April 2015

Comments to the U.S. Senate Committee on Finance
Savings and Investment Working Group
On Protecting the Small Business Retirement Plan System

Senator Crapo, Senator Brown and Members of the Senate Committee on Finance Savings and Investment Working Group, the Small Business Council of America (SBCA) appreciates the opportunity to share its insight on the relationship between current tax laws and the small business retirement system and comment on the potential impacts of various tax reforms on the small business retirement system.

Longer life expectancies demand increased retirement savings. The present qualified retirement plan system, which has been very successful in providing retirement security, is largely dependent on federal tax laws. The SBCA hopes that this working group will consider the following points as it reviews and makes recommendations about the current federal tax laws as they relate to the pension and retirement system.

- **The Qualified Retirement System is the Primary Way that Most Americans Save for Retirement**

A 2011 study,[1] which used actual data from employees' W-2 forms, found that 77% of all employees who work in companies with 10 or more employees are offered a retirement plan and that, of these employees, 62% made 401(k) contributions.[2] Because of the large number of employees who are actually covered by the qualified retirement plan system, any changes that would motivate employers to freeze or eliminate the plans could have significant and detrimental long-term repercussions.

Many knowledgeable people believe the qualified retirement plan system covers about 50% of employees. It is startling that, when asked, only 49% of these employees thought they

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

[2] The size of the company makes a significant difference. W-2 data, which is accurate only to 401(k) plans and 401(k) contributions, reflects that 46% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that 60% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 70% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 84% of businesses with more than 100 employees offer a retirement plan. There is no further breakdown given for over 100 employees so we do not know how many small to mid-size businesses – often defined as up to 500 employees offer plans compared to the large businesses.

were contributing to a retirement plan. This means that 13% of all employees making 401(k) contributions through payroll deduction do not even realize that they are making 401(k) contributions. Note that this survey did not analyze the actual numbers for retirement plan contributions made by the employer because this data is not reported on the W-2. One must assume this number would be even greater than the 77% figure because many employees who receive employer contributions cannot afford, or choose not, to make 401(k) contributions and many small business' plans provide for employer contributions whether or not an employee chooses to contribute. If employees cannot remember that they reduced their take-home pay to make contributions into a retirement plan, it is even more likely that employees do not recall that their employer contributed to the plan on their behalf.

Only 34% of small businesses with fewer than 10 employees offer a retirement plan. The data, however does not take into account that in the first 4 years of a company's existence, approximately 40% of all new startups fail. One would assume that most startups have fewer than 10 employees. It is not surprising, then, that there is a lower level of sponsorship of retirement plans for this group when taking into account the precarious nature of most "new" small businesses.

These numbers reflect that the small business retirement plan system is successful in delivering benefits for small business employees. Further, most small business plans are adopted by the small business to provide a tax-advantaged way for the owners to save for their and the other key employees' retirement. The rules of retirement plans force the owners to make significant contributions for the non-highly compensated employees. Thus, *in the small business qualified retirement plan world, it is not unusual for the company (in addition to contributions made by the employee) to make contributions for its employees in the 3 – 8.5% of compensation range.*

In addition to Dushi, Iams and Lichtenstein utilizing verifiable data, they accounted for the fact that there is a difference between employees who do not participate in the retirement plan system and employees who are not eligible to participate in the retirement plan system. Most data used to measure the success of the retirement plan system (unlike the Dushi, Iams and Lichtenstein data), ignores the fact that not all employees meet the retirement plan eligibility requirements. Part-time employees, employees under age 21 and transient employees are generally ineligible to participate in a retirement plan. 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 significantly.

- **Tax Incentives in the Retirement Plan System are the Primary Motivation for Small Business Owners to Sponsor Retirement Plans**

Reducing the tax advantage of sponsoring a retirement plan will incentivize small business owners to freeze or terminate their plans. Most small business owners view the

meaningful contributions that are made for the non-key employees as the "price of admission" to be able to save in a qualified retirement plan for themselves. When a small business closes down its retirement plan, the owners are not likely to increase the pay of the non-key employees to compensate for the loss of the plan contribution. Instead, the owners are likely to take the amount that would have been contributed to the non-key employees as additional compensation for themselves, or reinvest it in the company.[3] In the early 1980s, a series of laws decreased benefits for the key employees and increased contributions for non-key employees while increasing administrative burdens. As a result, many small business owners determined that the costs of sponsoring a retirement plan outweighed the benefits to be derived for the key employees. Accordingly, existing plans were frozen or terminated in droves and new plans were not established. This will happen again if the tax incentives are limited or removed from the underpinning of the small business qualified retirement plan system.

- **Taxing 401(k) Contributions for Higher Income Contributor Will Motivate Business Owners to Freeze or Terminate Their 401(k) Plans**

Small business plans are adopted by the small business to provide a tax-advantaged way for the owners to save for their and the other key employees' retirement. The rules of retirement plans force the owners to make significant contributions for the non-highly compensated employees. If the 401(k) contributions of small business owners and their key employees are taxed at the time the contributions are made, small business owners will be likely to cut back or freeze the 401(k) feature in a profit sharing plan since this is the most burdensome part of the plan. The data clearly demonstrate that the most effective way for people to save is through payroll deduction. Employees are far more likely to save in a 401(k) plan than in any other vehicle, far more than in IRAs.

- **Forcing Assets Out of IRAs Shortly After Death Will Deter Employees from Fully Utilizing IRAs as a Means of Saving**

Both the administration and the Senate Finance Committee have presented proposals that would require retirement plan assets to be forced out of an IRA shortly after the passing of both spouses. While IRAs are not always the optimal vehicle for many employees to save for retirement since they allow for easy withdrawals and do not provide ERISA safeguards, they nevertheless play a critical role in the retirement plan system. This role is as the final receptacle for account balances of employees.[4]

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[3] Some economists have claimed that if a small business did not sponsor a retirement plant, the small business owners would pay the employees their regular compensation plus the amount that would have gone into the retirement plan for them. These claims do not account for the financial decisions faced by small business owners nor the fact that many employees themselves do not consider retirement contributions when assessing their compensation. Based on anecdotal evidence from our members, when a small business closes its retirement plans, owners usually do not increase the pay of non-key employees to take into account the loss of the plan contributions.

[4] This is done by employees directly transferring or rolling over their account balances from retirement plans to an IRA.

It is likely that a proposal eliminating "stretch IRAs" (which allows the amount remaining in an IRA at an employee's death to be distributed over the life expectancy of the beneficiaries who inherit it), will cause people to be wary of accumulating "too much" retirement money because of its ultimate undesirable tax treatment. This may cause employees to under-save for their retirement and could further give rise to owners freezing contributions or closing down the plan. It is important to many individuals who have accumulated funds that they can name their children as beneficiaries. This is why, for most employees, IRAs are a preferable alternative to annuities. The employee who purchases an annuity with his/her retirement plan money runs the risk that in the event of premature death, his/her investment will be a windfall for the insurance company. In contrast, an employee who rolls his/her funds to an IRA can ensure that any remaining funds in the IRA at death will pass to his/her beneficiaries.[5] With the "stretch IRA," employees can invest in an IRA not only to secure their own retirement future but knowing that any remaining funds in the IRA at their death (and their spouse's death, if any) can provide their children with a safety net. This is achieved by allowing the children to take the funds out of the IRA over their lifetimes rather than being forced to take the funds out in a lump sum as called for in these proposals. With every generation of employees seeming to live longer than the prior generation, the law should be structured so as to encourage employees to plan for their futures without the fear that over-investing will result in a loss of their hard-earned money due to adverse tax consequences. Proposing to eliminate the "stretch IRA" runs counter to these goals.

The SBCA is concerned that the proposal to eliminate the "stretch IRAs" will cause the same response by accountants as the "excess" retirement plan accumulations law did. That is, accountants will let their clients know that they should not save "too much" retirement money because of its undesirable tax treatment. This may cause employees to under-save for their retirement and could further give rise to owners freezing contributions or closing down the plan.

Many workers have made irrevocable financial decisions relying on the existence of the stretch IRA. If an elimination of the stretch IRA is planned, the proposal should either a) grandfather current funds in plans and IRAs to receive existing tax treatment, b) not apply to anybody over a certain age, i.e., any employee who is age 50 or older, c) allow payments to be made over the lifetimes of at least the children, or twenty years, whichever is longer, or d) allow payments to be made over twenty-five or thirty years instead of five years. The first two alternatives would allow the funds in the current retirement plan system to stay in the system and provide the long-term financial security for those who saved in reliance upon the existing law. Younger employees could choose to save only the amount they were certain to spend during their lifetimes and to save the remainder in other, more tax-advantaged vehicles. The last two

[5] There are many taxpayers who would not have chosen to save as much as they did in the retirement plan system if they had anticipated the elimination of the stretch IRA. This is especially true of individuals who converted retirement plan assets to Roth IRAs relying upon the law remaining constant.

alternatives would hopefully alleviate any negative impact that this proposal would have on individuals saving in retirement plans.

- **Reducing the Contribution Limits for 401(k)/Profit Sharing Plans Will Motivate Employers to Terminate Their Plans and Make it More Difficult for Workers to Save**

Proposals to reduce the amount that can be contributed to a 401(k)/profit sharing plan to the lesser of 20% or $20,000 would likely "tip the scales" so that the small business owners would determine that from a tax perspective it is better to close down the plan and take out the extra funds as compensation or to reinvest them in the business. Funds taken out as compensation could then be invested in capital gain assets which receive a step up in basis at death or in insurance which gives rise to favorable tax treatment.

- **Capping Contributions for Employees Who Have Retirement Plans and IRAs That Contain Assets That Will Generate a $210,000 Annuity at Age 62, Particularly When Coupled with Eliminating "Stretch" IRAs, will Lead to Lower Contributions and Eventually Frozen and Terminated Small Business Plans**

The administration has recently proposed that employees must stop making contributions when the employee has assets in all of his/her retirement plan and IRA accounts equal to an amount that would generate a $210,000 annuity at the employee's attainment of age 62. This proposal, when combined with a proposal that would force all money left in an IRA or Plan out into income five years after the death of the employee and the employee's spouse, will cause employees to under-contribute rather than ensure that they have sufficient assets for their retirement. For many small business owners and their advisors, there will be little motivation to continue to sponsor a plan once the small business owner and key employees have hit or are nearing the limit of what they can save. Funds taken out as compensation rather than contributed to a retirement plan could then be invested in capital gain assets which receive a step up in basis at death or in insurance. Perhaps the most significant drawback to this proposal is that the cap would impact the youngest plan participants the most which is precisely the group that should be incentivized to save as much as possible.

- **Deductions for Retirement Plan Contributions Are Primarily a Tax Deferral and Are Not a Significant Tax Expenditure**

In the recent discussions on how to raise revenue (and conceivably lower tax rates through tax reform), the deduction for retirement plan contributions has been treated the same as other tax expenditures in the tax code. This is a mischaracterization because retirement plan contributions are eventually brought into income along with any earnings.[6] The only loss to the

[6] There are approximately 670,000 private-sector defined contribution plans covering approximately 67 million participants and over 48,000 private-sector defined benefit plans covering approximately 19 million participants. The U.S. private retirement plan system paid out over $3.824 trillion in benefits from 2000 through 2009, and U.S.

government with respect to the deduction for retirement plan contributions and tax-free growth inside the plan is the time value of money. However, the potential detrimental impact on the retirement security of Americans due to a reduction in contributions to retirement plans could be huge.

A study prepared for the American Society of Pension Professionals & Actuaries (ASPPA)[7] reports the value of the retirement plan tax expenditure to be roughly 55 – 75% lower than estimates by the Joint Committee and the Treasury. This study assumes that people will enjoy lower income tax rates during retirement than when contributions are made to the retirement plan. This assumption increases the value of the "tax expenditure." Many experts believe, however, that tax rates are going to be higher for most taxpayers in the future and that the "real" cost of the retirement plan tax expenditure is even lower than that set forth in the ASPPA report.

A qualified retirement plan, whether small or large, creates significant rights for the plan participants and generates significant costs for the company. Funds in a retirement plan are not tax-sheltered; rather, they are tax-deferred until the participants receive them, at which time they are brought into the participant's gross income. Retirement plan assets are not subject to favorable capital gains treatment, nor do they receive a step up in basis at the owner's death. Those who specialize in the small business retirement plan area know that those plans that benefit the owners of small businesses also provide significant benefits for the non-highly compensated employees. Therefore, any tax reform proposal that would motivate employers to freeze or eliminate retirement plans or pose a disincentive to offering new plans should be rejected.

- **Detrimental Proposals to the Small Business Defined Contribution Retirement Plan System Must be Rejected.**

Despite common misperceptions, as a whole, the tax treatment of retirement plans is not particularly attractive since all retirement plan funds are eventually subject to ordinary income. Further, retirement plan assets do not receive a step up in basis upon the death of the owner. Because of this, it is important that all existing tax incentives for retirement plans be preserved. This includes maintaining existing contribution levels, not subjecting 401(k) contributions to additional personal income taxes for individuals in higher tax brackets and retaining the ability of individuals to have any money remaining in an IRA be paid in installments over their beneficiaries' lifetimes, especially for their children.

Proposals that curtail or eliminate the existing tax treatment for retirement plans must be rejected because the small business retirement plan system is largely dependent upon its tax

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public sector plans paid out $2.651 trillion during the same period. All of this money was brought into income and subject to regular income tax rates (the only exception would be money that was contributed on an after-tax basis).

[7] Xanthopoulos and Schmitt, Retirement Savings and Tax Expenditure Estimates, ASPPA May, 2011.

advantages for its survival. Any of the proposed changes listed above (and particularly all of them taken together) could cause employees to decide against participating in a retirement plan. More significantly still, they could also cause small business owners to take out the funds that would have gone into the retirement plan (including all of the employer contributions for the non-owner employees and the costs of running the plan) as compensation and invest the assets in a more tax advantaged method – e.g., life insurance or assets subject to capital gains treatment. Ultimately, the real losers will be the small business employees who often enjoy generous employer contributions. This is what happened when "excess" retirement plan accumulations were taxed with an excise tax. Accountants advised small business owners that retirement plan money was "tainted" and that they should not accumulate "too much." The "excess" accumulation tax caused retirement plan contributions to be significantly reduced and significant numbers of small and mid-sized plans to be prematurely frozen or terminated.

The retirement plan system should not be used to generate revenues, particularly when the savings are largely illusory due to budget timeframes that do not accurately portray the economic reality.

The Small Business Council of America (SBCA) is a national nonprofit organization that has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters since 1979. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans.

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