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

Committee on Ways and Means Hearing on
Tax Reform and Tax-favored Accounts
April 17, 2012

Thank you Chairman Camp, Ranking Member Levin and members of the Committee for the opportunity to speak with you about the current tax incentives for employer-sponsored retirement plans – how they are working to promote retirement security, and how the Committee might streamline the law and regulations to make them work better. I am Judy Miller, Chief of Actuarial Issues and Director of Retirement Policy for the American Society of Pension Professionals and Actuaries (“ASPPA”). ASPPA is a national organization of more than 8,000 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.

I also am speaking on behalf of the Council of Independent 401(k) Recordkeepers (CIKR), as well as ASPPA’s sister organizations, the National Tax Sheltered Accounts Association (NTSAA), the National Association of Plan Advisors (NAPA) and the ASPPA College of Pension Actuaries. CIKR is a national organization of 401(k) plan service providers. CIKR members are unique in that they are primarily in the business of providing retirement plan services as compared to financial services companies who primarily are in the business of selling investments. As a consequence, the independent members of CIKR offer plan sponsors and participants a wide variety of investment options from various financial services companies without an inherent conflict of interest. By focusing their businesses on efficient retirement plan operations and innovative plan sponsor and participant services, CIKR members are a significant and important segment of the retirement plan service provider marketplace. Collectively, the members of CIKR provide services for over 70,000 retirement plans covering 3 million participants with approximately $130 billion in retirement assets. NTSAA’s members share a strong interest in the 403(b) and 457(b) marketplace. NAPA is an organization of advisors serving employer-sponsored retirement plans. ACOPA represents enrolled actuaries who are credentialed members of ASPPA.
The goals of simplification, efficiency, and increasing retirement and financial security for American families are goals we share with the Committee. The primary message I want to convey today is that the current tax incentives are working very efficiently to promote retirement security for millions of working Americans. The most important factor in determining whether or not taxpayers across the income spectrum save for retirement is whether or not there is a workplace retirement plan. If increasing retirement and financial security is the goal, increasing the availability of workplace savings is the way to get there, and modifications to the current incentives should be evaluated based on whether or not the changes will encourage more businesses to sponsor retirement plans for their employees.

In ERISA, Congress decided to direct tax incentives for employer-sponsored plans toward coverage of substantially full-time employees. Nearly 80% of full time civilian workers now have access to workplace savings, so the incentives have been effective in providing coverage for the targeted group. The incentives are also very efficient at providing coverage to all income groups. This efficiency is derived in large part from two features that set the retirement savings incentives apart from other individual tax incentives:

- The retirement savings incentive is income deferral, not a permanent exclusion. Every dollar that is excluded from income this year will be included in income in a future year. Unfortunately, that is not reflected in the cash basis measurement of the retirement savings “tax expenditure”. In fact, the current methodology overstates the true cost by over 50%.

- Nondiscrimination rules for employer-sponsored plans assure the plans do not discriminate in favor of highly compensated employees, and limit the amount of compensation that can be included in determining benefits and testing for nondiscrimination. As a result, this tax incentive is more progressive than the current progressive tax code.

The hearing notice raised the question as to whether the “large number of plans with different rules and eligibility criteria leads to confusion, reducing the effectiveness of the incentives in increasing retirement savings.” The answer is a resounding “No”.

- If an individual has a workplace plan, he or she is 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. Consolidating all types of defined contribution plans into one type of plan would not be simplification. It would disrupt savings, and force state and local governments and nonprofits to modify their retirement savings plans and procedures.
• Small employers that do not sponsor a retirement plan consistently point to business concerns as the main reason they do not sponsor a plan\(^1\), not “confusion” about available options. Flexibility in plan design gives practitioners the tools to design arrangements that are attractive to more employers than a “cookie cutter” approach. Less flexibility would reduce coverage, not enhance it.

The discussion of simplification needs to be expanded beyond consolidation or otherwise limiting employer-sponsored plan design options. There are legislative and regulatory changes that could smooth the way for more small employers to adopt plans, and ease compliance concerns, but consolidation and loss of flexibility in plan design are not on that list. Improved retirement security, and meaningful simplification, will be accomplished through thoughtful modifications to the existing structure, without wasting resources on cosmetic overhauls that produce more change than gain.

\(^1\) See for example:

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.²

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.³

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. In ERISA, Congress decided to target tax incentives toward substantially full-time workers, and the incentives have worked well. Contrary to the common assertion that only half of working Americans are covered by a retirement plan, Bureau of Labor Statistics (BLS) data shows that 78 percent of all full time workers have access to a workplace retirement plan, with 84 percent of those workers participating. 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.

Current Tax Incentives

What are the incentives?

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 2012, the maximum elective deferral to a 401(k) or similar plan is $17,000. 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 $50,000. 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 $55,500.

The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year’s pay or $200,000. 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 $250,000 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 $250,000, 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 $50,000 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.]

**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 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 nondiscrimination rules that apply to qualified retirement plans, putting $50,000 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 $50,000 will substantially 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.

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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. This incentive for the business owner to contribute for other employees results in a distribution of tax benefit that is more progressive than the current income tax structure. Just how progressive is illustrated in Figure 6 (on page 13), showing the share of this tax benefit going to households earning under $50,000 is almost four times the share of income taxes paid by these households.

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.

**Figure 2**

<table>
<thead>
<tr>
<th>Importance of Being Able to Deduct Retirement Contributions From Taxable Income</th>
</tr>
</thead>
</table>

The importance of the tax deferral on retirement contributions was also born out in a recent Investment Company Institute (ICI) survey in which more than 80% of households
owning DC plan accounts said the immediate tax savings from their retirement plans were a big incentive to contribute.\textsuperscript{5}

\section*{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 \textit{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 – \textit{more than 50\% lower than JCT or Treasury estimates for a 5-year budget window}.\textsuperscript{6}

The following chart illustrates the results.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Comparison of Tax Expenditure Estimates \newline Joint Committee and Treasury Annual Estimates Compared to the New Methodology*}
\end{figure}

* 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.

\textsuperscript{5} Investment Company Institute, \textit{America's Commitment to Retirement Security: Investor Attitudes and Actions January 2012} available at \url{http://www.ici.org/pdf/ppr_12_retir_sec_update.pdf}

\textsuperscript{6} Judy Xanthopoulos and Mary Schmidt, \textit{Retirement Savings and Tax Expenditure Estimates} (April 2012), available at \url{http://www.asppa.org/Main-Menu/govtaffairs/RET2012.aspx}
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.

**Who Benefits**

**Who is participating?**

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. 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. 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.” 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.

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9 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.”).
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.

**Figure 4**

Estimated Private Sector Active Participants in 401(k) and Profit Sharing Plans, Distributed by Adjusted Gross Income

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Percent of All Active Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>under $50,000</td>
<td>38%</td>
</tr>
<tr>
<td>$50,000 under $100,000</td>
<td>36%</td>
</tr>
<tr>
<td>$100,000 under $150,000</td>
<td>11%</td>
</tr>
<tr>
<td>$150,000 under $200,000</td>
<td>10%</td>
</tr>
<tr>
<td>$200,000 or more</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Internal Revenue Service (IRS) Statistics of Income Division (SOI)

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).
How is the tax benefit distributed?

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. 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,

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10 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.
households with incomes of less than $50,000 pay only about 8% of all income taxes, but receive 30% of the defined 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.  

Figure 6

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

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owner is transferred to employees in the form of employer contributions. The standard methodology credits the small business owner contributing $50,000 on her own behalf with $14,000 “tax savings” (28% marginal rate times $50,000). 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 $6,800 ($14,000 - $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 $14,000 for the owner and $1,500 for the other employees, the true allocation is $6,800 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 $50,000 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 $50,000 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 $50,000 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.
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 if there is consistent availability of workplace savings.

Figure 7

Median Replacement Rates for Participants Reaching Age 65 Between 2030 and 2039, by Income Quartile at Age 65
(percent of final five-year average salary)

- Quartile 1
- Quartile 2
- Quartile 3
- Quartile 4

Social Security 401(k) Accumulation* Social Security and 401(k) Accumulation*

The 401(k) accumulation includes 401(k) balances at employer(s) and rollover IRA balances.
Source: Tabulations from the EBRI/ICI 401(k) Accumulation Projection Model

Figure 8

Median Replacement Rates for 401(k) Accumulations* for Participants Reaching Age 65 Between 2030 and 2039
(percent of final five-year average salary)

- Baseline
- Don’t always have a 401(k)

The 401(k) accumulation includes 401(k) balances at employer(s) and rollover IRA balances.
Source: Tabulations from the EBRI/ICI 401(k) Accumulation Projection Model
One of the challenges faced in analyzing the adequacy of retirement savings is that the usual method of measuring savings is based on average or median 401(k) accounts or IRA accounts. The result is often an underestimation of individual’s accumulations since many individuals have retirement savings held in more than one account. For example, I have only been employed by ASPPA for a little over 4 years, and considering only my ASPPA 401(k) balance would present a very different picture than considering my funds in an IRA, another 401(k) plan and TSP. Since it is not possible to consolidate accounts for everyone from everywhere, the adequacy of a lifetime of retirement savings through an employer-sponsored plan can be estimated by looking only at individuals nearing retirement age with long tenure with their current employer. As shown in the following table, substantial account balances are accumulating for these older active participants with long tenure in 401(k) plans:

**Figure 9**

Note that these are not “final” balances – many of these individuals are still working, with additional contributions being made to these arrangements. Also, “tenure” is years of service with the employer, not years of participation in a 401(k) plan. Since 401(k) plans did not become widely used until the early 1990’s, employees with 30 years tenure with an employer today are not likely to have had 30 years of participation in a 401(k) plan.
Impact of Proposed Changes

$20,000 Cap

The Deficit Reduction Commission and the President’s Economic Recovery Advisory Board (“PERAB”) both floated the idea of reducing the current $50,000 maximum contribution for defined contribution plans to the lesser of 20% of pay or $20,000. Reducing the maximum contribution from the current $50,000 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 (less than 100 participants), 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.
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. A recent proposal from William Gale\textsuperscript{12} 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 \textit{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 other words, the “problem” being addressed by this proposal is not the problem, and the “solution” will only make the situation worse.

\textsuperscript{12}William G. Gale, \textit{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.

• If the proposal applies to all defined contribution plan contributions, not just elective deferrals, the administrative problems would be severe. Some employer contributions are not vested when contributed, so the incidence of taxable income would depend on the year of vesting, not the year of contribution. Consider an employee of modest income in a plan where employer contributions are fully vested after three years of service, and not vested before three years of service are completed. The employee would have to have income tax withheld on two or three years of employer contributions in one year, which would place a financial burden on the worker. Note that this problem would apply to any proposal that includes employer contributions in taxable income. The problem would be exacerbated if the employer contribution also becomes subject to FICA.

The following chart shows the decline in projected account balances for participants considering both changes in employee behavior and employer behavior, including the termination of plans, if the current year’s exclusion were modified to an 18% refundable credit. As expected, participants in smaller plans would suffer most, with the lowest income quartile showing the largest reduction for all plan sizes.
Proposals to modify the retirement savings tax incentives have included proposals to “simplify” the system by consolidating various types of plans into a single plan, by restricting plan designs to a limited number of safe harbor contribution formulas— in some cases a single safe harbor, or both. The effort is generally couched in statements regarding how the large number of options is confusing to employees and employers, and discourages participation in the system.

For example, proponents of combining all defined contribution plans into a single type of plan claim it would lead to higher participation rates, apparently based on a theory that employees don’t join a plan at work because they are confused about the difference between a 401(k), a 403(b) or a 457(b) arrangement. That theory makes no practical sense, since employees are not asked to choose between these types of arrangements. The employee is asked whether or not they want to contribute to the plan the employer has made available – or the employee may even be automatically enrolled. Although combining 401(k), 403(b) and 457(b)’s into a single type of plan might look like simplification on paper, in practice it would disrupt...
savings and require state and local governments, nonprofits, and possibly private plan sponsors, to modify their defined contribution arrangements.

I spent over 20 years working with small businesses that were considering whether or not to set up a retirement plan. I can assure the Committee that “complicated” testing does not discourage employers from establishing plans, and employers would be less likely to establish plans that include employer contributions if the employer had less flexibility in plan design. The truth is, it is that flexibility that creates sufficient tax savings for the small business owner to fund the contributions for employees, and the availability of general nondiscrimination testing is key to this flexibility.

There are, however, complexities that discourage small business owners from taking advantage of the tax incentives for maintaining a plan, or incorporating features that would make the plan more effective as a savings vehicle for all employees. These complications are not rigidity in plan design, but the significant red tape, fines and penalties that can accompany even the most basic of these arrangements.

Some complications are statutory and some are regulatory. For example, multiple employer plans (MEPs) are one approach that is gaining favor in the marketplace. However, the growth is hindered by regulatory confusion that is a perfect example of how a business operating in good faith can be tripped up by conflicting regulations. The Internal Revenue Code clearly states that a retirement plan operated by more than one unrelated employers is a multiple employer plan. ERISA doesn’t clearly contradict this definition, but the ERISA definition applies to welfare plans as well as retirement plans, and guidance on welfare plans has established that the employers must have a relationship other than joint sponsorship of the plan to participate in a “multiple employer plan”. The sad thing is, if DOL doesn’t conclude that MEP under the Code is also a MEP under ERISA, it’s the small business owners that have in good faith joined these arrangements that could be faced with penalties for not filing an annual Form 5500. Mr. Kind and Mr. Reichart have a provision in their SAVE Act that addresses this concern, and if DOL does not take care of it, Congress will need to fix the problem.

Another regulatory issue that may require a legislative fix is electronic delivery of information. ASPPA has been a strong supporter of disclosure. We also think information delivered in a thick stack of paper is unlikely to be read. If a participant wants paper, they should be able to get it. However, the default delivery system should be the one that provides the most useful form of information to most participants, and that is not a pile of paper. We thank Mr. Neal for including default electronic disclosure in HR 4050.

There are numerous other examples of how the framework for operating a small qualified plan could be simplified, but here are a few suggestions:

- Eliminate mandatory “interim amendments” which increase the cost and burden of maintaining a plan without any corresponding benefit. The current process is

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13 Qualified retirement plans are governed by written documents that must meet certain requirements under the Internal Revenue Code to maintain tax-favored status. Revenue Procedure 2005-66, as modified by Rev. Proc. 2008-56, provides staggered dates for plan documents to be submitted to IRS for review as to a plan’s qualified status. Individually designed plans are on five-year cycles, and pre-approved documents are on six-year cycles. During these five or six-year cycles, plans must adopt amendments to reflect legislative and regulatory changes to the qualification requirements. Except as provided by law or other guidance, these “interim amendments” must generally be adopted by the due date (including extensions) for filing the income tax return for the taxable year the change is effective. There is no coordination of the due dates of these required “interim amendments” with the cycle for submission of documents to IRS.
incredibly complicated, with different amendment deadlines that vary based upon the type of amendment and the plan’s fiscal year. This leads to mistakes being made by well meaning plan sponsors (who are voluntarily providing this benefit). Small plan sponsors in particular are shocked and surprised when asked to pay thousands of dollars in sanctions when an inadvertent amendment mistake is uncovered during an IRS audit. Amendment deadlines co-ordinated with the plan’s 5 or 6 year review cycle would be user friendly and cost-effective.

- Don’t penalize small employers for allowing employees to start contributing to a 401(k) plan immediately upon employment. This could easily be accomplished by excluding employees the statute would have allowed to be excluded from participation in the plan from the 3% minimum “top heavy” contribution requirement.

- Make it less “dangerous” for small employers to use automatic enrollment by making it less expensive when the plan inadvertently fails to automatically enroll an employee. Small employers shy away from automatic enrollment, often because a mistake can cost the employer 3% of the employee’s pay for the year, in addition to any matching contribution the employer would have made if the employee had been enrolled and contributed the default amount. It is reasonable to require the employer to make any matching contributions that would have been due if the employee had contributed the default amount, but to impose an additional cost because the employer voluntarily adopts automatic enrollment simply discourages adoption of automatic enrollment.

- Eliminate unnecessary notices, such as the notice requirements for the 3% safe harbor. The safe harbor information is already provided to participants in the Summary Plan Description, and since employees receive the contribution whether or not they contribute to the plan, it does not cause participants to change their behavior.

- Simplification should not be limited to defined contribution plans. Enactment of the proposal to eliminate reduction of assets by credit balances in applying the benefit restrictions of Code section 436 would not only make sense from a policy standpoint, but would dramatically simplify the operation of that provision. (This proposal is included in H.R. 3561 – The Small Business Pension Promotion Act, sponsored by Representatives Kind, Gerlach and Neal.)

ASPPA looks forward to working with the Committee to simplify the rules and regulations surrounding retirement savings incentives, and to help American workers, especially small business owners and their employees, take advantage of workplace savings.

14 Employees who have not attained age 21 or who have not completed a year of employment with at least 1000 hours of service may be excluded from plan participation.

15 A plan is considered top heavy if over 60% of the accrued benefits are for “key employees”. Many small business plans are top heavy and, as a result, must provide all participants in a defined contribution plan with a contribution of at least 3% compensation. For a defined benefit, the requirement is a minimum accrued benefit of 2% of pay per year of service, with a 20% maximum. Special rules apply to participants covered under both types of plans.
Auto-IRA

ASPPA supports the auto-IRA proposal developed by the Retirement Security Project, and proposed in HR 4049 sponsored by Representative Neal (D-MA). The proposal does not require employers to contribute to a retirement plan, or impose fiduciary responsibilities on business owners. It does give employees an opportunity to contribute to an IRA on their own behalf through payroll deduction. Providing a payroll deduction arrangement will also make it more of a natural step for employers to consider sponsoring a SIMPLE or 401(k) plan when the business reaches the point that, with the assistance of the tax incentives, it can support employer contributions.

Summary

The current system is working very well for millions of working Americans. Expanding availability of workplace savings is the key to improving retirement security. 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. ASPPA looks forward to working with the Committee to achieve meaningful simplification, and retirement security for American families.

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