hearing the complaints of small business owners who want to make everything as easy as possible. However, we believe that Congress has gotten this right and that if the SIMPLE is made stronger (by increasing the retirement plan contributions allowed to the IRA) that it will be detrimental to new small business 401(k) plan formation. This would be harmful to small business employees because they will lose the ERISA protections inherent in the 401(k) plan, the preselection of investment vehicles and most of all, they will gain the ability to have easy access to the money.

Over the years the data has consistently shown two things – give the money to an employee and they won't save it – give the money to an employee with easy access and they'll get to it and spend it. Because the goal is to encourage long-term retirement savings, Congress needs to ensure that the 401(k) continues to be the more attractive plan to employers. Thus, it is critical that Congress maintains the existing proportionate differential between contributions allowed to the SIMPLE and those allowed to a 401(k) plan. *The SBCA is opposed to changes in the law which would make the SIMPLE more attractive to a small business as compared to a 401(k).*

Under current law, a company is not allowed to make contributions to a SIMPLE IRA and contribute to any qualified retirement plan in the same calendar year. This provision is unduly restrictive and hampers the ability of small business to switch from a SIMPLE IRA to a trust-based qualified retirement plan such as a safe-harbor 401(k) plan. Taken literally, this provision would invalidate the SIMPLE IRA for the entire calendar year if the employer, at any time during that calendar year, maintained a qualified retirement plan to which contributions were made (by the employee or employer) or benefits accrued for service in the same calendar year. There does not appear to be a good reason why a SIMPLE plan should be invalidated for the entire year if a small business chooses to switch to a qualified retirement plan (which is therefore a stronger plan for the employee) during the year, as long as the same compensation is not taken into account under both plans.

For example, assume that an employer offers a SIMPLE for calendar year 2006 and notifies employees that it will make 100% matching contributions up to 3% of compensation. Assume that the employer decides to terminate the SIMPLE as of June 30, 2006, and institute a safe harbor 401(k) plan as of July 1, 2006. The employee will receive at least the same contribution by the employer (if not more) than under the SIMPLE. Moreover, under the 401(k) safe harbor plan, the employee generally has the opportunity to defer more compensation and receive more contributions than under the SIMPLE. Thus, the employee is not harmed and may well be significantly benefitted. *This rule needs to be eliminated.*

IRA PAYROLL DEDUCTION

The goal, of course, is to encourage more small businesses to offer retirement plans. A very small company that cannot absorb additional administrative burdens should be encouraged to join the system via the SIMPLE. But the laws should encourage the company to join the "real" qualified retirement system, probably through the 401(k) safe harbor plan, as soon as possible. In other words, even though a small business will probably begin with the SIMPLE as a start up plan, it should be encouraged, primarily by larger contribution limits, to "graduate" to the 401(k) plan as soon as possible. But what about the company that is too small or too unstable to even sponsor a SIMPLE? The SBCA believes that it is possible for an IRA payroll deduction system to be constructed that would not trigger any employer fiduciary liability which might prove helpful in allowing the employees to save by payroll deduction. Of course, the details of such a proposal would be critical so that such a rule should not apply to new start ups or to micro businesses.

THE 401(K) PLAN – MAJOR SUCCESS STORY

The 401(k) plan is a tremendous success story. The excitement generated by this plan in the small business arena is amazing. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much the employer contributes. Employees meet with investment advisors to be guided as to which investments to select and have toll-free numbers to call to see how their investments are doing and to determine whether they want to change them. 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. There is no question that this is the most well-known and well-liked retirement plan design today.

401(K) SAFE HARBORS

Safe harbor provisions were added by Congress to the 401(k) plan specifically to make the plan more attractive to small business.[8] Prior to 1999, all 401(k) plans were subject to complicated discrimination plans which tied contributions that highly compensated employees could make to the contributions made by non-highly compensated employees. These tests are expensive to administer. Additionally, if non-highly compensated employees did not optimize their participation, then highly compensated employees could not contribute as much as they wished.

It is now possible for 401(k) plans to eliminate the discrimination tests and allow every employee (including highly compensated employees) to contribute up to the maximum. Under

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[8] I.R.C. § 401(k)(12) as amended by Small Business Job Protection Act of 1996.

current law, a 401(k) plan will be treated as meeting the discrimination tests if the employer: (i) makes a contribution for every eligible non-highly compensation employee equal to at least three percent of that employee's compensation (referred to as the 3% non-elective contribution); or (ii) makes a required matching contribution set forth in the tax code. These contributions must be 100% vested and made to every employee even if he/she does not meet the 1,000 hour requirement or is not employed on the last day of the plan year. In addition the employer must provide written notice to employees apprising the employees of their rights and obligations under the plan. This notice must be comprehensive and be written in "plain" English.

There appears to be no rationale for such advanced notice in the context of the non-elective three percent contribution - no employee is going to change any behavior with respect to making 401 (k) contributions merely because a contribution will be made for them at the end of the year.[9] If anything, it could depress employee contributions since the employee might be satisfied with the employer's contributions alone. The notice requirement, however, may have an inadvertent chilling effect on a company's ability to use the safe harbor. Unless an outside advisor informs a small business that it must give a fairly extensive written notice to employees about the safe harbor by a certain date and the company complies with the notice requirement, the company may not be able to take advantage of the safe harbor for an entire year.[10] Treasury and IRS have worked around this requirement as much as possible.[11] However, the notice requirement is a statutory requirement. Thus, Treasury and IRS are not capable of removing it. The notice requirement serves no purpose with respect to the 3% non-elective safe harbor. It is at best a nuisance and at worst a trap for the unwary. *The SBCA suggests that the notice requirement for the 3% non-elective safe harbor requirement be eliminated. It serves no purpose.*

TOP-HEAVY ISSUES IN THE 401(K) CONTEXT

The top-heavy rules discourage small businesses from allowing employees to become immediately eligible to participate in a top-heavy 401(k) plan in which the company is making plan contributions. In the normal retirement plan world (that is outside the top-heavy rules[12]), merely allowing a new employee to become eligible to participate in the 401(k) portion of a plan immediately upon employment would not, by itself, trigger any additional company contributions. In a top-heavy plan, in contrast, a non-key employee who is merely eligible to participate in the 401(k) portion of the plan must receive the 3% top-heavy minimum contribution even if he or she is not eligible to receive any other employer contribution (i.e, a

[9] The rationale for advance notice in the context of the match safe harbor is self evident. An employee may very well change his or her behavior and contribute more knowing that a match is going to be made.

[10] I.R.S. Notice 98-52, 1998-46 I.R.B. 16 at V.C.

[11] I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #1.

[12] The top-heavy rules, because of the make up of most small businesses, basically apply to almost all small business plans and thus, small business plans counter intuitively are actually subject to increased burdens.

profit sharing contribution or a match contribution).[13] For example, if a small business sponsored a top-heavy profit sharing/401(k) combination plan which had a one year wait for eligibility for the profit sharing portion and immediate eligibility for the 401(k) portion, most practitioners believe that every non-key employee would be entitled to receive the 3% top-heavy contribution regardless of whether the employee chose to make 401(k) contributions. Unfortunately, as is the case with many of the obscure top-heavy rules, there are many advisors who are not even aware of this issue. Because of this requirement, knowledgeable small business retirement plan advisors tell their clients to have a one year wait for both the 401(k) portion and profit sharing and/or match portion of the plan. This hurts the first year employees by keeping them out of the 401(k) portion of the plan for the first year, thereby delaying their chance to save in a tax free environment. If they were employed by a larger entity, they likely would not encounter this problem because the top-heavy rules would not apply. *This rule should be changed so that any employee entering the 401(k) portion of the plan before meeting the one year eligibility requirement for the profit sharing portion of the plan is not entitled to the top-heavy contribution (nor to any profit sharing or gateway contribution).*

Perhaps the most unfair rule in the context of top-heavy 401(k) plans was imposed on small business through the regulations on employee pay-all plans.[14] This rule converts 401(k) contributions made by key employees into employer (profit sharing) contributions, thus triggering the top-heavy minimum contributions. In practical effect, the key employees are precluded from making 401(k) contributions to an employee pay-all plan even if these employees would have been allowed to do so under the ADP rules. Because this rule only applies to top-heavy plans, it primarily affects small business.[15] This is simply unfair to small business. If a larger entity (that is, one which is essentially exempt from the top-heavy rules) sponsors an employee pay-all plan, all employees (highly compensated, keys or otherwise) can make 401(k) contributions allowed by the ADP tests without triggering any profit sharing contribution. The very same plan, in the small business context, triggers a 3% top-heavy contribution for the non-key employees, if the plan is top-heavy.[16] *The SBCA strongly supports your proposal to change this unfair rule which will act to increase coverage.*

Because of this rule, most small businesses simply do not offer employee pay-all 401(k) plans. This represents a real lost opportunity to encourage small businesses to offer qualified

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13 Treas. Reg. § 1.416-1, Q & A M-7 and M-10 (as amended in 1992); 29 U.S.C. § 1002(7) (1999) (ERISA § 3(7)).

14 Treas. Reg. § 1.416-1, Q & A M-20 (as amended in 1992).

15 The SBCA has never been able to come up with an acceptable rationale for this rule.

16 The top-heavy rules rankle small business owners. The top-heavy rules are one of the primary reasons why small business owners maintain that the qualified retirement plan system discriminates against them and small businesses. As mentioned above, the vast majority of small business plans are top-heavy because of the mechanical mathematical tests utilized to determine top-heavy status which largely depend upon the number of key employees, as defined under I.R.C. § 416, employed by the company compared to the number of non-key employees.

retirement plans. These plans would allow small business employees to defer up to $15,000 (or even higher if they are 50 or older) if allowed under the anti-discrimination tests (ADP tests). Small business owners likely would sponsor employee pay-all 401(k) plans, notwithstanding the administrative burdens and expenses, if they knew they could participate in the plan like other employees.

CASH BALANCE PLANS

Cash balance plans are not inherently “bad” plans. In fact, in the small business world, they are the “Cadillac” plan. Due to legislative changes in the 1980's, small business by and large has no interest in the defined benefit plan. For this reason, small businesses are not confronting the same conversion issues as are large companies. Some small businesses, however, do sponsor cash balance plans. Often, this is the plan of choice as it blends the best of the defined contribution and defined benefit worlds.

The cash balance plan looks like a defined contribution plan built upon a defined benefit chassis. The plan is essentially a defined benefit plan, but unlike a defined benefit plan it provides separate account balances for each plan participant. By providing individual account balances, cash balance plans give employees a “proprietary” interest in the plan. At the same time, the cash balance plan offers many of the safeguards of a defined benefit plan. Of greatest importance, the investment risk is assumed by the employer rather than the employee. *It is essential that Congress makes it clear that cash balance plans are not inherently age discriminatory so that this valuable plan will be sponsored by small businesses. Congress should also make it clear that the benefit of the plan can be measured by the lump sum value of the participant’s account and not require that the account be changed to an annuity and then changed back to a lump sum value which can give rise to a lump sum distribution different than the participant’s account balance which of course makes no sense to the plan participant.*

REQUIRED BEGINNING DATE

Employees, other than 5% owners, may delay distributions from qualified retirement plans until actual retirement if that date is later than the date that otherwise would be the employee’s required beginning date. *This rule should be extended to 5% owners*. By and large a 5% owner is a small business owner. If the small business owner is still working, this rule in effect requires the small business owner to remove retirement funds sooner than he or she would need them. There is no apparent policy rationale for this result. First, this approach is financially wasteful since the account owner is forced to withdraw retirement assets prior to retirement. When the business owner actually does retire, he or she will have fewer assets in the plan. Since the withdrawn assets are reduced by income taxes, only the after-tax dollars are available for re-investment and the appreciation on these investments is subject to additional tax as interest, dividends or capital gains are realized. This deleterious impact is compounded by the fact that small businesses seldom provide retirement income streams other than by means of the retirement plan.

SIMPLIFICATION SHOULD BE OPTIONAL

Many changes which are intended to simplify the qualified retirement plan system should be optional. The 401(k) safe harbors are an excellent example of an optional simplification. Although these safe harbors create an alternative to the cumbersome ADP and ACP tests, companies are free not to utilize these alternatives. Indeed, many companies choose not to use the safe harbor because they consider a 3% employer contribution or required match contribution too high a price to pay for the reduced administrative burdens. Many companies expend significant time and money on their retirement plan software and/on employee communications. For these companies the cost of new software and written communication materials for employees may exceed the prospective administrative savings offered by the safe harbor. Thus, what may look like simplification to Congress may end up costing companies countless dollars and time. By making these intended simplifications optional, companies retain the flexibility to decline the "savings" of the perceived "simplification." In this vein, a proposal, such as the ERSA proposal, which provided an easier anti-discrimination testing, should be adopted by Congress, but made *optional*. Some companies will prefer to move to that new model of testing and others will find it easier to leave their plans, SPDs, testing software, etc. intact and forgo a slightly easier test because it actually costs more to move over to another plan design.

NEW USES FOR 401(K) PLANS

The 401(k) plan could be utilized to allow employees to make pretax contributions to a retiree health care account. This would enable employees to afford supplemental health insurance after retirement. The 401(k) feature could be expanded to include a second account into which the employee could make contributions for his or her retiree health care. This could operate essentially as a HSA. Funds accumulated in the retiree health care account would, as with the 401(k) account, grow tax deferred, and qualified contributions by the employees would be exempt from income tax. Upon the employee's retirement, disability or termination of employment, the employee would be allowed to roll over the retiree health care account to an HSA. Money in the retiree's health care accounts could be used to purchase supplemental health insurance, to defray major medical expenses that are not covered by insurance (possibly even if needed prior to retirement) or perhaps for long term care costs.

The permissible maximum annual contribution to a retiree health care account would, of course, need to be determined by Congress after taking into account projections of the costs that the nation would have to absorb in the next two or three decades if retirees cannot provide for those long term care or medical expenses not covered by the Government. The lost tax revenues resulting from incremental contributions to long term health care and retiree health care accounts (in addition to the § 415 limits which apply to profit sharing and 401(k) contributions) may be smaller than the increased governmental expenditures needed in the next few decades to provide long term care and retiree medical care to retirees who lack adequate savings to provide for this care themselves.

FORM 5500

The Form 5500 is administratively burdensome and might well prove a deterrent to small businesses considering switching from a SIMPLE to a 401(k) safe harbor. With the SIMPLE the annual reporting requirements are imposed primarily on the IRA trustee or custodian, with a 401(k) plan, significant reporting requirements are imposed on the employer. These reporting requirements are so daunting that many small businesses simply may not be able to handle these forms internally. They will need to engage outside benefits advisors, at considerable cost, to ensure compliance. This form should be simplified significantly for small businesses, particularly for plans with fewer than twenty-five employees. The objective would be to devise a form that provides the IRS and Department of Labor with sufficient information to monitor compliance matters but that can be readily completed by the owners or the company's accountant without relying upon a retirement plan expert.

404(C) SAFE HARBORS

To encourage businesses to offer qualified retirement plans, the DOL should provide voluntary ERISA §404(c) safe harbors for businesses. Satisfying the safe harbor would ensure that the business has met the fiduciary standards of § 404(c). Many small businesses are concerned about the fiduciary liability inherent in establishing a trusteed plan such as a 401(k). Section 404(c) was originally established to alleviate trustees' and plan sponsors' fear of liability with respect to plan investment. Unfortunately, because of the way this section has been implemented, many advisors consider it impossible to determine whether a company has met the § 404(c) requirements.

A clear, voluntary safe harbor could eliminate these fiduciary risks. Such a safe harbor could, for instance, require the plan to provide at least eight investment choices, for example, at least one money market fund, one stock index fund, a balanced stock fund, a balanced bond fund and a large cap value fund. The plan would be free to offer different investment options in addition, but at least a minimum variety of selections would be required. The safe harbor could require that all investments be offered by one or more financial institutions which had more than a stated minimum amount of dollars under management. There could be additional objective standards regarding stated loans or commissions. Perhaps a second voluntary safe harbor could be designed to allow the plan to offer a choice of a few different life style funds.

To be effective, any safe harbors would have to set forth clear guidelines and should not rest upon a facts and circumstances standard. This type of standard affords small business no meaningful assistance. Only voluntary safe harbors with clear cut rules can afford small business the necessary comfort regarding liability while still offering employees investment choices.

TAX REVENUE LOSS FROM IMPROVING RETIREMENT PLAN COVERAGE

SBCA suggests that a sea change is needed in how we view our loss of tax revenue due to increased retirement contributions by employees and employers. This revenue is not "lost," it is merely deferred. Further, the short term loss of those tax dollars may do more for the income security for our taxpayers in their retirement than almost any other change in the tax code. For example, reducing the marriage penalty may provide extra dollars to raise living standards for families in the short term. But these families are not likely to use a significant portion of those dollars to save for retirement, medical disasters or long term care. Instead they will rely on Social Security and a company sponsored retirement plan. The relatively few dollars that would be required to make these suggested changes would return far higher dividends to the country's well being than almost any other tax expenditure.

Because qualified retirement plans are subject to a myriad of technical, micro-focused rules, relatively small changes ("micro" changes) in the qualified retirement plan system can bring about a substantial or "macro" result. A change in a single technical rule can have a dramatic impact.

The qualified private retirement plan system is remarkably successful. By making the EGTRRA pension provisions permanent as well as making improving the system as discussed above, (which are by no means intended to be exhaustive), small businesses will continue to embrace qualified private retirement plans so that small business employees will receive the significant benefits of retirement plan coverage.