ASPA ASAP

• A publication of the ASPA Government Affairs Committee • Feb. 3, 2003 • No. 03-03 •

Bush Administration Announces Major Savings Initiative

Small Business Workers Will Lose Retirement Benefits if Proposal is Enacted

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Last week, press reports indicated that the Bush Administration was about to announce a major policy initiative intended to promote savings. Last Friday, the Department of Treasury formally announced the proposal (which would be generally effective beginning in 2003) and provided more specific, albeit preliminary, details. As discussed below, the impact of the proposal is significant and far-reaching. Although ASPA supports some aspects of the proposal designed to make it easier for small businesses to establish and maintain retirement plans for their workers, the remainder of the proposal renders these initiatives of little value. Specifically, the proposal's substantial expansion of tax-favored opportunities to save on an individual basis will eliminate the incentive for many small business owners to incur the cost and administrative burdens of establishing a retirement plan for their small business employees. Consequently, if this proposal is enacted, millions of our nation's small business workers will be left without a meaningful opportunity to save for retirement. This is simply unacceptable from a retirement policy standpoint, and thus ASPA is forced to oppose the proposal in its current form. As Congress considers this proposal, ASPA will be dedicated to modifying the proposal in a way that does not harm small business retirement plan coverage, or, if it can not be so modified, ensuring its defeat. No issue is more central to ASPA's core mission of protecting and enhancing the private retirement system than this one. We must and shall prevail.

Summary of Bush Administration Proposal

Lifetime Savings Accounts (LSAs)

Under the proposal, individual taxpayers, regardless of their level of income or whether or not they had income, would be permitted to contribute up to $7,500 (indexed) annually to an LSA. A taxpayer could also contribute $7,500 annually to an LSA on behalf of any other individual.[1] Like current-law Roth IRAs, contributions made to an LSA would be on an after-tax basis and distributions (including any earnings) would be tax-free. However, unlike Roth IRAs there would be no restrictions on when you can take a distribution and no associated early withdrawal penalties. There would be no required minimum distributions until death when, as with Roth IRAs, required minimum distribution rules would apply to the beneficiary. Amounts in Medical Savings Accounts, Education Savings Accounts, and Qualified State Tuition Programs would be retained, but amounts in those accounts or programs could be converted to an LSA prior to January 1, 2004. Accumulated amounts in LSAs could be transferred to family members, subject to estate and gift tax rules.

Retirement Savings Accounts (RSAs)

In additions to contributions to an LSA, individual taxpayers would also be permitted to contribute another $7,500 (indexed) annually to an RSA. Unlike current-law traditional or Roth IRAs, the ability to contribute to an RSA would not be subject to any income limits. However, the amount of the annual contribution to an RSA would be limited to the taxpayer's wage income (*i.e.,* the taxpayer would have to earn at least $7,500 in wages to contribute the maximum $7,500 to an RSA). Contributions made to an RSA would be on an after-tax basis and distributions (including any earnings) would be tax-free if made after age 58 or upon death or disability. Early distributions would be subject to income tax (after basis is exhausted) and a penalty tax. As with LSAs, there would be no required minimum distribution rules until death. Existing Roth IRAs would automatically be converted to RSAs. Beginning in 2004, deductible contributions could no longer be made to traditional IRAs. However, a traditional IRA could still be created to accept rollover contributions. Prior to January 1, 2004, an existing traditional IRA could be converted to an RSA and would be subject to a 4-year income tax spread. After 2003, conversions would still be permitted, but the full amount of the conversion would be subject to income tax in the current year.

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Employer Retirement Savings Accounts (ERSAs)

ERSAs would replace existing 401(k), 403(b), governmental 457, SIMPLE, and grand-fathered SARSEP plans with a single plan available to all employers with rules essentially similar to existing rules governing 401(k) plans.[2] In other words, the plan would still have to satisfy the qualified plan (and trust) rules and would still be subject to ERISA's various requirements. Thus, among other things, an ERSA would still be subject to the Section 402(g) limit [annual employee contribution limit ($12,000 in 2003)], plus catch-up if applicable, the Section 401(a)(17) annual compensation limit ($200,000 in 2003), the current law restrictions on distributions, and the current law minimum required distribution rules. However, some major changes to the existing qualified plan rules would be made.

Under the proposal, the top-heavy rules for defined contribution plans would be repealed. Further, the ADP/ACP nondiscrimination tests would be repealed and replaced with a less onerous nondiscrimination test. Under this proposed new test, if the average deferral percentage for non-highly compensated employees is greater than 6 percent, there would be no restrictions on the deferral percentages of highly compensated employees. If the average deferral percentage of non-highly compensated employees is equal to or less than 6 percent, then the average deferral percentage for highly compensated employees may not exceed two times the deferral percentage for non-highly compensated employees. However, since the current maximum contribution is $12,000, for highly compensated employees above the $200,000 compensation limit, the deferral percentage needed is only 6 percent ($200,000 times 6 percent). Thus, if rank-and-file employees save on average at least 3 percent on their own, the highly compensated employees in this example would be able to save the maximum in the ERSA without making any matching contributions for the rank-and-file workers.

Further, the proposal would provide for two safe harbors in order to avoid any nondiscrimination testing. The first safe harbor would be the same as the current law safe harbor exempting the plan from nondiscrimination testing if it provides a 3 percent of pay contribution to participants regardless of whether they save on their own. The alternative safe harbor would exempt the plan from nondiscrimination testing if a 50 percent match on employee contributions up to 6 percent of pay (or a more generous formula) is provided. This is a significantly less generous matching contribution than the current law matching contribution safe harbor which requires a 100 percent match on employee contributions up to 3 percent of pay and an additional 50 percent match on subsequent employee contributions up to an additional 2 percent of pay.

Governmental plans would be completely exempt from any nondiscrimination rules applicable to ERSAs. Charitable organizations would also be exempt, provided all employees are eligible to participate and the plan does not accept after-tax contributions. To the extent an ERSA accepts after-tax contributions, distributions of amounts attributable to such after-tax contributions made after 2003 would be tax-exempt as if coming from an RSA. This appears to be conceptually the same as the current law Roth 401(k) enacted as part of EGTRRA, but not yet effective.

Other changes proposed would include a uniform definition of compensation (essentially W-2 compensation plus deferrals), a revised definition of highly compensated employee (which would be employees with compensation above the Social Security wage base for the prior year without regard to ownership status), and a single coverage rule, (the 70 percent ratio percentage test). These changes, plus the repeal of top heavy, would apply to all defined contribution plans in addition to ERSAs. Further, defined contribution plans would no longer be permitted to utilize permitted disparity or cross-testing. I am told that this last change was proposed as a simplifier, although it is totally perplexing why they would propose to repeal something they just completed a multi-year regulation project on, and which, at a minimum, guarantees rank-and-file workers a 5 percent of pay contribution regardless of whether the worker saves on his or her own.

Finally, none of the above apparently affects defined benefit plans in any way. (This is simplicity?) Thus, apparently cross-testing (even with a defined contribution plan) and permitted disparity would continue to be available for defined benefit plans.

Retirement Policy Analysis

Impact on Small Business Retirement Plan Coverage

It is an understatement to suggest that the impact of these proposals on small business retirement plan coverage will be anything less than devastating. If enacted, a small business owner would be able to actually save more on an individual basis between an LSA and an RSA ($15,000) than if he or she established an ERSA ($12,000 in 2003) even before the added costs of employer contributions and the administrative burdens. Further, unlike ERSAs, LSAs have no restrictions on distributions and both LSAs and RSAs are not subject to the minimum required distribution rules, making them significantly more attractive for estate planning purposes. Simply put, establishing an ERSA will no longer make any financial sense for many small business owners and no doubt their financial advisors will tell them as such.

Ivory tower economists supportive of the President's proposal will assert that small businesses will still maintain plans in order to compete for employees. But ASPA members who actually work with real small businesses know this is a complete fallacy. To the extent there is any competition for some workers, those small business workers will gladly take the cash compensation instead (and maybe setup their own LSA/RSA), leaving the remaining small business employees without a retirement plan. At best, small businesses will establish deferral-only plans for their workers with no employer matching contributions. However, over time the vast majority of small business retirement plans will simply disappear without any real motivation (and significant disincentives) for the small business owner to continue them.

Impact on Retirement Benefits for Small Business Workers

Without a meaningful way to save for retirement, many small business workers, particularly those workers with moderate incomes, will not save at all. It is well accepted that taxpayers with moderate incomes are much more likely to save in an employer-sponsored plan than in a current-law IRA. For example, according to the Employee Benefits Research Institute, in 1998 only 4.3 percent of taxpayers with incomes between $40,000 to $50,000 contributed to an IRA. By contrast, according to Fidelity's 2000 survey of plan participation, 74 percent of taxpayers with the same level of income participated in an employer-sponsored plan.

In large part, the significantly better participation rates by moderate income taxpayers in employer-sponsored retirement plans is due to the convenience of payroll deduction and the incentive of employer matching contributions necessitated by operation of the current-law nondiscrimination rules. Proponents of the President's proposal argue that LSAs will be more attractive to moderate-income workers since assets will not be subject to any distribution restrictions. However, this assertion has little substance since the current law exceptions to the early withdrawal penalties for IRAs exist for the purchase of a home, educational and medical expenses. Ultimately, moderate-income small business workers left only with the option of an LSA or RSA and without the convenience of payroll deduction and the incentive of employer matching contributions will , as with IRAs, be unlikely to save on their own. Thus, the President's proposal will leave these working Americans much less prepared for retirement.

Retirement Savings Versus Savings Generally

Even for those individuals who make the effort to save on their own, they will be much more likely to save first in an LSA since it has no restrictions on distributions. The average American does not save the maximum possible to a current law IRA, which is less than the maximum annually allowed into the LSA, and thus the majority of American taxpayers will never establish an RSA. Why would they choose such a vehicle if they can get the same tax treatment in a less restrictive vehicle where they can get access to the funds whenever needed? Further, since the vast majority of working Americans are not saving the maximum under current law (either through an IRA or an employer-sponsored plan) and are unlikely to save more whether or not the President's proposal is enacted (they simply cannot afford it), any savings into LSAs will likely be at the expense of retirement savings. The net consequence from a policy standpoint will most certainly be much more leakage from the system than currently exists. Thus, not only will most Americans not save more under the President's proposal, but ready access to existing savings could seriously threaten their retirement security.

Retirement Policy Versus Tax Policy

Many tax policy theorists believe that our current income tax system discourages savings. They would prefer a tax system based on more of a consumption model in which savings and investment earnings are not subject to tax. At their essence, the President's proposals outlined above are a major step towards that model of taxation. However, although these proposals may in fact increase savings in the aggregate, they will do so at the expense of savings by moderate income small business workers. In the macro sense, some may argue this is better tax policy, but it is terrible retirement policy and the nation would suffer in the long run for it.

Apparently, the Bush Administration's proposed solution to perceived inefficiencies in national savings is to significantly dismantle the private retirement system—the one system that actually has successfully generated national savings. Over half of the nation's stock market is attributable to retirement savings of one form or another. The President's proposal would in a major way cause a shift from employer-sponsored retirement plans toward individual savings, leaving many low-to-moderate income workers without an effective opportunity to save.

There is no question that our current private retirement plan system is not perfectly efficient. Current coverage rates among workers could certainly be better. However, employer-sponsored retirement plans have shown to be a fabulously effective way to promote savings, particularly for moderate income workers covered by such plans who are much less likely to save on their own. Clearly, the most sensible way to promote savings is by expanding and enhancing an employer-sponsored retirement plan system with a demonstrated track record. Ironically, recent data suggests that we *have* learned from past mistakes and are making some progress in large part thanks to recent bipartisan legislation enacted by Congress, including legislation signed into law by President Bush in 2001. According to the Census Bureau, from 1995 to 1999, the percentage of full-time employees of small businesses at firms with less than 25 employees covered by a retirement plan increased from 27 percent to 33.4 percent. This is partly in response to bipartisan legislation in 1996 creating the SIMPLE retirement plan for small business. Further, many of the pension reform provisions included in the Economic Growth and Tax Relief Reconciliation Act of 2001 were designed to improve small business retirement plan coverage, including a tax credit for the start-up costs associated with a new small business retirement plan.

Instead of evaluating these new initiatives to determine whether they have successfully expanded the employer-provided retirement system—a system that has been proven to work—the President's proposal would be a step toward abandoning this system in favor of a program of individual savings with a dubious track record for producing results, particularly for moderate-income individuals. This may make sense to those ivory tower economists with their theoretical equations, charts, and graphs. But, it will be a very real catastrophe indeed to the millions of America's small business workers who lose their retirement benefits if this proposal is enacted.

Footnotes

[1] Thus, an employer conceivably could make after-tax contributions on behalf of certain employees without having to comply with the nondiscrimination rules.

[2] Beginning in 2004, all 401(k) plans will automatically become ERSAs. SIMPLEs, SARSEPs, 403(b) plans, and governmental 457 plans may continue in existence indefinitely, but would not be permitted to accept any future contributions after 2004. The ERSA would not replace nongovernmental 457 plans.

ASPA PAC

ASPA PAC Needs Your Support

Now more than ever, ASPA's Political Action Committee needs your help. The battle to fight the Bush Administration's proposals and protect the private retirement plan system will be just as much a political fight as a policy one. Your contributions will help ASPA's Government Affairs Committee gain access to key members of Congress so we can tell our side of the story. If you have been thinking about making a contribution, now is the time. Contributions of any size will make a difference. To find out more information, including how to make a contribution, go to http://www.aspa.org/gov/pac.htm or e-mail Jolynne Flores, ASPA PAC Manager, at jflores@aspa.org.

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