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SUBCOMMITTEE HEARING ON PENSION PARITY: ADDRESSING THE INEQUITIES BETWEEN RETIREMENT PLAN OPTIONS FOR SMALL AND LARGE BUSINESSES

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SUBCOMMITTEE HEARING ON PENSION PARITY: ADDRESSING THE INEQUITIES BETWEEN RETIREMENT PLAN OPTIONS FOR SMALL AND LARGE BUSINESSES

Wednesday, October 24, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON FINANCE AND TAX
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. Melissa Bean [Chairwoman of the Subcommittee] presiding.

Present: Representatives Bean, Ellsworth, Sestak, and Heller.

OPENING STATEMENT OF CHAIRWOMAN BEAN

ChairwomanBEAN. Now calling this hearing to order on Pension Parity: Addressing the Inequities Between Retirement Plan Options for Small and Large Businesses.

Retirement security is a universal goal for most Americans. As part of their retirement plan, most Americans rely on three very important pillars as they plan for their financial future: personal savings, Social Security, and employer-based retirement plans.

As the baby boomer generation ages, raising real questions about the sustainability of Social Security benefits, it is critical that all employers and their employees have financial security as they enter their retirement years.

A recent Employee Benefit Research Institute study revealed that less than half of all workers were participating in a retirement plan. While it is clear the overall number needs to be improved upon, the story for small businesses is even more disappointing. Employee participation for small businesses is alarmingly low.

Businesses with 25 or fewer employees have only 23 percent of their workers enrolled in a retirement plan. Businesses with 25 to 99 employees have only 43 percent of their workers enrolled in a plan, while employers with 100 to 500 employees have a little more than half of their employees enrolled in a retirement plan.

Given that 80 percent of new domestic jobs are created in the small business community, this hearing addresses those Americans employed in that sector. Employees of large companies often contribute to 401(k) pension plans. Those employees can borrow from their plans for certain purposes, including first-time home purchases, college tuition, medical emergencies. Conversely, many re-

tirement plans small businesses are able to provide don't give their employees access to their tax-deferred pension monies.

This hearing is intended to address those inequities, and others, and seeks to identify ways to provide greater pension parity between large and small business offerings. American employees should have equal access and flexibility in their pension plans.

I look forward to today's hearing, which will allow members of the Committee to discuss the current vehicles used by many small businesses to provide retirement benefits, and ways in which those can be improved upon to encourage small business involvement while discussing new solutions.

I appreciate the participation today from our members and from our—those who are here to testify today and look forward to hearing it. I now would like to yield to Ranking Member Heller for his opening statement.

OPENING STATEMENT OF MR. HELLER

Mr.HELLER. Thank you very much, Madam Chairwoman. I appreciate the opportunity to be here this morning and for you taking on this important issue.

I want to thank all of you for being here today as we examine inequities between retirement plan options for small and large businesses. I would like to extend a special thanks to our witnesses, some of which have traveled great distances to be here today.

Few debates in Washington have as significant or real world impact on quality of life for older Americans as retirement security. Last week a recently retired teacher from New Jersey became the first baby boomer to apply for Social Security benefits. A wave of nearly 80 million more will follow over the next two decades. In its current state, Social Security will struggle to meet the retirement needs of the millions of baby boomers, much less future generations.

In a little more than 10 years, Social Security will reach a critical juncture in its history paying out more in benefits than it takes through in payroll taxes. This untenable financial situation must be addressed, and I applaud Chairwoman Bean for calling this timely hearing.

America's 25 million small businesses compose—we are going to hear a lot of statistics today—99.7 percent of all employers and are responsible for generating 60 to 80 percent of all new jobs. Nevada is one of the fastest-growing states for small businesses. Nevada alone is home of more than 200,000 plus small businesses. Last year alone, 90,000 new businesses incorporated in the State of Nevada, which provides for more than 425,000 jobs in my state. This means 44 percent of Nevada's working population relies on small businesses.

As Secretary of State, I was responsible for registering thousands of businesses a year, and I fought to keep Nevada friendly to small businesses. And I look forward to continuing to keep small businesses vibrant and healthy in America and the State of Nevada.

Unfortunately, despite their contributions to our economy, there is a substantial discrepancy between large/small businesses' ability to offer employer-sponsored retirement benefits. According to the

Congressional Research Services, only 26 percent of firms with 25 employees or fewer offered employer-sponsored retirement plans. In contrast, 72 percent of firms with 100 or more employees do sponsor plans.

With small businesses playing such an integral role in our economy, it is important that we identify and remove the barriers that prevent our small companies from offering retirement benefits. When looking at the specific issues that hinder small businesses' retirement benefit participation, we must expand the scope. Isolating specific concerns neglects the relationship that exists between energy prices, health care costs, taxes, and the price tag of complying with government regulations.

Small business owners are habitually asked to make difficult choices about where to dedicate their resources, with extras like retirement benefits often falling at the wayside. Our job on this Committee is to help enable small businesses to succeed. I believe an excellent starting point would be to reduce tax and regulatory burdens to allow for small—for more employer benefits.

Employment in health care plans can make the difference between a new hire and a lost prospect. As companies rigorously compete for talented employees, let us give the little guy the flexibility to attract good candidates to develop and grow.

We have an excellent panel that will shed some light on the challenges small businesses confront in offering retirement packages. I look forward to hearing the testimony. I appreciate Chairwoman Bean for calling this hearing, and I yield back.

Thank you.

ChairwomanBEAN. Thank you, Congressman Heller. And thank you for your leadership on this issue as well.

We are now going to move to testimony. Witnesses will have five minutes to deliver their prepared statements and/or a summary of those prepared statements, since we have them. The timer begins when the green light is illuminated. When one minute of time remains, the light will turn yellow. The red light will come on when time is up.

I know a number of us have other hearings going on simultaneously today, as it just so works out here in many cases. So I am going to try to urge you to stay on the time, because I think what we are most interested is getting to the Q&A and discussing that testimony, since we have already had a chance to review it.

Our first witness is Catherine Collinson. Ms. Collinson is the Senior Vice President of Strategic Planning for Transamerica Retirement Services. She also directs the Transamerica Annual Retirement Survey, which explores the attitudes and behaviors of American workers and employers regarding retirement security and workplace benefits. With over a decade of experience, she has become a recognized voice on retirement trends for the industry. The companies of Transamerica offer a wide array of innovative financial services, including retirement plan options.

Thank you.

STATEMENT OF CATHERINE COLLINSON, SENIOR VICE PRESIDENT, STRATEGIC PLANNING, TRANSAMERICA RETIREMENT SERVICES, LOS ANGELES, CALIFORNIA

Ms.COLLINSON. Good morning, and thank you for this opportunity to testify.

Employer-sponsored retirement plans play a critical role in facilitating our savings in our society. Americans are far more likely to save for retirement by participating in their company's retirement plan versus contributing to an IRA. The Eighth Annual Transamerica Retirement Survey found that 71 percent of small businesses with 10 to 499 employees sponsor a 401(k) or similar defined contribution plan. And that is in contrast to 95 percent of companies with over 500 employees.

Only 24 percent of small businesses surveyed sponsor a defined benefit plan. Therefore, this testimony will focus on defined contribution plans.

Of the small business employers that do not currently sponsor a defined contribution plan, the Transamerica survey found that 73 percent are not likely to do so in the next two years. The most frequently cited reasons include perceptions that their company is not large enough, lack of interest, concerns about cost, administrative complexity, and potential fiduciary liability.

The Transamerica survey also found disparity in plan participation rates, with 70 percent of small business employees indicating that they participate—that is, 70 percent who have access to a plan—compared to 76 percent, 70 percent at small businesses, 76 percent at large companies.

The Economic Growth and Tax Relief Reconciliation Act of 2001—EGTRRA—and the Pension Protection Act of 2006—PPA—took important steps to increase retirement savings rates and employer plan sponsorship, yet much more work needs to be done to bridge the gap between benefits offered by small businesses relative to large companies.

On behalf of Transamerica Retirement Services, I would like to set forth the following recommendations. Opportunities to increase plan coverage in the small business sector—one, offer additional tax incentives for small business employers to establish a retirement plan.

Under a provision of EGTRRA that was made permanent by PPA, small businesses may claim a tax credit for establishing a retirement plan equal to 50 percent of qualifying costs up to $500 per year for the first three years. Consideration should be given to increasing the available amount of the credit and increasing the number of years that it may be claimed.

Second, non-discrimination rules, compliance testing, and the costs associated with correcting failures increased the employer's overall cost of sponsoring a plan, especially for small businesses. Further simplification of the administrative requirements can be achieved while preserving the basic spirit of fairness.

Third, for small businesses in which a stand-alone plan is not feasible, consideration should be given to enabling and providing incentives for them to join a multiple employer plan to be provided by a financial institution.

And, lastly, any new legislation and regulatory relief should be broadly promoted to help ensure that small businesses are aware of the advantages and feasibility of sponsoring a plan.

Next, I would like to talk about increasing opportunities to our important opportunities to increase plan participation and savings. The saver's credit, a tax credit which was created by EGTRRA and made permanent by PPA, offers a meaningful incentive for low to middle income Americans to save for retirement. However, very few are aware of it.

Earlier this year, Transamerica commissioned a survey and found that only 11 percent of adults who fall within the credit's income eligibility requirements are familiar with it. Further, 29 percent of qualifiers indicated that they have filed or plan to file their taxes with a 1040EZ form, which does not mention, nor has provisions for, claiming the credit. So, conceivably, they are missing out simply because they don't know about it.

Further compounding the issue, while it is most commonly known as the saver's credit, the IRS forms and publications refer to it as the retirement savings contribution credit and a number of other terms. Therefore, it is highly recommended that the IRS should broadly promote the saver's credit, update the tax forms and instructions to consistently refer to it as the saver's credit, and add it to the 1040EZ form. Further, consideration should be given to expanding the saver's credit in terms of increasing the income requirements and making it refundable.

On a different note, while much emphasis is placed on saving for retirement, it is also important for employees to have the tools to manage their savings at retirement. Congress should consider creating incentives that encourage individuals to convert a portion of their savings into a guaranteed lifetime income.

In conclusion, Transamerica Retirement Services appreciates the opportunity to present its views and recommendations and commends Subcommittee Chairwoman Bean and Ranking Member Heller on their consideration of these issues.

Thank you.

[The prepared statement of Ms. Collinson may be found in the Appendix on page 29.]

ChairwomanBEAN. Thank you for your testimony.

Our next testimony is going to come from Sal Tripodi, currently—who currently maintains a nationally-based consulting practice in the employee benefits area, TRI Pension Services.

Mr. Tripodi started his employee benefits career with the IRS, and since 1983 has been in the private sector consulting on employee benefit matters, writing reference materials concerning employee benefit plans, and conducting numerous seminars. He is President of the American Society of Pension Professionals and Actuaries. ASPPA is the premier national organization for career retirement plan professionals with more than 6,000 members.

Please proceed.

STATEMENT OF SAL TRIPODI, TRI PENSION SERVICES, HIGHLAND RANCH, COLORADO, ON BEHALF OF THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES

Mr.TRIPODI. Thank you. Good morning, Madam Chair, Ranking Member Heller, and other members of the Committee. I am Sal Tripodi, President of ASPPA, and we appreciate this opportunity to testify before the Committee on the issue of pension parity in the workplace.

I, too, have some statistics with me on establishment of plans by smaller employers versus larger employers, but I think we have those on the record here. It will help me stay within my five minutes.

There is no question that the most effective way to get Americans to save for retirement is through the workplace retirement system. And in fact—and I will add another statistic to the mix today—the lower income workers in particular making $30- to $50,000 per year are almost 20 times more likely to save for retirement when covered by a workplace plan as opposed to saving on their own.

One effective way to increase coverage of small business workers would be to require employers who do not maintain a retirement plan to provide some mechanism at the workplace by which its employees have an opportunity to save for retirement through payroll deduction IRAs. A number of proposals like this have recently been discussed by several members.

While ASPPA supports these proposals, we believe they must be structured to preserve the incentive for employers to sponsor a qualified retirement plan. To this end, we believe that any payroll deduction IRA requirement should apply only to employers that do not maintain a qualified retirement plan with broad-based coverage. We believe it is vital to continue to encourage employers to offer qualified retirement plans which, because of non-discrimination rules, will provide more substantial retirement benefits for workers than payroll deduction IRAs.

Forcing small businesses to maintain two separate programs would discourage such businesses from forming or graduating to a qualified plan. Encouraging such programs is critical to the realization of adequate retirement savings, especially for lower income workers.

In addition, any such exemption should not be limited to employers that maintain plans that have elective savings features, such as 401(k), and employers should be able to maintain a broad-based retirement plan that is funded solely by the employer, such as a defined benefit plan or a profit-sharing plan, without having to incur the additional administrative expense of a separate payroll deduction savings program.

Another important initiative is to have major expansion of the current law, saver's credit. We have heard some discussion already on the saver's credit, which has become permanent due to the PPA. But what we would like to see is increasing the number of households that would be eligible for the credit, and to have more gradual phaseouts of the credit over a wider income bracket of eligibility.

In addition, the credit should be transformed into a government match by requiring that the saver's credit be deposited directly into the taxpayer's IRA, or the taxpayer's account in an employer-sponsored plan, if the employer is willing. Thus, small businesses that would be required to offer a payroll deduction IRA program at the workplace would be able to provide a government-subsidized matching program for lower income workers.

And employers who maintain a broad-based qualified plan, or choose to install one in lieu of a payroll deduction IRA program, would be able to provide their lower income workers a double match, meaning a government match on top of any employer-provided match in the workplace plan.

The lack of coverage in the employer-sponsored retirement plan system has often been cited as a chief reason to propose the creation of high dollar limit tax-favored individual savings accounts. ASPPA believes that a payroll deduction IRA program presents a far better alternative for American workers and small businesses than expanded individual savings accounts that would undermine existing qualified retirement savings programs.

With employers required to have either a payroll deduction IRA program, or a broad-based retirement plan, virtually all American workers would have access to an employer-based retirement savings program. Additionally, for lower income workers, those most at risk respecting retirement savings, the expanded saver's credit would offer them an enhanced incentive to save. This greater targeted incentive will likely produce a much higher level of savings by lower income individuals than savings through expanded individual account proposals.

Also, and not insignificantly, a payroll deduction IRA requirement would serve to institutionalize the employer-based model for delivering retirement benefits, which statistically is the most effective way to enhance the level of retirement savings for American workers. It will require tens of thousands of businesses, most of them smaller businesses, to have to consider offering a retirement savings program for workers, either through the payroll deduction IRA or a workplace retirement plan.

Many of these businesses might be persuaded to take the further step of offering a qualified plan, such as a 401(k) or a defined benefit plan, where the business owners can save even more, and through non-discrimination testing standards the rank-and-file employees would enjoy higher levels of retirement savings as well.

Further, even if businesses do not initially step up to a qualified plan, the fact they would then be familiar with offering a retirement savings program through the payroll deduction IRA will make it more likely that they would be willing to move up to a qualified retirement plan at some point in the future. This would be significant wind for the state of retirement savings in this country.

Thank you for your time.

[The prepared statement of Mr. Tripodi may be found in the Appendix on page 36.]

ChairwomanBEAN. Our next witness is Jim McCarthy, who is head of retirement and solutions for the Global Wealth Manage-

ment Group, Morgan Stanley, and serves as a member of the group's Operating Committee. One of the largest businesses of its kind in the world, with over $680 billion in client assets, Morgan Stanley provides a range of wealth management products and services to individuals, businesses, and institutions.

Mr. McCarthy is testifying on behalf of the Securities Industry and Financial Markets Association. SIFMA represents more than 650 member firms of all sizes in all financial markets in the U.S. and around the world.

Thank you.

STATEMENT OF JIM McCARTHY, MANAGING DIRECTOR, RETIREMENT SERVICES, MORGAN STANLEY, PURCHASE, NEW YORK, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr.MCCARTHY. Thank you. Madam Chairwoman, Ranking Member Heller, members of the Subcommittee, thank you for holding this hearing on retirement coverage for small business, and for offering SIFMA the opportunity to testify on this important issue.

In my testimony today, I will focus on three areas. First, I will highlight the barriers that discourage small businesses from establishing retirement programs for their employees, then discuss milestones that actually must be achieved before a small business offers retirement plan coverage, and, finally, suggest legislative reforms that would lead to more small business pension coverage.

Surveys consistently report that cost and complexity are the leading barriers to plan formation. The owner of a newly-formed business is, first and foremost, concerned with the capital requirements of that business. Adequate capital is key to early survival.

In general, small business does not embark on the search for a retirement plan without the assistance of a professional. Advice, in consultation with a business or personal advisor, such as the owner's personal financial advisor, an accountant, or another trusted professional, is a common starting point for discussions about the potential benefits of offering a plan.

When this conversation occurs, the businesses most typically enter in years where profitability has been reached, survival is more likely, and revenue is more certain. At the point of profitability, the tax incentives available are an important factor that encourage the business to start a plan.

A small business plan that provides health care is probably a prospective retirement plan client. However, we don't limit ourselves to firms that are offering health care. Once the business begins to grow, it needs to attract good, stable employees. For those small businesses that do offer a plan, retention and recruitment is a key benefit of offering this type of program. They are easily understood by potential employees who are weighing the pros and cons of relative offers between employees.

In terms of recommendations, Congress has been a strong advocate of initiatives to expand participation in retirement savings programs for small businesses. In '96, it created the SIMPLE IRA. The SIMPLE IRA has proven itself in the marketplace, gaining quick acceptance. For example, in statistics from 2001, a mere four

years after the SIMPLE was created, there were nearly two million taxpayers with SIMPLE IRAs.

SIFMA believes that the SIMPLE IRA offers the most potential for growth. The SIMPLE IRA is unique among retirement savings programs, in that any employer who participates in a SIMPLE IRA will always receive a benefit under the program. The employer must make employee contributions up to three percent of compensation, must match contributions up to three percent of compensation, or make non-elective contributions for all eligible employees, which is inclusive of part-time and seasonal workers—a major component of the small business labor force and a major source of the flexibility in labor staffing that is a key component of the small business owners' ability to adapt to changing business conditions.

There is also immediate ownership of that contribution. Employees will not forfeit a benefit if they terminate employment. To make SIMPLEs more attractive, SIFMA believes the following enhancements should be enacted. We believe that the contribution limit should be raised to put it on par with that at 401(k) plans. SIMPLE plans require that employees either match or make a contribution, thus the business owner who installs a SIMPLE is providing employees with substantial benefits. We believe the inducement to the owner by increasing the contribution limit will create more SIMPLE plans and bring more workers along with the owners who adapt—who adopt.

We would also advocate adding the ability to make additional non-elective employer contributions. Currently, employers can't—we see no reason why a simple plan should not be allowed to receive, for example, in a good year or as part of an ongoing retention strategy, non-elective contributions up to 10 percent in terms of additional contributions.

We think we should eliminate the higher penalty on simple distributions. It was enacted in a prophylactic means to make sure that there wasn't early leakage out of the programs. There is no data on file to support that there is relatively more leakage out of these programs than any comparable retirement programs, and we think that the current 25 percent withdrawal tax is confusing and inequitable.

From a portability standpoint, we believe that SIMPLE participants should be able to port their balances to other plans. The inability to rollover assets causes taxpayers to have very fragmented retirement savings, and what we observed from a leakage perspective is that small balances get dissipated, while larger aggregated balances get nurtured and built up.

Finally, we would allow a mid-year change from a SIMPLE IRA to another plan. We believe that that—if a workforce wants—excuse me, if a business owner wants to enhance their plan during the year, they should be able to do so.

And, lastly, we would enhance the tax credit. We see little use of the tax credit, and we think that's a major way, if we made it a refundable tax credit, the businesses that don't have a tax liability today could still put in a plan and avail themselves of the tax credit.

We look forward to working with you on ways to improve the situation.

[The prepared statement of Mr. McCarthy may be found in the Appendix on page 41.]

ChairwomanBEAN. Thank you very much.

Paula—is it Calimafde?

Ms.CALIMAFDE. Wow. Yes.

ChairwomanBEAN. It was okay?

Ms.CALIMAFDE. Yes. That is a first.

ChairwomanBEAN. I wanted to make sure I got that right. Ms. Calimafde is a principal at the law firm of Paley, Rothman located in Bethesda, Maryland, and is testifying on behalf of the Small Business Council of America. Ms. Calimafde's practice encompasses sophisticated estate planning and advising individuals with significant assets, including retirement plan assets. She is the current chair, past president, and a member of the Board of Directors of the SBCA, which is an organization representing the tax, pension, and other benefit interests of privately-held and family-owned businesses.

Thank you for being here.

STATEMENT OF PAULA CALIMAFDE, CHAIR, SMALL BUSINESS COUNCIL OF AMERICA

Ms.CALIMAFDE. Thank you, and I—at the outset, I want to thank you, Chairwoman, and Congressman Heller for holding these hearings, and for the interest of the other members of the Subcommittee, and also to thank you, the entire Small Business Committee of the House, for the work you have done over the years, because you are really a beacon to small businesses. And over the years you have distinguished yourself as someone that we can come to and talk about our problems, and it is very appreciated.

I am going to try to do a whirlwind tour in five minutes, and I am going to try at some point to talk about 409A, which I hope I can get in, because talk about problems for small business, that is probably the biggest problem facing us today. It is in the non-qualified world, not the qualified, but hopefully we will get to it.

We do know some things about retirement plans now after the last, what, 30, 40 years together working on it since ERISA. What we know is that if you take money out of a person's paycheck before they get it, they tend to save it. And we also know if that money goes into a trust plan, like a 401(k) plan, where there is not easy access to the money, they tend to keep the money in the plan, because they have to.

With a 401(k) plan, you can get to money by loans, which are rigidly enforced, and there is all sorts of requirements, as you can imagine, when IRS gets involved. And there is also—you can get to money in a 401(k) through hardship distributions, but that is it.

Also, with 401(k) plans, we know that companies take the educational component very seriously. They work with advisers to come up with a group of mutual funds that will work for the employees, and very often there is web sites. The employees can go on the web sites, they can see what their account balances are,

they can change between investments. It is a very interactive plan, and plan people like a lot.

Mr. McCarthy was talking about the SIMPLE plan and why the SIMPLE plan should be given the same contribution limits as a 401(k) plan. And I would say that the Small Business Council of America is really opposed to that, and the reason why is that a SIMPLE plan is exactly that—it is simple, because it allows the employer to make the contributions directly into an IRA and then walk away, so it is amazingly popular with small business owners.

The problem with it is that walking away part of the SIMPLE is what is wrong with it, because it an IRA, so employees can go and access their money any time they want to. You know, their daughter needs a dress for the prom, and they love their daughter, and there is that money in the IRA, and let us just go to the IRA and get the money. Very unlikely they will go to their employer and say, "I need to take a loan out of the 401(k) plan and pay $150 to get the loan out for the dress that is going to cost $150." So it is a completely different dynamic.

The 401(k) plan is a more serious plan. It is got—there is fiduciary obligation on the part of the employer. They are taking it on. But, today, working with brokerage houses, insurance companies, and banks, this 401(k) plan is now much more accessible and much easier for small business employers to deal with.

By the way, the small business system is covering 19 million small business employees, which is a pretty good number. And when you look at the numbers you say, "Oh, they only cover a third of all workers in the small business area," that is true, but those numbers do not take into account the fact that, unfortunately, almost a third of all small businesses fail within the first two years of going into—coming into existence, and almost half fail within the first four years.

So if you take those numbers into account, I think the fact that small business is only covering a third of all employees may not work. I think if you took into account small businesses who have been around for five years, and then saw the coverage numbers, I have a feeling the numbers would be much more realistic and would jump up to the 50 percent category or higher.

As far as interesting proposals out there, one is the proposal put forth by the administration back in 2004, and they have put it forth every year. They put it together with two other proposals. One is called the Lifetime Savings Account, or LSA, and the Retirement Savings Account called sometimes RSA, and then the Employer Retirement Savings Account called ERSA.

And we are completely opposed to the LSA account, because we think small business would just take their money and put it into that account. But the ERSA has never been given any serious consideration by anyone as far as we can tell, and we think it is a terrific attempt to try to simplify a number of different retirement plans that all have developed over the years and all have separate rules, but really could be made into a much more simple plan. And so we would suggest that the ERSA be sort of given some serious consideration, and we think that from a retirement plan viewpoint it is a very positive plan.

I see I am running out of time, so I just want to mention 409A quickly, which is—this is this new monster code section that was put in I guess a couple of years ago to meet the situation in Enron and WorldCom, where right before the company was going down key top executives literally were taking millions of dollars out of the company through non-qualified deferred comp plans.

And you all decided, we have to stop this. This isn't fair to the investors, it is not fair to the employees, something has to be done. And you came up with 409A, which at first no one thought applied to small businesses. Why? Because small businesses don't have non-qualified deferred comp plans.

But the way Treasury and IRS has interpreted 409A, it now applies to employment agreements, corporate stock agreements, LLC operational agreements. Almost any agreement you can imagine small business has out there may in fact be a 409A issue. And these—under 409A, there is 20 percent penalties involved by IRS.

IRS came out with 400 pages of regulations that we are trying to read—and, believe me, I don't want to read this—and all I can say to you is that it is a huge, huge, monster section that is going to cost small business tons and tons of dollars, and really there is no abuse in the small business world.

So we would respectfully ask you to come up with some kind of exemption that gets small business out of 409A, which it really never needed to be in.

Thank you.

[The prepared statement of Ms. Calimafde may be found in the Appendix on page 48.]

ChairwomanBEAN. Or exemption. Well, thank you for that.

We are going to move to questions, and I am sure we will come back to that.

Some of my questions, to start out, have to do with—and I spoke to a couple of you prior to the hearing—regarding access to tax-deferred pension dollars. And I mentioned it in my opening statement as well.

For those who have worked in corporate America or large organizations who have access to 401(k)s, they make their contributions and then for various purposes they can access those dollars on a loan basis—first-time home purchase, college loans, medical emergency. They move to their own business as entrepreneurs and start a company, they don't necessarily have access.

Now, I know there are simpler 401(k)s available today than there were years ago, but I guess I would like to know where you still see disparity relative to the small business community who maybe isn't the new one-person 401(k), which is new and available, but, you know, are using SEPs, and so they don't have access to that.

And one of my questions also is: what degree of awareness do you think there is for those who have been in other vehicles and haven't had access, that there might now be a simpler way to do it? And, number two, is there a way, or should there be, for them to move those funds to a different vehicle where they would then have access to them? And is there a retroactive way for them to get access to those funds?

Whoever wants to take that. Sal, did you want to maybe?

Mr.TRIPODI. Well, I—you know, I think there are—there is access for them to do this. I think the key is to make sure that we don't pile on regulatory burdens that dissuade them from using the qualified retirement vehicles that are available to small businesses on an equal basis with other companies, other size companies.

And as you noted, the cost of maintaining these plans has significantly been reduced over the last decade. That has made that more attractive.

We would prefer at ASPPA to continue to see that, as through the employer-sponsored retirement programs, that some of this additional access is available, particularly loan programs where there is more likelihood of being administered in a way that is not going to—it is going to include fiduciary standards, for example, rather than having employees have enhanced access through the IRA vehicles.

And once the company is able to establish a qualified plan, they are able to take those IRA monies and roll them in. We have expanded the rollover opportunity, so that in effect will—those will not retain their taint as IRA assets, if you will, from—

ChairwomanBEAN. From IRAs and from SEPs?

Mr.TRIPODI. That is from SEPs as well, yes. So that once they are in the workplace-sponsored plan they can become eligible for the loan program, for example.

ChairwomanBEAN. Even the past contributions.

Mr.TRIPODI. Even the past contribution.

ChairwomanBEAN. Okay. Others want to make a comment on that?

Ms.CALIMAFDE. I wanted to make a comment about parity. There is one place where there isn't parity, and that is the so-called top heavy rules. And these rules apply primarily to small businesses, because the way you determine whether a plan is top heavy is you look at how much of the account balances are for the owners compared to how much the account balances are for everyone else. And most small businesses, as we know, are owner heavy.

So because of that, we have these top heavy rules, and I could argue with different people across the country that in the cash balance plan the top heavy rules make sense, and even in a defined plan they make sense. But when you get to the 401(k) plan area, the top heavy rules do not make any sense at all. They don't do anything anymore.

When they first came in, they did do—they did provoke—they did provide extra contributions for staff people, and they accelerated vesting. As the years have gone by, they don't do either of those things any longer. And, unfortunately, what they do is the top heavy rules often make small businesses not give immediate eligibility to new participants coming in to 401(k) contributions, because they don't want to trigger the top heavy rules.

So a large business, when a company—when an employee comes in, they are almost always eligible for the 401(k) plan part. They may not be eligible for the employer contribution part, but they are able to start saving their own money. In the small business area, we can't do that because of the 401(k) rules—I mean, sorry, because of the top heavy rules.

ChairwomanBEAN. So it becomes a disincentive.

Ms.CALIMAFDE. It is a disincentive, and I that—I think it—I would like to hear anybody who could tell me what the top heavy rules are doing today in the 401(k) area that protects an employee. I really don't think they do anything anymore.

ChairwomanBEAN. All right. Thank you for that.

Another question I would like to ask about before we move to other questions is relative to the automatic enrollment that is now available, and what impact you have seen on overall pension savings, not just small business community but the degree to which it has or has not been helpful for the small business community.

Mr.MCCARTHY. I think that we at Morgan Stanley have seen a little bit of hesitancy to move toward open enrollment until the most recent pronouncements about qualified default investment vehicles. So when you do automatic enrollment, inherent in that is the selection of the qualified default investment, and it has just been in the last few days that there has been clarity as to what that is likely to include in terms of balance funds and target date funds, and so forth, and not necessarily stable value options.

So since some of those rules become effective 1/1/08, I think a lot of people are gearing up for fall of '07, kind of during the open benefit enrollment period, to move forward with automatic enrollment, and in certain cases reenrollment. You have a population who doesn't get—as people on-board, right, there will be a new paradigm. But for the older population, which constitutes the majority of your workforce at least in the near future, those who didn't get caught up in automatic enrollment, many companies are going back and doing reenrollment of their existing populations.

ChairwomanBEAN. Okay. Others?

Ms.COLLINSON. From Transamerica Retirement Services' perspective, we are still seeing the small business community and the marketplace assimilating all of the changes that were enacted with the Pension Protection Act, including the QDIA. So there is still a lot of unanswered questions, and there are some concerns out there, would—especially for a small business employer, would it create additional administrative complexity that they—you know, that they are not ready to take on yet?

Interestingly—and we will see how it plays out over time—a number of small businesses feel like they already automatically employ their—enroll their employees, because it is a small company, it is a single location, and when people hire on, they give them the form, they sign up, and they are automatically enrolled.

ChairwomanBEAN. Okay.

Ms.COLLINSON. So I think it is going to take some time to play out. One comment on the saver's credit—since there is such a low level of awareness, with the proliferation of automatic enrollment plans and people becoming automatically enrolled, which are typically going to be low to middle income workers, because the higher income people already contribute, that could actually perpetuate the gap of people who are eligible to claim the credit who aren't because they don't know about it, it is coming out of their W-2 income, so there is no decisive action they have to take to say, "Oh, I need to do the 1040A form versus the 1040EZ form." And they are still most likely to be using the 1040EZ form.

So that is some dots that—with automatic enrollment and lower to middle income workers that should be connected.

ChairwomanBEAN. Okay. Thank you. Yes?

Ms.CALIMAFDE. On the auto enrollment, I think it is going to work fine with the larger companies. I think it is not going to work very well with the small business area. The input we are getting from our members is that they are not interested in doing it, which is a shame, because the statistics on auto enrollment are astounding. Like if you auto enroll, something like 85 percent of the people just stay in the plan. It is just inertia, but it works.

And, really, when we are thinking about what we are really talking about today, it is how do we get people into the system, and how do we keep them saving? And auto enrollment to me is an obvious answer.

The problem with auto enrollment in the small business area is that the 401(k) safe harbors that you all created many years ago to help out small businesses be able to take advantage of the 401(k) plans are very good, they are very effective, and they work. The auto enrollment safe harbor is—I think there is a slight difference in the amount of the required company match that has to be made, and everything else is the same as the regular safe harbor.

So a small business client could easily say to me, "Well, why should I go to auto enrollment safe harbor and pick up all this additional burden, including having people who say, 'I don't want to be in the plan, pay me back the money,' and I have to do all of this stuff, when it is not going to change my incentive that I get under the Tax Code at all?" And that is the problem.

So I would suggest that if you really want the 401(k) auto enrollment safe harbor to work in the small business area, the incentives have to be greater. Either the match has to be less or the non-elective contribution has to be less or something has to be done to make it work better.

ChairwomanBEAN. Well, that is helpful, and I want to do one follow up question with you before I come over to you. I think you also mentioned earlier that there is issues relative to the IRS rules around the safe harbor, and that it is delaying—they are delaying the actual implementation.

And if the whole point of getting new employees to participate, and to increase their pension savings, is to—if it is out of sight out of mind, and you take those monies early and they learn to live on that smaller paycheck, they are going to stick. But if you give them the bigger paycheck, and then you wait 90 days to implement it, now you are going to give them a smaller check because you are enrolling them, they are less likely to want to stick with it.

So that was also one of the concerns you have had?

Ms.CALIMAFDE. Exactly. Now, the regulations have not been issued, and what I told you as hearsay from an ABA Tax Section meeting where one of the folks who are writing those regs said that they are going to stay with a required notice to employees between 60 to 90 days that there is going to be an auto enrollment taken out.

ChairwomanBEAN. Right.

Ms.CALIMAFDE. Well, you know, you might as well raise a red flag saying, "Guess what is going to come up? The company is going to take the money away from you." Whereas, if day one you are automatically enrolled, and you don't have that money, the likelihood is you are not really going to miss it.

And, unfortunately, IRS tends to do this to you all. You know, you pass something that makes a lot of sense, and then by the time all the regulations come out very often your intent is somewhat lost, and—

ChairwomanBEAN. It sort of undermines congressional intent in this case, so—

Ms.CALIMAFDE. And the complexity they add. So, you know, here the goal should be, if we are going to do auto enrollment, let us make everything as easy as possible for the companies to deal with it, and then you end up with, you know, 100 pages of regulations that nobody wants to read.

ChairwomanBEAN. Thank you. I am going to let you finish, and then I am going to move on.

Mr.TRIPODI. I just want to make one other additional point, which I think is helping the small business community in embracing the automatic enrollment, and that was the coupling of it with the legislation, with this mandate to have the default investment rules, because small business owners tend to fall into the position of fiduciary of these plans.

And that was providing a fiduciary relief for them to offer some safe way to invest the money for employees who did not take the steps to affirmatively elect their investment. So believe that it is going to increase at least the exploration of using that feature in the plan.

ChairwomanBEAN. All right. I appreciate that.

Okay. And let me recognize Mr. Heller for his questions.

Mr.HELLER. Thank you. I appreciate it—bouncing around quite a bit, because you guys are giving some great examples of what can be done here. I will share some of my concerns, and that is that I served as Secretary of State of Nevada for 12 years, and just in the last year I was there 90,000 new small businesses came into the State of Nevada—incredible amount, number, for a small State like Nevada. No personal income tax in the State, no corporate income tax in the State, and for that reason I believe it was quite the incentive.

That being the case, I hear a lot from my constituents in Nevada that benefit from the saver's credit. And just the fact that it is so underutilized is a concern for me, that for some reason they are out there and they don't realize it, this is what is going on and the ability to do that.

Now, I spent a tremendous amount of time trying to explain to people who were on a plan or that were in a retirement system how important it is to expand that system. The underlying problem I think here that I see, at least through my experience, is that people still believe Social Security is going to be there for them and take care of them, and they don't realize that they have to supplement that plan, even more today than ever before, if in fact that plan will even be there available to them.

Even if they are in a retirement system, a public employees retirement system, they need to supplement that plan, because of the actuaries, the fact that people are living longer and there will be very, very difficult times in their older age, if they don't supplement some of these plans.

Having said all of that, one of the things that I find out there is that more individuals are receiving lump sums, and the fact that they are not prepared to receive lump sums of money as opposed to a defined contribution plan—or, excuse me, benefit plan, they are receiving lump sums, and they are not prepared.

I served on the—I worked both sides of the securities industry. I was a broker, worked on the Pacific Stock Exchange, wasn't a retail broker, but was a stockbroker, an institutional broker. But the more I follow this, the more I watch it, the more I am convinced that people are unprepared to—with their money, once they do receive it after they retire.

Having said all of that, I would like to ask Mr. McCarthy a couple of questions. And that has to do with, what is more stable, defined contribution or defined benefit plan?

Mr.MCCARTHY. More stable in terms of the source of income to the—

Mr.HELLER. To the individual.

Mr.MCCARTHY. Without a doubt, the defined benefit—the value of a defined benefit plan, if it is available to the worker, is tremendous. There is no—there is no debating that. The fact that you have taken longevity risk and a few other things off the table, very few defined benefit plans, at least in the private sector, have cost of living adjustments, so inflation still is a significant issue.

But defined benefit plans are an incredibly valuable resource, and, in fact, I think the two panelists on the outside would tell you that there has been some small resurgence of defined benefit in the small kind of profitable sector, where people have been coming back to defined benefit despite the down draft in the larger employer market.

So from that perspective, DB is the answer. We do see, in both our institutional and in our retail businesses, a lot more focus on education about the de-accumulation phase. So everybody conceptually understands the accumulation phase. Money in plus earnings builds up, and people either in a DB context or a DC context have a number in mind that they want to hit at an age.

The deaccumulation phase is they are not trained for, and they are not necessarily prepared for, so it is the equivalent of a marathon where instead of getting additional sustenance out on the course, the race director gives you all your water and Gatorade and energy bars day one and says, "Make this last," right? And, unfortunately, the course is getting longer, because longevity is—

Ms.CALIMAFDE. Well, that might be fortunate.

[Laughter.]

Mr.MCCARTHY. Unfortunate in terms of the complexity of the calculus that you have to do. But, yes, excess longevity is—I guess is not the way you would think of it if you were having the longevity, but—

Ms.CALIMAFDE. If you were enjoying it, yes.

Mr.MCCARTHY. Right.

Ms.CALIMAFDE. Could I just add to your comments? Because I think—I think you are right; there is a slight resurgence in the defined benefit area in small business, particularly in the cash balance area, which is if you look at it from the viewpoint of small business, that is probably the most powerful plan a small business employee will ever get, because it is a defined contribution plan sitting on a defined benefit chassis.

So you have individual accounts, so employees know what they have got in their retirement plan. And what drives employees crazy about defined benefit plans is they never know what they have. It is just some kind of formula that they don't really get. But at the same time, the company assumes all investment risk in the cash balance plan, so employees are not able to individually direct.

I would say—actually, the question as to which one is better, I would say it depends on who you are. If you are a young employee and you are going to work at a company for three years, I would rather have a 401(k) any day with a match. But if I am going to stay with a company for a long time, and this is my work for life, then I would much rather have a defined benefit plan.

So, but going to your question about lump sums, my hope is that as people are educated in their 401(k) plans about the different choices, and folks are coming in and talking to them about what bonds are, and, you know, what a large cap fund is, and stuff, that training is going to carry them over.

And we are starting now, and we talked to our employees to say you don't want to take this into income. When you leave us, just immediately transfer this to an IRA and let it just sit there until you are 65. So we give like a whole extra speech that we never used to give at all because of that.

The other thing that is strange is the required beginning date today is 70-1/2 if you are a small business owner. But if you are not a small business owner, then your required beginning date to take money out of a retirement plan or an IRA—or your retirement plan is when you actually retire from the business.

So, you know, these rules where you say, "Where is parity between big business and small business?" the owner of a small business has to start taking money out before the same type of person in a big business would have to. And that makes no sense, really.

Mr.HELLER. Yes. Yes.

Mr.TRIPODI. I would like to comment, too, if I may.

Mr.HELLER. Absolutely.

Mr.TRIPODI. There are three things I think that are important on this issue. One we actually have moved a lot towards with the help of Congress, and that was enacting encouragement to have both types of plans actually. And in the small business community we are seeing an increase of that because of some tax incentives that were part of the Pension Protection Act.

Secondly, we can offer some tax incentives for employees to annuitize in the distribution stage out of defined contribution plans, not necessarily just through true life annuity type of products, although that would be part of it, but even through just life expectancy type of dribble out, where they would get tax incentives to do that.

And the third thing is I think we are getting to a point that we need to start having a conversation about how better to coordinate the use of your retirement benefits with health care and long term care issues, and how we can perhaps create some tax incentives or other types of incentives to allow employees some flexibility during that increased longevity risk, because you don't know for sure how much of this I am going to need for health care and how much of this I am going to need for true retirement-type income approach. And I think we can brainstorm some good ideas to help that flexibility.

Mr.HELLER. Okay.

Ms.COLLINSON. I would also like to chime in with the question regarding defined benefit plans in the small business community. One of the—in theory, defined benefit plans are wonderful, and yet there is reality. And one of the realities that we are facing right now is, as we have alluded to earlier, that the business startup rates and failure rates, so there is a lot going on in the small business sector.

And then, we have a workforce that changes jobs far more frequently than our parents' generation. So one of the real keys is: how can we create something that achieves the same end result or a similar end result as a defined benefit plan, but also can factor in, you know, the current dynamics of our society today with startup companies and failure rates and mergers and acquisitions and employee turnover?

So the other issue with that is—so a solution to do that, and right now we have seen some statistics, I shared some statistics on companies that are loathe to set up a 401(k) plan, so the challenge of convincing them to set up a defined benefit plan would be that much greater. We are really excited about the DBK plans that came out of the Pension Protection Act, but we anticipate a lot of the adoption is going to take place with employers that already have plans. the startup rate—it is going to be a greater challenge to go to the small businesses that don't have a plan to get them to do that, to encourage them to do that.

Also, I couldn't agree more on the lump sum issue at retirement, and I think the education needs to start early on. One of the issues is, a lot of people in their lump sum haven't saved enough to really create a meaningful annuity stream. So we have a—we need incentives to help educate people in their earlier years to build up balances and even start saving in their twenties and thirties into something that will create an annuity stream, as well as help people understand at retirement age what their overall assets are and how to achieve some sort of lifetime income from it.

Mr.HELLER. Well, I appreciate your mentioning that. We had several educational programs. I actually believe that children now are learning more about investments. They are taking courses now in elementary, middle school, junior high, and high school that I didn't get until I was in college.

We had a game—we had a program called the Stock Market Game where we gave them X amount of dollars, $100,000 in play money, and they had six weeks to nine weeks to invest that, and whoever came back with the best return, you know, won a trophy, and so on and so forth, to have that kind of experience at that level

where, in fact, elementary schools were competing against elementary schools across the state, and for that matter across the country, junior highs against other junior highs.

But just as a side note, fascinating enough, one group of children who went after everything—did everything wrong, invested in one stock that went nuts, went crazy, there was like a 600 percent return in a nine-week period, ended up winning the whole program and did everything wrong, so we weren't quite sure if we were—

[Laughter.]

—actually sending the right message out there. It was probably GAP or something or cell phones. I can't remember what it was.

Needless to say, I think I have taken up my time. I have more questions, but I will yield back to the Chairwoman.

ChairwomanBEAN. Thank you. And, obviously, you had some good questions, and everybody weighed in.

The gentleman from Pennsylvania, Mr. Sestak, did you have some questions?

Mr.SESTAK. Thank you.

ChairwomanBEAN. You have five minutes.

Mr.SESTAK. Thank you. I am sorry I was late. I had another hearing, and I am going to leave right after this for another one. And so—but I read your testimony and also what the staff prepared, and they were both very good, I thought.

The reason I am interested is I am on the—I have asked to be on the Subcommittee and the Education and Labor that does—and that is why I liked your comment about fungibility, ability to have maybe something go into health and something move over into the—because on the Health, Employment, Labor, and Pensions Subcommittee, which I purposely asked to be on.

My only question, and probably since I missed most of what you all had to say, if you had to prioritize the top three things of all the great ideas that both the staff have put in preparation and you had talked about—I mean, from pooling small businesses so that the administrative burden might be shared rather—so that is not so much, to removing or exempting small businesses from any liability—fiduciary liability or, you know, removing the limitations that are in some of the plans, or, you know, SEP, you know, how much—or the penalties for withdrawal.

Which of these, you know, from portability to other tax incentives, if you just had to quickly say, what were the top three? And I know that it matters which type of plan and all, but if you really had to focus on—and I had to walk out of here being on this Subcommittee, and also the Health, Employment, Labor, and Pension one, what were the top three out of all of those lists that you would say really focus upon? If you just quickly could go through.

Mr.TRIPODI. You want me to start?

Mr.SESTAK. Please.

Mr.TRIPODI. I guess what I—I would say that one of the top three would be the expansion of the saver's credit that I discussed in my testimony, including creating that government-type match approach where the saver's credit would come back—part of the saver's credit would come back into the plan system for accumulation.

I would say, and this is piggybacking on Paula's comment earlier, for the small business community whether it is complete repeal or it is simplification of the top heavy rule impediments to establishing the savings programs for their employees, that would be very helpful. And I can—

Mr.SESTAK. Do you mean the top heavy ones that have—the big businesses do?

Mr.TRIPODI. No, that is—the top heavy issue is for small businesses.

Mr.SESTAK. But I thought it was that—you are talking about defined benefits right now, correct?

Mr.TRIPODI. No.

Mr.SESTAK. Then, I have got it wrong.

Mr.TRIPODI. The top heavy issue that we were talking about had to do with the impediment with the 401(k) type of system for the small business to establish that. The business owner is really being penalized in saving through the 401(k) program with the rules that—that the top heavy rules have in what they have to then deliver to the workforce through a non—

Mr.SESTAK. Oh, I am sorry. I thought that had pertained to trying to establish the defined benefit plan. And if you wanted it there for a small business, some of these heavy—overarching ones that big businesses have to deal with would be removed. I have got it wrong. Thanks.

Mr.TRIPODI. It would be more focused on the 401(k), delivery of the 401(k).

And then, the third, I guess I would just reiterate my point that I really believe we have to start in keeping in this theme of focusing not just on accumulation but proper use of these benefits in the distribution stage is to explore ways we can coordinate the use of these monies for health and long-term care along with retirement.

Mr.SESTAK. Be more fungible.

Mr.MCCARTHY. I would actually yield back one of my three options, and say that there is two things that I am focused on. The first one is I believe that the savings challenge, while brought forward and advanced by plans in the workplace, the problem gets solved when people stop being spenders and start becoming savers.

And all of the data that we see across all of the industry says that at some point your retirement balances become big enough that you stop thinking of them as the equivalent of a large screen TV or getting rid of that credit card bill that has been hanging around, or the leakage out of the system, which is a problem, right, in absolute terms for all forms of programs, right? I don't think that there is a relative difference between things like SIMPLE and 401(k). All small balances are prone to dissipation.

So where I am going with this is a couple of things. It is undeniable that a program like SIMPLE, for example, is the farm system to more sophisticated programs, be they 401(k)s, be they defined benefits, paired plans, right? I do think that whatever we can do to make that farm system so we greenhouse savers, get more people into the system, is important.

It seems like the data indicates, it is clearly a personal issue, but the data indicates that around$15- to $20,000 of accumulated retirement savings, the rate at which that dissipates or leaks out of

the system, when, for example, you turn over—Ms. Collinson talked a little bit about workplace mobility. Leakage in the system comes not at all, as far as I can tell—and I have run this business at Morgan Stanley, at Fidelity Investments, and at Merrill Lynch, so I have a—you know, people like Dallas Salisbury at EBRI have, you know, great data sets. I would argue I have a pretty good one.

We don't see leakage with people running in and raiding, for example, their SIMPLE plan today. Where we see the leakage is with job turnover. When tenure is, you know, on average four or five years, we see small balances at the point of the job switch get dissipated. So I think—

Mr.SESTAK. So that argues for portability? Is that what you are—

Mr.MCCARTHY. Right. So, a) a robust farm system that is getting people in and starting to save, and 2) really simple portability, and an aggregation and concentration, because it is the small balance, the quick cycling through jobs, and the fragmentation of the issue that I—of your savings. Not only can you not—you know, people are busy. They can't go through having five or six statements and reading them and trying to asset allocate this $1,800 and this $4,200.

To the extent that they can get it to a place where it is 12 or 13, you know, that starts to become something that is serious money to which you have to pay some serious attention.

Mr.SESTAK. Got it. Thank you.

Ms.COLLINSON. Okay. Top three priorities—one, increasing plan sponsorship and plan coverage rates in the small business sector by creating greater incentives for small businesses to sponsor a plan as well as simplifying some of the administrative complexity that exists today.

Mr.SESTAK. And those are tax incentives?

Ms.COLLINSON. Tax incentives, correct.

Mr.SESTAK. And the increase in membership would be automatic, or just incentives?

Ms.COLLINSON. Incentives. In my testimony I discussed expanding the tax credit that exists today for establishing a plan—

Mr.SESTAK. Right.

Ms.COLLINSON. —expanding that credit. The second thing would be expanding the saver's credit in ways that I have discussed as well as the other panelists have testified. And then, lastly, creating incentives for savers of all ages, not just people approaching retirement, to convert—invest or convert part of their savings into some sort of guaranteed lifetime income, to start looking towards the future to help start creating that defined benefit result in the absence of a true—in the absence of access to a defined benefit plan.

Mr.SESTAK. So to some extent, that is a corollary to what you said, Mr. McCarthy, correct? I mean, in the sense of the farm system and eventually—I mean, it is not the same thing, but it kind of parallels that, correct?

Mr.MCCARTHY. That, and the fact that with the education, right, financial literacy—Mr. Heller talked about the Stock Market Game, which is in fact a SIFMA creation. Reorienting people's paradigm that a four to six percent withdrawal rate is kind of what a sustainable income plan looks like, as opposed to their expectation,

which might be set at seven, eight, and nine, which is not really a sustainable type of withdrawal rate.

Mr.SESTAK. Thank you.

Ms.COLLINSON. And, lastly, any changes that are made should be broadly promoted, because we have seen a lot of great changes over recent years. However, our sense in the marketplace is there is still not the level of awareness that we would like to see, especially in the small business community and low to middle income workers.

Mr.SESTAK. Thank you.

Ms.CALIMAFDE. I will try to be brief. The first thing I would do is I would eliminate the top heavy rules in the 401(k) area. I think that would really simplify the system and give us parity with bigger business. The second thing I think I would do is fix the automatic enrollment 401(k) safe harbor, which is designed primarily for small businesses and does not give enough of a tax incentive to encourage them to do it.

The third would be to keep the current balance between the SIMPLE limits and the 401(k) limits, and this is—I am really directly opposing what Mr. McCarthy is saying. I understand what he is saying, because that IRA plan is so desirable for small business.

But if you make the farm system too good, no one is going to graduate to the trusteed 401(k) plan, and I think the educational component of a 401(k) plan, the ability to learn how to go and invest on web sites, and the fact that you don't have easy access to the money, I think those factors make the 401(k) such a stronger plan that the system needs the balance that it has right now today, the SIMPLE is not as good as the 401(k) plan, and that is why you often hear from small business, "Make the SIMPLE as good as the 401(k)."

Well, if you make the SIMPLE as good as the 401(k), there isn't a small business around who is going to be—go into a 401(k) plan.

Mr.SESTAK. Thank you all. And I like that last point, although I do understand yours. I mean, we are at a negative savings rate for the first time in America since the Great Depression. And somehow getting us into somehow getting going, however it is, is going to be important.

Thank you very much. I am sorry I went over.

ChairwomanBEAN. They were good questions and a good summary across the board.

I want to thank all of you for your testimony and bringing your subject matter expertise to this important subject. I want to thank Ranking Member Heller for his leadership on this issue, and Congressman Sestak for some very good questions.

I know there was a lot to cover. We didn't get through all of it in depth, but your testimony certainly did, and I anticipate we will be doing more on this and we will be following up with you personally.

Actually, before I adjourn, we are going to let the Ranking Member ask a follow up question.

Mr.HELLER. Mr. Tripodi, as President of ASPPA, aren't you guys here for a conference this week?

Mr.TRIPODI. We are.

Mr.HELLER. You are?

Mr.TRIPODI. We just finished it today.

Mr.HELLER. Okay. Because I had a couple in my office. Are you an actuary yourself?

Mr.TRIPODI. I am not. I am an attorney. Our organization is represented by all diverse retirement plan professionals.

Mr.HELLER. I was given a definition of an actuary, someone—

[Laughter.]

—someone who wanted to be an accountant but didn't have the personality.

[Laughter.]

Mr.TRIPODI. As President now, I would never subscribe to that.

[Laughter.]

ChairwomanBEAN. And you couldn't quite go there. Yes.

I ask unanimous consent that members will have five days to submit statements and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 11:13 a.m., the Subcommittee was adjourned.]

STATEMENT
Of the Honorable Melissa Bean, Chairwoman
United States House of Representatives, Committee on Small Business
Finance and Tax Subcommittee Hearing : "**Pension Parity: Addressing the Inequities between Retirement Plan Options for Small and Large Businesses**"

I now call this hearing to order on the "**Pension Parity: Addressing the Inequities between Retirement Plan Options for Small and Large Businesses.**

Retirement security is a universal goal for most Americans. As part of their retirement plan, most Americans rely on three very important pillars as they plan for their financial future: personal savings, social security, and employer-based retirement plans.

As the baby boomer generation ages, raising real questions about the sustainability of social security benefits, it is critical that all employers and their employees have financial security as they enter their retirement years.

A recent Employee Benefit Research Institute study revealed that less than half of all workers were participating in a retirement plan. While it is clear the overall number needs to be improved upon, the story for small businesses is even more disappointing.

Employee participation for small businesses is alarmingly low. Businesses with 25 or fewer employees have only 23% of their workers enrolled in a retirement. Businesses with 25 to 99 employees have only 43% of their workers enrolled in a retirement plan, while employers with 100 to 500 employees only have a little more than half of their employees enrolled in a retirement.

Given that 80 percent of new domestic jobs are created in the small business community, this hearing addresses those Americans employed in this sector.

Employees of large companies often contribute to 401k pension plans. Those employees can borrow from their plans for certain purposes, including first time home purchases, college tuition, and medical emergencies. Conversely, most of the retirement plans small businesses are able to provide do not give their employees access to their own tax deferred pension monies.

This hearing is intended to address those inequities and seeks to identify ways to provide greater pension parity between large and small business offerings. American employees should have equal access and flexibility in their pension plans.

I look forward to today's hearing, which will allow members of the Committee to discuss the current vehicles used by many small businesses to provide retirement benefits, ways in which those can be improved upon to encourage small business involvement while also discussing potential new solutions.

I appreciate the witnesses coming here to discuss this important issue and look forward to your testimony. I would now yield to –Ranking Member Heller for his opening statement.

Opening Statement

Hearing Name	Pension Parity: Addressing the Inequities between Retirement Plan Options for Small and Large Businesses
Committee	Subcommittee on Tax and Finance
Date	10/24/2007

Opening Statement of Ranking Member Heller

Opening Statement of Finance and Tax Subcommittee Ranking Member Dean Heller
Pension Parity: Addressing the Inequities between Retirement Plan Options for Small and Large Businesses

"Good morning. Thank you all for being here today as we examine the inequities between retirement plan options for small and large businesses. I'd like to extend a special thanks to our witnesses, some of whom have come a great distance to testify before us.

"Few debates in Washington have as significant a real-world impact on the quality of life for older Americans as retirement security. Last week, a recently retired teacher from New Jersey became the first "baby boomer" to apply for Social Security benefits. A wave of nearly 80 million more will follow over the next two decades. In its current state, Social Security will struggle to meet the retirement needs of the millions of baby boomers, much less future generations. In little more than ten years, Social Security will reach a critical juncture in its history, paying out more in benefits than it takes in through payroll taxes. This untenable financial situation must be addressed, and I applaud Chairwoman Bean for calling this timely hearing.

"America's 25 million small businesses compose 99.7 percent of all employers and are responsible for generating 60 to 80 percent of all new jobs. Nevada is one of the fastest growing states for small businesses. Nevada alone is home to more than 204,000 small businesses which provide more than 425,000 jobs in my state. This means 44 percent of Nevada's working population relies on small businesses. As Secretary of State, I was responsible for registering thousands of businesses a year and I fought to keep Nevada friendly to small businesses. I look forward to continuing to keep small businesses vibrant and healthy in America and the state of Nevada.

"Unfortunately, despite their contributions to our economy, there is a substantial discrepancy between large and small businesses' ability to offer employer-sponsored retirement benefits. According to the Congressional Research Service, only 26 percent of firms with 25 employees or fewer offer an employer-sponsored retirement plan. In contrast, 72 percent of firms with 100 or more employees sponsor plans. With small businesses playing such an integral role in our economy, it is important that we identify and remove the barriers that prevent our smaller companies from offering retirement benefits.

"When looking at the specific issues that hinder small businesses' retirement benefit participation, we must also expand the scope. Isolating specific concerns neglects the relationships that exist between energy prices, health care costs, taxes, and the price tag for complying with government regulations. Small business owners are habitually asked to make difficult choices about where to dedicate their resources, with "extras" like retirement benefits often fall by the wayside.

"Our job on this committee is to help enable small businesses to succeed - I believe an excellent starting point would be to reduce tax and regulatory burdens to allow for more employer benefits. Retirement and health care plans can make the difference between a new hire and a lost prospect. As companies rigorously compete for talented employees, let's give the little guy the flexibility to attract good candidates to develop and grow.

"We have an excellent panel that will shed some light on the challenges small businesses confront in offering retirement packages. I look forward to hearing the testimony and I appreciate Chairwoman Bean for calling this hearing.

"I yield back."

Statement Presented to
The U.S. House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax

Hearing on
Pension Parity: Addressing the Inequalities between Retirement Plan Options for Small and Large Businesses

October 24, 2007

Transamerica Retirement Services appreciates the opportunity to provide this written testimony in connection with the hearing of the U.S. House of Representatives Committee on Small Business, Subcommittee on Finance and Tax on the issues related to the offering of retirement benefits by small business. TRS commends Subcommittee Chairwoman Bean and Ranking Member Heller for focusing on the particular concerns of small business in providing retirement benefits.

Transamerica Retirement Services ("TRS"), a marketing unit of Transamerica Life Insurance Company and its affiliates, designs customized retirement plan solutions to meet the unique needs of small to midsized businesses. TRS serves more than 14,500 small business clients who collectively represent over $14 billion in plan assets under management as of December 31, 2006. Transamerica Retirement Services is part of the AEGON companies. Headquartered in the Netherlands, AEGON is one of the leading insurance and pension groups, and a strong provider of investment products. AEGON's businesses focus on life insurance, pension, supplemental health, savings and investment products.

Pertinent Facts about Small Business

According to the U.S. Census Bureau, small businesses (less than 500 employees) represent 99.7% of the total firms and 50.9% of the workforce in the United States.[1] Further, according to the U.S. Small Business Administration, small businesses have generated 60 to 80% of net new jobs annually over the past decade in the United States and supply more than half of U.S. non-farm private gross domestic product.[2] Given the prominent role that small businesses play in the U.S. economy, it is vital to encourage small business owners to sponsor retirement plans and help the small business workforce adequately prepare for retirement.

The small business sector is highly dynamic with high start up rates, closure rates, and merger and acquisition activity. Small businesses are represented in all industries and generate a wide range of revenue, earnings, and payroll. As such, at any given time, a small business may have unique needs and objectives for sponsoring a retirement plan.

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[1] U.S. Census Bureau, 2004 County Business Patterns. For information on confidentiality protection, sampling error, non-sampling error, and definitions, see http://www.census.gov/epcd/susb/introusb.htm
[2] *See* U.S. Small Business Administration, Frequently Asked Questions, at www.sba.gov.

While some small business owners feel that they need to sponsor a plan to attract and retain employees, others may be somewhat more focused on how a retirement plan will meet their own personal retirement savings needs. Regardless of the specific rationales at play, and there are usually several, all small employers interested in sponsorship of a plan seek to do so at a cost that they can afford.

Small Businesses' Role in Providing Workplace Retirement Benefits

It is well documented that Americans do not save adequately for their retirement. Yet employer-sponsored retirement savings plans play a critical role in facilitating such savings and making the savings process easy and attractive for American workers. With the benefits of saving in an employer-sponsored plan (investment education, the potential for employer contributions, fiduciary oversight), combined with the convenience of automatic payroll deduction, Americans are far more likely to save for retirement through participating in a company-sponsored retirement plan versus contributing to an individual IRA. The Eighth Annual Transamerica Retirement Survey[3] (the "Transamerica Survey") found that 73% of employees with qualified plans (at companies with greater than 10 employees) participate in their company's defined contribution retirement plan. By comparison, the Investment Company Institute found that only 17% of U.S. households contributed to an IRA in 2004.[4]

The role of employers in providing retirement savings plans to their employees has long been supported by public policy and the work of this and prior congresses in enacting tax incentives both for employers to sponsor retirement plans for their employees and for employees to accumulate long-term savings through those plans. The current tax system

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[3] The 8th Annual Transamerica Retirement Survey can be found at http://www.transamericacenter.org. Harris Interactive was commissioned to conduct the Eighth Annual Transamerica Retirement Survey. There are two components to the survey: Employer and Worker. Where appropriate, questions were tracked and some new questions were added to investigate new topics of interest. The *worker survey* component was conducted via telephone by Harris Interactive within the U.S. between July 27 and October 7, 2006 among 1,402 workers. Respondents met the following criteria: work full-time for pay at a company with at least 10 employees, are age 18 or older, and do not work for the government nor a non-profit organization. Results for age, sex, race/ethnicity, education, region and household income were weighted where necessary. Data were weighted to ensure that each quota group had a representative sample based on the number of employees at companies in each employee size range.
The *employer survey* component was conducted by Harris Interactive on behalf of Transamerica Retirement Services via telephone within the U.S. among 659 owners/heads of small businesses and benefits decision-makers in larger companies, using a nationally representative random sample. Respondents met the following criteria: business executives who make decisions about employee benefits at their company, must be at a company that employs 10 employees or more, and not work for a government, education or not-for-profit organization. Interviews averaged 18 minutes in length and were conducted between July 25 and October 10, 2006. Data were weighted to ensure that each quota group had a representative sample based on the number of companies in each employee size range.
All sample surveys and polls, whether or not they use probability sampling, are subject to multiple sources of error which are most often not possible to quantify or estimate, including sampling error, coverage error, error associated with nonresponse, error associated with question wording and response options, and post-survey weighting and adjustments. Therefore, Harris Interactive avoids the words "margin of error" as they are misleading. All that can be calculated are different possible sampling errors with different probabilities for pure, unweighted, random samples with 100% response rates. These are only theoretical because no published polls come close to this ideal.

[4] Investment Company Institute, The Role of IRAs in Americans' Retirement Preparedness, January 2006

also helps to ensure that these savings will be there for retirement by placing restrictions on pre-retirement distributions and imposing tax penalties for early withdrawals.

However, it is striking that while small business accounts for 50.9% of jobs in the economy, according to the Transamerica Survey only 71% of small business employers with 10-499 employees reported that they provide 401(k) or other employee retirement savings plans for their employees. This is in contrast to the fact that 95% of large employers with over 500 employees reported that they provide 401(k) or other employee-funded retirement plans for their employees.

According to the Transamerica Survey, while 71% of small businesses reported providing 401(k) or similar retirement savings plans for their employees only 24% indicated that they provided a company funded defined benefit pension plan. Therefore, this testimony will focus on those retirement savings/defined contribution plans.

There are many reasons for the disparity between small and large businesses in providing retirement savings benefits for their employees. Many small businesses do not have the financial or administrative resources to provide or maintain such plans. The Transamerica Survey found that of small business employers that do not sponsor a defined contribution plan, and are not likely to offer 401(k) in the next two years, 73% do not plan to do so in the future with their reasons cited as: their company is not big enough (43%); company management is not interested (41%); concerned about cost (34%); employees are not interested (34%); company encountering difficult business conditions (21%); concerned about administrative complexity (11%); and concerned about fiduciary liability (8%); some other reason (7%); and not sure (3%).

Further, despite finding that nearly all small business employees (93%) consider an employee-funded retirement plan an important benefit, the Transamerica Survey found that only 40% of small business employers who offer 401(k) or other self funded plans believe that a company's retirement savings plan is "very important" to attracting and retaining employees .

There is also a disparity in employee participation in retirement plans provided by small versus large businesses. According to the Transamerica Survey, 76% of employees in large businesses indicated that they participate in their employer-sponsored retirement plans while a somewhat lower 70% of small business employees do so. Furthermore, employees of small businesses only contribute 7% of their salary (median) to employer plans as compared to employees of large companies who contribute 8% of their salary (median).

There are several reasons for this disparity. First, the household income of employees in small businesses is typically much lower than that of employees in large businesses, and therefore these employees generally have less disposable income to contribute to a retirement plan. Second, due to the dynamic nature of the small business landscape, employee turnover also tends to be higher than that of large companies. Such turnover can be involuntary, often as the result of the business going under or merger and

acquisition activity, or voluntary on the part of employees as they decide to seek jobs with higher pay and better benefits. For plan sponsors, employee turnover may increase administrative costs. For plan participants, the benefits of participating may be reduced if they leave their employer prior to vesting in any employer contributions. Further, plan sponsors often have the ability to cash out terminated plan participants with small balances.

Recent Accomplishments: Pension Reform in the 2000s

With the increasing number of Americans employed by small businesses and the particular challenges faced by small businesses in providing retirement plans for their employees, regulatory relief and incentives have been needed to ease the burdens of small businesses in providing retirement savings plans for their employees and creating incentives for employees to participate in these plans.

Many important steps were taken by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Pension Protection Act of 2006 ("PPA") (which both made the positive EGTRRA changes permanent and instituted a number of additional positive reforms). Legislators are commended for passing these laws that promote plan sponsorship and participation through provisions including: (1) higher retirement plan and IRA contribution limits, (2) catch-up contributions for individuals who are age 50 or older, (3) establishment of the Saver's Credit tax credit to encourage plan or IRA savings for those who meet the income and eligibility requirements, (4) a small business employer tax credit for plan formation, (5) creation of the Roth 401(k), (6) simplification of a number of complex administrative requirements, (7) incentives and safe harbors needed to increase participation in employment-based plans through automatic enrollment, and (8) removal of certain impediments to employers providing participants with investment advice and annuity distribution options to provide lifetime income.

These laws continue to be extremely valuable in increasing both the number of retirement plans offered by employers and the participation of employees in these plans; however, given the persistence of the significant disparity between the sponsorship and participation rates of small business and their employees relative to large companies, much work still needs to be done to help bridge the gap.

Recommendations

Increasing Plan Coverage in the Small Business Sector

The Transamerica Survey's findings suggest that opportunities for increasing plan coverage in the small business sector involve providing greater incentives, offering regulatory relief to help address concerns about cost and administrative complexity, and promoting greater awareness.

Congress is urged to consider additional tax incentives and guidance for small employers to establish new retirement savings plans. Tax incentives provide a valuable financial

tool to small businesses that are considering establishing a retirement plan for their employees. These incentives will help to reduce the cost of establishing and administering a retirement savings plan and the relative burden this cost places on a small employer vs. a large employer. Under a provision of EGTRRA that was made permanent by PPA, small businesses may claim a tax credit for establishing a retirement plan equal to 50% of qualifying costs up to $500 per year for the first three years. Consideration should be given to increasing the available amount of the credit and increasing the number of years that it may be claimed. This would provide greater incentive for small businesses to establish a plan as well as help alleviate concerns about the cost of sponsoring a plan.

Not only are the absolute costs of implementing and administering a retirement plan great, but they are relatively greater than those for larger businesses on a per employee basis due to the difficulty of achieving economies of scale. Nondiscrimination rules, compliance testing, and the cost associated with correcting failures increase the employer's overall cost of sponsoring the retirement plan. While TRS supports the spirit of the nondiscrimination rules, TRS believes that further simplification of the regulations and administrative requirements can be achieved while preserving this basic spirit of fairness.

Legal certainty and protection from fiduciary liability provide another powerful incentive to small businesses considering establishing a retirement plan. Additional guidance on safe harbors from fiduciary liability should be provided for employers whose plans meet certain requirements with respect to investments, asset class coverage, administration and processing, disclosures, etc. Further, consideration should be given to further streamlining reporting and notice requirements to make it administratively easier for small businesses to sponsor a plan.

For small businesses in which a stand-alone plan is not feasible, TRS recommends that consideration should be given to enabling and providing incentives for them to join a multiple employer or group plan to be provided by a financial institution. To be effective, this plan should be simple to administer and should provide safe harbors from fiduciary liability for each employer. In addition, care should be taken to (1) protect employers from any fiduciary liability for the acts or failure to act of other employers participating in the plan, (2) provide tax incentives for employers and employees to encourage participation and (3) provide the means to ensure reasonable compensation for financial institutions for taking on investment and administrative functions. Multiple employer plans would provide very standard plan terms, and therefore, employers that want plan design flexibility, such as by offering a more robust investment menu, would continue to offer their own plans.

Lastly, any new legislation and regulatory relief directed towards increasing plan sponsorship rates in the small business sector should be broadly promoted to help ensure that employers are aware of new advantages and the feasibility of sponsoring a plan.

Encouraging Increased Plan Participation and Savings

Congress should also consider reforms directed at helping small business employees increase their participation in those plans. The Saver's Credit, a tax credit which was created by EGTRRA and made permanent by the PPA, offers a meaningful incentive for encouraging low- to middle-income Americans to save for retirement. However, very few Americans are aware of it.

According to a recent survey commissioned by Transamerica,[5] very few American adults are aware of this tax credit designed to help low- to middle-income Americans build their retirement nest eggs. The survey found that only 11 percent of American adults who fall within the Credit's income eligibility requirements are familiar with it. The survey results could raise concerns that many Americans who are already saving for retirement through a company-sponsored retirement plan such as a 401(k), or through an individual retirement account, may miss out on taking the Credit simply because they don't know about it. Particularly vulnerable are the 29 percent of individuals and households who meet the Credit income limits and have either filed, or plan to file, their taxes using the 1040EZ form. The 1040EZ has no provision for claiming the credit, which can only be claimed using the 1040, 1040A or 1040NR (along with the accompanying Form 8880). Adding to the confusion, the Credit is most commonly known as the "Savers Credit," but the IRS refers to it as the 'Retirement Savings Contributions Credit' and the 'Credit for Qualified Retirement Savings Contributions' in its forms and publications.

While many qualifiers may be missing out on a significant tax credit, there are also many non-savers who might start saving for retirement with the help of an incentive like this if they were aware of the opportunity.

The Saver's Credit, in its current form, should be more effectively utilized to encourage increased retirement savings plan participation and help more low- to middle-income Americans save for retirement. It is recommended that the IRS broadly promote the Saver's Credit through outreach efforts, updating the tax forms and instructions to consistently refer to it as the "Saver's Credit," and adding it to the 1040 EZ form.

Senate Finance Committee Chairman Max Baucus and Ranking Republican Member Chuck Grassley are commended for their July 12, 2007 letter to the Internal Revenue Service (and accompanying press release) that requests the IRS to better publicize the Saver's Credit.

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[5] This survey was conducted online within the United States by Harris Interactive® on behalf of Transamerica from February 7 to 9, 2007 among 2,482 adults (aged 18 and over)) including 316 who meet the Saver's Credit income eligibility requirements. Figures for age, sex, race/ethnicity, education, region and household income were weighted where necessary to bring them into line with their actual proportions in the general population. Propensity score weighting was also used to adjust for respondents' propensity to be online. With a pure probability sample of 2,482, one could say with a ninety-five percent probability that the overall results have a sampling error of +/- three percentage points. Sampling error for subsamples would be higher and would vary. However, that does not take other sources of error into account. This online survey is not based on a probability sample and, therefore, no theoretical sampling error can be calculated.

Additionally, Congress should consider expanding the Saver's Credit by making it refundable so that those many low- to middle-income workers without federal income tax liability would receive a direct and meaningful financial incentive to save.

Incentives to Help Employees Manage their Savings upon Distribution.

While EGTRRA and PPA have provided many valuable reforms to help employees increase their retirement savings while participating in employer-sponsored plans, it is also important for employees to have the necessary tools to manage their employer plan savings upon distribution. Given the choice, a majority of employees elect a lump sum payout and few employer plans provide an annuity as a distribution option. TRS urges Congress to enact tax and other incentives to encourage all individuals to convert a portion of their savings into guaranteed lifetime income. Representatives Pomeroy, Tubbs-Jones and English have all taken important leadership roles in introducing bills encouraging individuals to annuitize their savings by providing a tax incentive for the purchase of a lifetime annuity.

Conclusion

TRS commends Subcommittee Chairwoman Melissa and Ranking Member Heller on their consideration of the particular challenges and needs of small businesses in providing retirement savings plans to their employees. TRS appreciates the opportunity to present its views on the particular challenges faced by small businesses and its suggestions for reforms that can help to alleviate those burdens.

Statement by Sal Tripodi, Principal of Tri Pension Services, on behalf of ASPPA

Comments Presented to the Committee on Small Business, Subcommittee on Finance and Tax, United States House of Representatives

Hearing on Pension Parity: Addressing the Inequities between Retirement Plan Options for Small and Large Businesses

October 31, 2007

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to testify before the House Small Business Committee on the issue of pension parity in the workplace. Ensuring that most employees have a vehicle available at the workplace to provide retirement savings is an important goal, and ASPPA supports those legislative proposals that promote such a goal without unduly burdening small employers and without discouraging formation and continued maintenance by employers of qualified retirement plans.

I am Sal Tripodi, the current President of ASPPA and founder of TRI Pension Services, a nationally-based employee benefits consulting practice that provides technical training in ERISA-related areas. Through my practice, I provide seminars around the country to groups involved in retirement plan services. I also author a five-volume reference book, aimed primarily at retirement plan service providers, consultants and advisors, regarding the legal and administrative requirements for retirement plans. In addition, I serve as an Adjunct Professor at the University of Denver Graduate Tax Program.

ASPPA is a national organization of more than 6,000 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's large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the private retirement plan system.

Need for Expanded Coverage of Employees Working for Small Businesses

It is well known that small employers, particularly those with fewer than 25 employees, lag far behind larger firms in sponsoring retirement plans, leaving an unacceptably large percentage of workers without retirement plan coverage. Although tax incentives have helped increase the percentage of small businesses maintaining retirement plans, they haven't resulted in the levels of coverage that would be considered desirable. As of 2006, less than 27% of full-time workers in businesses with fewer than 25 employees were employed at firms that sponsored a retirement plan. Compare this to firms with 100 or more workers, where over 70% of such employers sponsor retirement plans. Are we capable of turning this around? ASPPA believes that we can, and there are some significant steps that can go a long way toward addressing the issue of inadequate coverage.

There is no question that the most effective way to get Americans to save for retirement is through workplace retirement plans. We would like to focus on two important proposals that can help us move toward the goal of better access to retirement plan savings: requiring payroll-deduction IRA savings opportunities at the workplace and an expanded SAVERs credit to target lower income workers.

Proposal to Expand Retirement Plan Coverage

One effective way to increase coverage of small business workers would be to require employers who do not maintain a retirement plan to at least provide a mechanism at the workplace by which its employees have an opportunity to save for retirement through payroll-deduction IRAs. Although an employee can simply establish an IRA on his or her own, statistics show that where an employee has a mechanism for making retirement contributions at the workplace, the percentage of employees who actually save for retirement dramatically increases. Employers who currently do not offer a qualified retirement plan would be required to offer workers the opportunity to contribute out of their paychecks for retirement savings through a payroll-deduction IRA. Employees who would have to be offered this arrangement would be those who have reached a specified age, have worked a minimum period of time with the employer, and are expected to earn a certain minimum amount of compensation in the current year. A tax credit would be provided to very small employers to help defray the cost of the program.

It is important, however, that this requirement be focused on employee-initiated savings, and not on employer contributions. Of course, employers should be encouraged to contribute to these plans, but it also is important to retain flexibility with respect to plan design, particularly in the small business context.

ASPPA's support for proposals of this type turns on preserving the incentive for employers to sponsor a qualified retirement plan in lieu of this required payroll-deduction IRA. To this end, we believe that any requirement to offer a payroll-deduction IRA program should be conditioned on the employer's not maintaining a qualified retirement plan with broad-based coverage. We believe it is critically important that employers, particularly small businesses, should not have to maintain two separate retirement savings programs. We believe it is vital to continue to encourage employers to offer qualified retirement plans for their workers, which will provide more substantial retirement benefits for workers than payroll-deduction IRAs or similar savings programs because of the operation of the nondiscrimination rules.

Forcing small businesses to maintain two separate programs would discourage such businesses from forming or "graduating" to a qualified plan. In particular, qualified plans can provide a means of accumulating retirement savings through employer contributions that are not contingent on whether an employee can afford to make meaningful contributions through payroll deduction. Encouraging such programs is critical to the realization of adequate retirement savings especially for those lower income hard-working Americans.

Some features that we believe would be a critical component of any required payroll-deduction IRA savings proposal include the following.

(1) *Rewarding companies that maintain broad-based qualified retirement plans.* An exemption for employers maintaining qualified plans in which the eligibility requirements do not exceed the statutory standards regarding minimum age (currently 21) and minimum service (currently 1 year of service, with limited exceptions). In addition, statutory standards allow the exclusion of employees covered by a collective bargaining agreement, where retirement benefits have been the subject of good faith collective bargaining. Preserving this exclusion in identifying which employers have to offer a payroll-deduction IRA savings program is critical to preserve the flexibility union workers and their employers have in fashioning compensation packages through the collective bargaining process. For purposes of our testimony, we'll refer to plans that are limited to these statutory exclusions as Broad-Based Retirement Plans.

We recognize that complex coverage testing rules in the tax code would permit an employer to carve out a significant percentage of its workforce by job classification (other than the union exclusion) and still meet tax qualification standards, even though the plan does not cover the employees who would be eligible for a Broad-Based Retirement Plan. We do not believe that such programs would need to have an exemption from a payroll-deduction IRA requirement. Frankly, many small businesses do not use these more expansive job classification exclusions anyway.

(2) *Maintain flexibility in retirement plan delivery.* An employer should be able to satisfy the exemption described in our first point by treating two or more plans as a single plan. This preserves important flexibility for an employer to offer various qualified plans for components of its workforce without having the added requirement of a separate IRA-savings vehicle, provided that the plans examined as a whole would meet the Broad-Based Retirement Plan coverage standard.

(3) *Support the value of employer-funded plans outside of the 401(k) arena.* The exemption from a payroll-deduction IRA savings requirement should not be limited to employers that maintain qualified retirement plans that have elective savings features built into them, such as a section 401(k) plan or a section 403(b) plan. An employer should be able to maintain a Broad-Based Retirement Plan that is funded *solely* by the employer, such as a defined benefit plan or a profit sharing plan, without having to incur the additional administrative expense of a separate payroll-deduction savings program. Defined benefit plans are an important component of the private retirement savings landscape, and represent the sole "safety net" type of qualified plan. These plans have faced challenges with various other legislative and regulatory developments. Employers willing to fund these programs, which in particular have a better chance of providing adequate retirement income to lower-paid workers than an employee-provided payroll savings program, should not be faced with additional impediments. Profit sharing plans also can provide an important means of retirement savings

that does not depend on an employee's ability to make payroll deduction contributions. In this regard, ASPPA understands possible concerns that an employer might not contribute to a profit sharing plan for several years due to the discretionary contribution feature in such arrangements. Thus, the exemption from the payroll deduction IRA requirement for an employer maintaining a profit sharing plan should include a limitation where the exemption is available only if contributions have been made within a certain period of time or if the plan also contains a section 401(k) arrangement.

Carving out these reasonable exemptions from a payroll-deduction savings opportunity requirement would ease the administrative burden for most employers that already maintain, or may later adopt, qualified retirement plans, which facilitates compliance and reduces the chances of coverage errors. A more straightforward approach to the implementation and administration of any statutorily-required program also promotes better communication to employees, and a better chance of employees understanding the retirement savings opportunities that are available at their place of work.

Expanded SAVERs Credit

Another important initiative is to have a major expansion of the current law SAVERs credit. The SAVERs credit needs to be retooled to expand the number of households that would be eligible for the SAVERs credit, and to have more gradual phase-outs of the credit over a wider income bracket of eligibility. Furthermore, the credit should be transformed into a government match by requiring that the SAVERs credit be deposited directly into the taxpayer's IRA or the taxpayer's account in an employer-sponsored retirement savings plan if the employer would be so willing. In effect, small businesses that would be required to offer a payroll-deduction IRA savings opportunity at the workplace also would be given a government-subsidized matching program for lower income workers. Employers who already maintain a broad-based qualified retirement plan, or who choose to install such a plan in lieu of a payroll-deduction IRA program, would be able to provide a double match (a government match on top of any employer-provided match) for lower income workers.

ASPPA is very supportive of the expanded SAVERs credit initiatives and believes that they will contribute greatly to a more robust retirement savings landscape for American workers.

Answering the Call for Expanded Coverage

The employer-sponsored retirement plan system is often criticized for its lack of coverage. Depending on what data you look at, somewhere between 40-50 percent of the nation's workforce is not offered a qualified retirement plan by their employer, although as noted earlier, the percentage of coverage is far lower for employees of small businesses. This lack of universal coverage is often cited as a chief reason to propose new and/or expanded individual savings accounts as part of various tax reform proposals (e.g., significantly higher IRA limits or the offering of high dollar limit tax-favored savings accounts). ASPPA believes that a payroll-deduction IRA savings opportunity requirement, as discussed above, presents a far better alternative for American workers and small businesses, than expanded individual savings accounts. With payroll-deduction IRA programs required to be available at the workplace in the absence of a broad-based retirement plan, virtually all American workers would have access to an employer-based retirement savings program. This alleviates the need for expanded individual accounts that would undermine existing qualified

retirement savings programs. Additionally, for lower income workers, those most at-risk respecting retirement savings, the expanded SAVERs credit would offer them an enhanced incentive to save. This greater, targeted incentive will likely produce a much higher level of savings by lower income individuals than savings through expanded individual account proposals. Also, and not insignificantly, a payroll-deduction IRA requirement would serve to institutionalize the employer-based model for delivering retirement benefits which statistically is the most effective way to enhance the level of retirement savings for American workers.

Preserving the Social Security Safety Net

In the midst of these legislative proposals to stimulate retirement savings at the workplace, the debate over the fate of our Social Security system continues. Initiatives like a payroll-deduction IRA requirements along the lines of what we describe above, and the expanded SAVERs credit proposals, will alleviate the need to mandate employer "add on" contributions to Social Security, which could have a detrimental impact on the financial resources available to employers to fund qualified retirement plans. Again, the most likely group affected by a diminishing of employer-funded retirement plans are the lower-income workers, who simply cannot afford to make the payroll deduction contributions necessary to build an adequate retirement savings. The initiatives discussed above will promote employer-funded programs, and enhance matching contributions to boost the retirement savings impact of the payroll deduction contributions that are within the financial wherewithal of a significant percentage of the working population.

Expanded Plan Sponsorship by Small Businesses

An added bonus of payroll-deduction IRA initiatives is that they will require tens of thousands of businesses, most of them smaller businesses, to have to consider offering a retirement savings program for workers, either through the payroll-deduction IRA savings opportunity or through the establishment of a broad-based retirement plan. Thus, it jump starts the conversation about whether to cover employees in a qualified retirement plan. Getting the employer to focus on the issue and have that discussion is the critical first step toward seeing a greater penetration of qualified retirement plans in the small business community. If all of these businesses are faced with having to provide the benefit, it is possible that many of them could be persuaded to take the further step of offering a qualified plan, such as a 401(k) plan or a defined benefit plan, where the business owners can save even more and, through nondiscrimination standards, the rank-and-file employees would enjoy higher levels of retirement savings as well. Further, even if businesses do not initially step up to a qualified plan, the fact they would then be familiar with offering a retirement savings program through the payroll-deduction IRA program, will make it more likely that they would be willing to move up to a qualified retirement plan at some point in the future. This would be a significant win for the state of retirement savings in this country.

Statement of Jim McCarthy,
Managing Director, Retirement Plan Services
Morgan Stanley

On behalf of the
Securities Industry & Financial Markets Association

Before the
House Small Business Subcommittee
for Finance and Tax

"Pension Parity: Addressing the Inequities Between
Retirement Plan Options for Small and Large Businesses"

October 24, 2007

Madame Chairwoman and members of the Subcommittee, thank you for holding this hearing on expanding retirement coverage for small businesses, and for offering the Securities Industry and Financial Markets Association ("SIFMA")[1] an opportunity to testify on this important issue. I am Jim McCarthy, Managing Director, Retirement Plan Services, for Morgan Stanley.

SIFMA's member firms are engaged in every aspect of the retirement plan industry, including retirement plan creation, investment management, recordkeeping, and advice and education. Morgan Stanley is a global financial services firm, providing brokerage, custodial and investment-related services to approximately 255,000 retirement plan accounts and approximately $29 billion in assets. Like many brokerage firms, Morgan Stanley's financial advisers are actively engaged in marketing retirement programs to the business community, in particular the small and medium-sized marketplace.

In my testimony today, I will focus on three areas: first, I will highlight the barriers that discourage small businesses from offering retirement programs to their employees, then discuss milestones that usually must be achieved before a small business offers retirement plan coverage, and finally, suggest legislative reforms that would lead to more small business pension coverage.

Retirement savings adequacy, expanding pension coverage – particularly for small business, and easing the burden of paying for health care in retirement – still need the attention of policy makers. Research by SIFMA makes clear that Americans are doing far too little to prepare financially for retirement. Thirty-five percent of early Boomers – those who are in the mid-50s to early 60s will not be able to maintain their standard of living in retirement.[2] The percentages worsen for those who are younger. And, one of the most effective ways to increase savings is to get workers actively saving through payroll deduction. Research shows that when retirement savings opportunities are available in the workplace, at least 77 percent of workers participate when the opportunity is available.[3]

Small businesses are crucial to our economy and provide important job opportunities to workers. According to the Small Business Administration, 60 to 80 percent of net new jobs annually have been created by small business.[4] On average,

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] SIA Research Report, Vol. VII, No. 7, (June 27, 2006), Retirement Savings By the Numbers...

[3] Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007.

[4] Small Business Administration, Office of Advocacy.

private sector workers stay in a job for about 4 years.[5] With this type of mobility, it is likely that workers will be employed by a small business at some point in their career. If you are in the job market, it is more than likely that your next job will be with a small business. But it is not at all likely that the business will offer access to a retirement plan. This raises a significant threat to retirement security when there is no ability to save through an employer plan with payroll deduction and no employer contribution to leverage the employee's own contribution.

Leading Barriers to Plan Sponsorship

Survey data consistently reports that cost and complexity are the leading barriers to plan sponsorship. The owner of a newly formed business is first and foremost concerned with the capital requirements of the business. Nearly every penny earned is reinvested directly in to the business. Offering retirement plan coverage at the inception of a business is simply a luxury that cannot be afforded. I am sure the members of this Subcommittee are aware that fewer than half of start-ups survive more than the first four years.[6] Adequate capital is key to early survival.

Once the business is more stable, the business owner and the employees are typically more interested in getting access to health care insurance as the first step in the employee benefits ladder. As we know, health insurance is not universally offered. The National Compensation Survey, which looks at full-time workers, age 25- 64 indicates that 59 percent of businesses who employ less than 100 employees offer health care benefits. Only about 45 percent of those businesses sponsor some type of retirement plan.[7]

Once health care benefits are established, a small business may be on more solid footing and more open to sponsoring a retirement plan. Even at this point, the business owner may believe that the start up costs of offering a plan coupled with the need to make contributions on behalf of the employees is not a good value proposition.

Milestones

Experience has demonstrated that saving for retirement is much more effective if done through an employer plan that facilitates the convenience of making contributions through an employer payroll system. The key is getting the business owner to offer a plan.

In general, a small business owner does not embark on the search for a retirement plan without the assistance of a professional. Advice and consultation with a business or personal advisor such as the owner's personal financial adviser, an accountant, or other trusted professional is a common starting point for discussions about the potential benefits of starting a retirement plan. When this conversation occurs, the business is

[5] EBRI Notes, April 2007, Vol. 28, No. 4
[6] Kiplinger Letter, January 20, 2006, Volume 83, No. 3
[7] Bureau of Labor Statistics, National Compensation Survey, page 9 – page 12.

probably entering years where profitability has been reached and revenue is more certain. At the point of profitability, the tax incentives available are an important factor that encourages the business to start a plan.

Health care is also an important milestone. A small business that can provide health care is probably a prospective retirement plan client. However, we shouldn't limit ourselves and look only at firms that are offering health care. As the BLS study indicates, 40 percent of small businesses are not offering any health care benefit to their workers.

Finally, a business that has sustained growth has also achieved an important milestone. Once the business begins to grow, it needs to attract good, stable employees. For those small businesses that do offer a plan, retention and recruitment is cited as a very significant factor. Retirement plan benefits are easily understood by potential employees who are weighing the pros and cons of various employers.

Policy Recommendations

We encourage policy makers to consider ways to help small businesses offer retirement plans. Small business owners are competing to attract and retain the same workers as a larger business. The costs of providing these benefits can be overwhelming because there will always be a certain level of fixed cost and the small business has fewer employees over which to spread these costs.

Congress has been a strong advocate of initiatives to expand participation in retirement savings programs for small business. In 1996, Congress created the SIMPLE IRA. The SIMPLE IRA responds to the needs of many small business employers who would like to offer a retirement savings plan to their employees but are concerned about the administrative and legal obligations that come with a 401(k) plan.

The SIMPLE IRA has lower contribution limits than a 401(k), and requires an employer to either match employee contributions or to make non-elective contributions. In addition, the program provides for immediate vesting of participants. These plans have lower administrative costs than the traditional 401(k) plan, less liability, and permit the owner to reduce the employer contribution in the event of a downturn in the business (but not below 1 percent in any 2 out of 5 years.).

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) also targeted the low rate of plan sponsorship at businesses with less than 100 employees. To encourage additional plan sponsorship, EGTRRA raised the limit for SIMPLE IRAs, simplified the top heavy rules, and provided a tax credit to encourage small businesses to offer retirement savings programs.

The SIMPLE IRA has proven itself in the marketplace. IRS statistics from 2001 indicate that there were nearly 2 million taxpayers with SIMPLE IRAs, just 4 years after

the SIMPLE became available.[8] Industry studies indicate that the number of SIMPLE IRA accounts continues to increase each year.[9]

As you consider ways to encourage employers to sponsor retirement plans, SIFMA believes that the SIMPLE IRA offers the most potential for growth. The SIMPLE IRA is a worthy retirement savings program that – with some adjustments – holds real promise for millions of workers who are now without coverage. The SIMPLE IRA is unique among retirement savings programs in that any employee who participates in a SIMPLE IRA will always receive a benefit from the employer. The employer must match employee contributions up to 3 percent of compensation or make non-elective contributions for all eligible employees of 2 percent of compensation. And, there is immediate ownership of that contribution. Employees will not forfeit a benefit if they terminate employment.

To make SIMPLEs even more attractive, SIFMA believes the following enhancements should be enacted. First, we would urge Congress to increase the maximum contribution amount to put it on par with the contribution limit for 401(k) plans. Since SIMPLE requires that the employer either match employee contributions or make a non-elective contribution with immediate vesting, the small business owner who offers a SIMPLE is providing employees with substantial retirement benefits that potentially exceed the benefits offered by a business with a traditional 401(k) plan. We see no reason to continue a policy that discriminates against the small business owner when the expectation that benefits being provided to the employee are the same or better than what is found in traditional 401(k) plans.

We also support several changes that will provide more flexibility for SIMPLE plan sponsors.

- **Allow Additional Non-Elective Employer Contributions to SIMPLE Plans:** Currently, small businesses are not permitted to make any additional contributions to their employees' SIMPLE accounts. Allowing an employer to make additional non-elective contributions to the SIMPLE plan (up to 10 percent) for either non-elective or matching plans would allow small businesses to take advantage of a good year or as an ongoing benefit for employees.

- **Eliminate Higher Penalty on SIMPLE Distributions:** Distributions made before age 59 1/2 from a SIMPLE IRA are subject to a 25 percent excise tax (unless otherwise exempt) during an employee's first two years participating in a SIMPLE IRA and 10 percent each year after. The 25 percent excise tax should be repealed, because we believe that it is both confusing and counter-productive to single out this particular type of retirement vehicle as requiring additional penalties to prevent premature distributions. Premature distributions from SIMPLE IRAs should be subject only to the 10 percent excise tax applicable to other retirement plans, including SIMPLE 401(k)s and IRAs.

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[8] Internal Revenue Service, Statistics of Income, 2001.
[9] Investment Company Institute, *Perspective*, Vol. 11., No.1, February 2005

- **SIMPLE Plan Portability:** Eligible rollover distributions from qualified plans and traditional IRAs cannot be rolled over to a SIMPLE IRA. Distributions from SIMPLE IRAs can be rolled over to other retirement accounts only after two years of participation. Again, creating an artificial distinction between SIMPLE IRA plans and other qualified vehicles breeds confusion at the participant level and needless complexity at the recordkeeper. SIMPLE IRA participants should be eligible to rollover their retirement assets like other plan participants.

- **Allow a Mid-Year Change from a SIMPLE IRA or SIMPLE 401(k) to Another Plan:** A business owner should be allowed to move from a SIMPLE plan to another retirement plan during the year. Currently, a business owner must decide by November 1 if a plan is going to be offered for the next year. This rule does not recognize that businesses operate on a variety of cycles – often the last quarter of year is a pivotal period for the business making it a difficult time to decide about whether or not to offer a plan.

- **Simplify Some Operational/Compliance Issues for SIMPLE IRA and SIMPLE 401(k):** We would also suggest that Congress revisit some of the practical eligibility and operational issues that SIMPLE plan sponsors face, in an attempt to simplify the rules without undermining the integrity of the small plan program. Currently "related" employers are required to be treated as a single employer to satisfy the SIMPLE requirements, as they are for standard retirement plans for discrimination testing and benefits purposes. Such requirements make sense in the context of deterring inappropriate or excessive deferrals or contributions under a standard qualified plan, and may be relatively straightforward for SIMPLE plan sponsors in applying to a controlled group of corporations or brother/sister entities. However, in trying to interpret some of the more difficult affiliation rules under the Code that also apply, especially the definition of "affiliated service groups", SIMPLE plan sponsor eligibility becomes a much more difficult question to answer. We would encourage Congress to investigate whether all of these tests are truly needed to determine eligibility in the SIMPLE context.

We would also encourage Congress to review the tax credits available for small businesses that start retirement plans. SIFMA members have seen very little use of the tax credit by employers because many small businesses have no tax liability at all. You may want to give consideration to offering a refundable tax credit to businesses that is refundable against payroll taxes or offering a refundable tax credit for every employee that participates in the plan. We would also encourage Congress to expand the small business pension plan start-up credit to those businesses that offer a payroll deduction IRA.

The revenue cost associated with these proposals is likely to be relatively modest. Increasing our pool of savings must continue to be a priority both for the country and for individual financial security. Larger pools of savings will have positive benefits for economic growth. By encouraging savings, the amount of capital available for investment will increase. This investment capital is a primary source of job creation and

worker productivity – the primary components needed to raise living standards and generate sustainable economic growth

We look forward to working with you to narrow the gap in retirement coverage for small businesses and would be happy to provide assistance in any way that would be helpful.

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

BEFORE THE SUBCOMMITTEE ON FINANCE AND TAX OF THE COMMITTEE ON SMALL BUSINESS OF THE UNITED STATES HOUSE OF REPRESENTATIVES

"PENSION PARITY: ADDRESSING THE INEQUITIES BETWEEN RETIREMENT PLAN OPTIONS FOR SMALL AND LARGE BUSINESSES - HOW CAN WE INCREASE SMALL BUSINESS EMPLOYEE COVERAGE?"

October 24, 2007

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 retirement plan system as well as addressing how to achieve pension parity with larger businesses. At the outset, we would like to thank Chairwoman Bean and Congressman Heller, the other members of this Sub-Committee as well as Chairwoman Velazquez and Congressman Chabot, 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

[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.

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.

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 on 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 small business 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. Companies would have to be able to take actions knowing what the results would be and not be concerned about constant changes in the tax laws and regulations throwing their economic planning into disarray. 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 plan 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. Recently, Congress made permanent the important pension changes known as EGTRRA – this was a significant event and will go a long way towards buttressing the small business retirement system. These provisions 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 were met with approval by almost all groups affected and have been so successful in achieving their policy goals.

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 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 provide generous employer contributions (generally a profit sharing contribution) and/or an employer matching contribution, but they also often provide the best way for the 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 grows tax free inside the plan 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). Apparently, 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.

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.

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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.

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.[3] 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. We are not aware of any data that takes into account the coverage for small business employees working for small businesses that have been in business for five years.

Ten years ago there was an analysis done by the Congressional Research Service that showed that approximately 88% 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. Approximately 85% of employees in companies with 25 to 99 employees which sponsored such a plan participated and a slightly lower percentage of employees in firms with fewer than 25 employees participated. We have not been able to find this data updated so do not know if it is still valid. If it is, it illustrates 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.

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.[4] These

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

[4] 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.

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 and have outlived their initial good policy impact.

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 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, such as the 401(k) 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 contribution into the IRAs 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 (the latter two being 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 requirement of expressly asking 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 "real" 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 rather than SIMPLEs and SEPs. This is simply because as mentioned above, employees have a far greater opportunity to remove the money from IRAs, SIMPLES 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) contribution limits and the SIMPLE contribution limits should be carefully preserved so that the system does not tilt in the wrong direction.

We are aware that some small business groups have asked 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 amount of 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. ***Because of these vitally important policy reasons, 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 2007 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, 2007, and institute a safe harbor 401(k) plan as of July 1, 2007. The employee will receive at least the same contribution by the employer (if not more) under the new safe harbor 401(k) plan 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.*

IMPORTANCE OF AUTOMATIC ENROLLMENT – A MISSED 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.[5] 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.[6] Interestingly, when these factors are present, employees are willing to save 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

The automatic enrollment 401(k) safe harbor contained in the Pension Protection Act is doing little to encourage small businesses to offer automatic enrollment. The incentive offered to small businesses to take on the extra administration inherent in auto enrollment by reducing

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

[6] 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.

slightly the costs of the current 401(k) match safe harbor has proven to be an insufficient incentive to encourage small business to adopt it. Small business owners will 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 the incentive is not worth the expense. We have seen that very few small business employers are willing to take on the extra burdens and costs of the new auto enrollment 401(k) safe harbor. Although the regulations have not been issued yet, at least one IRS representative indicated at a recent ABA Tax meeting that IRS believes that there must be a 60-90 notice period before a company can bring an employee in for auto enrollment (which defeats the goal of getting people used to having the 401(k) contributions taken out with their first paycheck). An IRS representative also said that the rule will apply to every employee who have failed to make an affirmative election - which means if a company wanted to use the auto enrollment safe harbor, it could not limit it to new hires. Many believe that this is the type of policy decision that is making the auto enrollment unworkable. 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. What a lost opportunity!

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 become educated about investments and the choices under their plan. Very often plan participants 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. It is not unusual to even here employees discussing the pros and cons of life cycle funds, balanced funds and asset allocation models! **Truly, it is no exaggeration to say that the 401(k) plan has brought the stock market to the**

average American. There is no question that this is the most well-known and well-liked retirement plan design today.

ERSAs – THE SIMPLIFIED PLAN OF THE FUTURE?

The Administration first proposed Employer Retirement Savings Accounts as part of its Fiscal Year 2004 Revenue Proposals [7] in an effort to reduce unnecessary complexity in the qualified retirement plan system. The Administration has continued to propose ERSAs in each of its fiscal year revenue proposals thereafter. In 2005, Representatives Johnson and English introduced H.R. 1161 to add Section 401A to the Internal Revenue Code to provide for ERSAs. On the same day a companion bill was introduced into the Senate (S. 547).

The impetus behind ERSAs is to provide employers with a qualified retirement plan stripped of much of its complexity and the corresponding administrative cost and expense. As set forth in the Administration's Fiscal Year 2008 Revenue Proposals, "The rules covering employer retirement plans are among the lengthiest and most complicated sections of the Code and associated regulations. The extreme complexity imposes substantial compliance, administrative, and enforcement costs on employers, participants, and the government (and hence, taxpayers in general)...Moreover, because employer sponsorship of a retirement plan is voluntary, the complexity discourages many employers from offering a plan at all. This is especially true of the small employers who together employ about two-fifths of American workers...Reducing unnecessary complexity in the employer plan area would save significant compliance costs and would encourage additional coverage and retirement saving." [8]

ERSAs are designed to replace several different types of retirement plans, all of which provide some form of employee contribution, some on an after-tax basis, others on a pre-tax basis. The plans that would be changed into ERSAs include 401(k) plans, 403(b) plans, 457(b) plans maintained by a governmental agency, SARSEPs , SIMPLEs (IRA type and 401(k) type) and thrift plans. ERSAs would be subject to the current rules governing 401(k) plans, including the rules governing contributions and distributions. The tax rules governing the contributions and distributions from an ERSA would be identical to the tax treatment of such

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7 General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals, Department of the Treasury, February, 2003. As originally proposed, the top-heavy rules would be repealed and permitted disparity and cross-testing would no longer be permitted. In addition, the original proposal included (i) a uniform definition of compensation that would include all compensation provided to an employee by the employer for purposes of income tax withholding for which the employer is required to furnish the employee a written statement Form W-2, plus elective deferrals; and (ii) a definition of "highly compensated employee" that would be any employee with compensation for the prior year in excess of the Social Security wage base for that year. These proposed changes were not included in the Administrations Fiscal Year 2005 Revenue Proposals or in each revenue proposal offered by the Administration in each fiscal year thereafter. These proposals were eliminated after Treasury heard from many companies how draconian some of these proposals would be and how they would seriously damage the voluntary retirement plan system. All of the remarks in this paper with respect to ERSAs deal with the proposal as it emerged in 2005 and thereafter and do not apply in any way to the original 2004 proposal, which the SBCA does not support and believes would have greatly damage the retirement plan system for companies large and small.

8 General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals, Department of the Treasury, February, 2007 at 13.

contributions/distributions from the plan as it stood prior to becoming an ERSA. Thus, a pre-tax deferral or a Roth contribution would retain its characteristics after the original plan was changed into an ERSA.

In an effort to simplify the rules requiring contributions to qualified retirement plans not to discriminate in favor of the highly compensated employees ("HCEs"), there would be only one test which an ERSA plan must meet to satisfy the nondiscrimination requirements. (The complicated ACP test and the ADP test would no longer be applicable.) Under an ERSA the contribution percentage for eligible HCEs for the plan year cannot exceed 200% of such percentage for the nonhighly compensated employees ("NHCEs") if the contribution percentage of the NHCEs did not exceed 6%. If the contribution percentage of the NHCEs exceeded 6 percent, there would be no nondiscrimination test.

In addition, ERSAs offer two safe harbors to avoid the simplified nondiscrimination test. The first safe harbor is met if the employer is required to make contributions to a defined contribution plan on behalf of each NHCE in an amount equal to at least 3% of the employee's compensation. The second safe harbor sidesteps the nondiscrimination test if the employer makes matching contributions on behalf of each NHCE equal to 50% of the elective deferrals of the NHCE to the extent that such elective deferrals do not exceed 6% of the employee's compensation or the same type of alternative formula match allowed under the current 401(k) safe harbor rules.

In order to allow small employers to provide retirement plans through an IRA chassis which provides streamlined administration and little fiduciary responsibility, if any, an ERSA arrangement maintained by an employer with 10 or fewer employees will satisfy the ERSA rules if contributions are made to an IRA established on behalf of the employee.

WOULD ERSAS BE ACCEPTABLE TO EMPLOYERS?

If the ERSA were only applicable to 401(k) plans and optional for the other types of plans, it would be embraced by many, if not most companies. Because the new ERSA discrimination test would be so much easier than the existing ADP and ACP tests, it would seem that companies sponsoring 401(k) plans would view such a change as truly beneficial making the additional employee communication costs and software costs that would have to be expended to make such a change acceptable.

The problem with ERSAs comes into play with the 403(b) plans, SARSEPs and SIMPLE IRAs. If the ERSA is intended to only apply to an ERISA 403(b) plan then there should not be a problem. If it is intended to be applicable to all 403(b) plans, then sponsors of non-ERISA 403(b) plans would now be subject to a non-discrimination test where none applied before.

Today SIMPLE IRAs are not limited to companies with only ten employees so that this change could be viewed as taking something away from small businesses. (A SIMPLE IRA plan is available for employers who have no more than 100 employees who earned $5,000 or more in compensation during the previous calendar year.) Under a SIMPLE IRA, the employee may elect

to receive cash or have the employer contribute up to $10,500 of the employee's compensation to the employee's SIMPLE IRA account. In addition, the employer must either make matching contributions or nonelective contributions to the SIMPLE IRA on the employee's behalf. The employer is required to match 100% of the employee's deferral up to 3% of the employee's compensation. Alternatively, the employer may elect to make a nonelective contribution of 2% of compensation for each eligible employee who has at least $5,000 of compensation from the employer for the year. Under the ERSA plan, these small employers would be allowed to make the larger contributions that could be made to the 401(k) plan but companies with more than ten employees would have to use the trusteed and protected approach of the "real" qualified retirement plan. The SBCA thinks that the ERSA proposal strikes the right balance between allowing higher contributions but having the funds protected and insulated by an ERISA protected trust.

Thus, the new ERSA rules for SIMPLE IRAs would give small business owners something they have wanted for a long time – the higher contribution limits allowed under 401(k) plans, but this change comes at a cost. It will only be applicable to small businesses with ten or fewer employees. One would think that the small business community would have been upset with this change, but virtually every major association representing small businesses has embraced ERSAs.[9] It appears that the Administration wisely decided that the higher limitations deserve the higher safeguards of a trusteed plan rather than an IRA.

WOULD ERSAS ACCOMPLISH THE GOAL OF SIMPLIFICATION?

ERSAs would definitely simplify the qualified retirement plan area, which is without a doubt one of the most complex areas of the tax code. Today, there are different rules that apply to each of different types of plans which allow employee deferrals or after tax contributions. It is hard to justify from a policy viewpoint why rules that are different because of historical reasons which are no longer valid should hold up the simplification of the whole system dealing with employee contributions. When viewed from the macro level, the ERSA plan would effectively make all of these types of plans basically 401(k) plans with simplified and easier non-discrimination testing. This seems to be an eminently fair way to bring these diverse plans under one plan design while simplifying the overall structure of the 401(k) plan at the same time.

IS IT LIKELY THAT CONGRESS WILL ENACT ERSAS?

It is not clear whether Congress would pass ERSAs. There are certain members of Congress who believe that the current rules and the discrimination tests, in particular, are

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9 It is possible that these small business associations may have embraced the reduced number of employees to be eligible for the ERSA IRA plan, because they assumed that the Administration's proposals on Retirement Savings Accounts (RSAs) and in particular, Lifetime Savings Accounts (LSAs), would also be adopted. Many members of Congress were concerned that small business owners would simply fill up these accounts for themselves and drop the employer plan. They were also concerned that savings would be first put into the LSA rather than into a 401(k) plan because there were no penalties for withdrawal at any time. The SBCA believes that the LSA in particular could be very detrimental to increased retirement plan formation. The SBCA is not suggesting that the ERSA move through with its companion proposals, the LSA and the RSA, rather we believe the ERSA should be adopted on its own.

worth their complexity and the additional administrative costs they generate because they can cause the employer to give extra plan contributions to certain non-highly compensated plan participants to pass the tests, or alternatively cause certain highly compensated employees to have to take back a portion of their 401(k) contributions because the tests have not been passed. Given the grave lack of retirement savings facing the nation at this time, it seems short-sighted to require anybody (even if highly compensated) to have funds removed from a retirement plan. Further, the SBCA believes that the costs generated by these non-discrimination tests would be better spent by the company putting the money towards plan contributions or necessary administrative expenses. It is likely however, that in order to convert all of these different plans over to ERSAs, most of which have different non-discrimination tests, that coming up with one set of tests, which in some cases is harsher than the existing tests and in other cases, more lenient, would be the only way to get this much desired simplification into law.

There is no question that this major simplification would significantly assist IRS agents in auditing plans and would make it easier for many companies to know what they need to contribute without the necessity of hiring skilled plan administrators to run the non discrimination tests for them. If one were to factor in all of these costs, one would think that Congress should embrace the ERSA as a well thought out proposal that should be enacted for the sake of simplicity.

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.[10] 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 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 having advanced notice in the context of the non-

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

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.[11] 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. Treasury and IRS have worked around this requirement as much as possible.[12] 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.*** Note that if the ERSA was passed there would be no need to have the existing 401(k) safe harbors and all of the complexity under them would vanish.

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[13]), 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 profit sharing contribution or a match contribution).[14] 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)

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[11] 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.

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

[13] 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 and additional costs as compared to larger businesses. This is an area where there is no parity between larger and smaller retirement plans.

[14] 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)).

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 IRS regulations on employee pay-all plans.[15] This rule converts 401(k) contributions made by key employees into employer (profit sharing) contributions, thus triggering the top-heavy minimum contributions. In 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.[16] 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.** [17] ***The SBCA strongly supports changing this unfair rule - - changing this rule will encourage new small business 401(k) plans which will 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 retirement plans. These plans would allow small business employees to defer up to $15,500 (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

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

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

[17] 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.

In the small business world, cash balance plans are probably *the most desirable plan* a company can sponsor. Due to legislative changes in the 1980's, small business by and large has no interest in the defined benefit plan system. For this reason, small businesses are not confronting the same conversion issues as are large companies who are changing their defined benefit plans into cash balance plans. Some small businesses, however, do sponsor cash balance plans. **The cash balance plan is the plan of choice since 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 and they know how much they have 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. Congress went a long way towards encouraging new formation of this type of plan by making it clear that these plans are not inherently age discriminatory. Congress should continue to encourage formation of this valuable plan for small business employees.

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 any retirement income security other than through 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, larger companies often 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." Perhaps an exception to this general rule would be the ERSA where the costs of moving everyone over to the easier plan would be justified by the overall dramatic simplification in the system.

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 even to purchase long term care insurance or pay 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. This would reduce administrative costs which are higher for small business plans than those paid on a per participant basis by larger companies.

HELP NEEDED FROM IRS

For whatever reasons, in the last few years the laws and regulations governing the retirement plan system have become increasingly complex. Practitioners around the country are getting confused by the new laws, such as many of the new rules contained in the Pension Protection Act and even more confused by all the regulations and guidance coming out with respect to the new laws. It would be extremely helpful if the Internal Revenue Service provided practitioners with more examples, sample language and safe harbors. It would be extraordinarily helpful to the smooth operation of the qualified retirement plan system, if Congress urged IRS to actively assist practitioners in this regard. Finally, every time Congress changes a retirement plan law, it should provide for significant transition relief. Currently, plans are being required to be amended on an annual basis and it is beginning to really drag down the welfare of the system with unnecessary complexity and cost.

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 changes set forth 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.

THE LATEST SIMPLIFICATION TRAGEDY: NEW MONSTER IRS CODE SECTION 409A – NON-QUALIFIED DEFERRED COMPENSATION PLANS

Perhaps the most egregious area where immediate relief is needed for small business is under new IRC section 409A. Congress enacted 409A in response to the abuses seen in the

Enron, WorldCom, and similar situations. Its goal in creating this statute was to protect investors (and arguably the employees) in publicly traded companies. For publicly traded companies, the goals of 409A were, and still are, valid and important. However, its application to small businesses is unnecessary and unduly burdensome- the very opposite of what Congress intended. Accordingly, SBCA respectfully requests that Congress revise Section 409A so as to exempt (i) nonpublic companies or (ii) all companies with fewer than 100 stockholders or (iii) all companies using the cash basis method of accounting and all entities utilizing a pass through entity or (iv) all companies with gross receipts of less than $10,000,000.

409A requires all amounts deferred under a nonqualified deferred compensation plan (including arrangements set up by the employer unilaterally with no employee involvement or choice) after December 31, 2004 to comply with new, very, very complex rules. If these rules are violated, the amounts are currently included in the employee's income and also are subject to an additional 20% income tax.

In cases such as those of Enron and Worldcom, corporate executives either had or created large nonqualified deferred compensation accounts and withdrew their balances shortly before the corporation declared bankruptcy, effectively depleting company funds to the detriment of investors. These types of abuses simply do not exist in the small business arena. Due to the close identity of the owners and the executives in private businesses, there is no abuse by executives at the expense of shareholders. In public companies, those controlling the business (executives and directors) are often owners of a small percentage of the outstanding stock. In private businesses, the close alignment of the interests and identities of the owners and executives creates inherent safeguards – safeguards that were not present to protect the shareholders in Enron and similar cases.

The scope of 409A spans much farther than many originally expected or is warranted. It not only encompasses traditional nonqualified deferred compensation arrangements, but as interpreted by the IRS and Treasury, it also extends to *any* agreement which could conceivably have the possible effect of allowing an employee to receive income in the future. This is certainly not the traditional definition of a non-qualified deferred compensation with which tax practitioners or small business advisors are familiar. The effect of this is that owners of closely-held business must scramble to review, among other things, their employment agreements, buy-sell or other purchase agreements, stock options, restricted stock arrangements, partnership agreements, limited liability company operating agreements, and numerous other standard business arrangements. Because the reach of 409A is so great and the rules so complicated small businesses have spent and will continue to spend a great deal of money in unnecessary legal and accounting expenses. 409A prevents common sense economic arrangements that are sensible for the employees and businesses and pose **no** opportunity for abuse.

Congress wrote a five page Internal Revenue Code section to protect investors from top executives raiding a company by leaving with huge sums of money in non-qualified deferred compensation plans immediately prior to the company's collapse. It is not likely that Congress bargained for the 400 pages of regulations (with more guidance coming out soon!) that will

require teachers to make an election before the year begins if they want to take out their salary over a 9 month period instead of a 12 month period. It is doubtful that Congress is or has been concerned about teachers deciding during the school year whether they want to take their salaries over a 9 month period or a 12 month period – but under 409A this is now a timing issue which is somehow deemed to be abusive and needs to be curbed. Initially small business advisors did not think 409A would apply to many small businesses because few small businesses have non qualified deferred compensation plans – because of tax reasons small businesses cannot afford to set up a plan where there is no deduction. Unfortunately the regulations make it clear that 409A applies to many situations that are not non qualified deferred compensation plans. Just last week, many tax practitioners listened to two governmental spokespeople on an ABA program explain that language found in almost every agreement providing that payments to be made to an employee after termination of employment "as soon as practicable" will have to be changed because that is not acceptable under the regulations. It is ridiculous for privately owned companies to spend countless dollars to comply with these overreaching regulations when there is virtually no policy goal being achieved.

Since Congress drafted 409A in such a way that its application could be construed very broadly and the Department of Treasury, in turn, interpreted the statute to be applied as such, 409A has developed into the very antithesis of simplification. In fact, the Treasury Regulations issued for 409A are nearly 400 pages long! Until two days ago, small businesses were suppose to have all of their agreements in operational compliance with 409A by the end of this year. Those small businesses fortunate enough to have advisors who are even aware of this new burdensome and overly broad section are at least attempting to deal with the unnecessary and costly changes that will be made to their operating agreements. The vast majority of small businesses, however, are simply not even aware that 409A exists nor are they aware of the extraordinary tax penalties that will apply to them. Private businesses and their advisors are experiencing significant uncertainty and burdens as a result of the new provisions, and the burdens far outweigh any possible public benefit. This is completely counterintuitive to Congress's greater goal of providing certainty, simplicity, and fairness in the tax code.

Furthermore, no real income deferral results from nonqualified deferred compensation arrangements in the typical small business context. A private business (or its owners, in the case of a flow-through entity) pays taxes on income as earned. It receives no deduction for deferred compensation paid unless and until the amounts are includible in income by the employee. Accordingly, the perceived need for specific tests when nonqualified deferred compensation arrangements in fact defer income is misleading. The real issue is when the incidence of taxation shifts from the employer to the employee. Therefore, there would be little or no revenue impact from restricting the application of 409A to publicly traded companies.

409A is also problematic in that it inhibits negotiation of severance pay agreements where it is in the business interest of the employer to accelerate payments in exchange for a reduction in the amount due. There may also be valid business reasons for an employer to pay off a deferred compensation obligation earlier. This is usually done by paying bonuses during employment. This would currently violate both the rule against acceleration and the rule that

precludes payments except on termination of employment or change of control.

Another issue surfaces where small employers, who often prefer to issue stock options at low values as an added incentive to employees, also risk running afoul of 409A. 409A applies if the exercise price of the stock option is below fair market value as of the date of the grant. But the value of a closely-held company is often open to debate, even among valuation experts. As such, the uncertain value of closely-held business interests presents a huge risk to a closely-held businesses considering issuing stock options since, under 409A, the IRS can challenge the value (even if supported by an independent appraisal).

Existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business, where Enron-type abuses do not occur. Moreover, any perceived abuses could be eliminated by simply tightening up the rules already applicable to these arrangements instead of creating a new section to the tax code, especially one like 409A that comes along with its own 400-page set of incomprehensible regulations. Congress should create an exemption similar to that applied to IRC Section 280G exempting private businesses with fewer than 100 owners. Alternatively, Congress could exempt all nonpublic companies from 409A or all companies using the cash basis method of accounting and all entities utilizing a pass through entity or all companies with gross receipts of less than $10,000,000. In the alternative, Congress could exempt specific arrangements from 409A, such as buy-sell agreements, salary continuation arrangements for owners who are slowing down (phased in retirement), and equity positions subject to a vesting schedule of a privately owned company. Small businesses and our country's economy would be better served if they could take the money they will have to spend on tax advisors to cope with 409A, and instead invest more money in making their businesses profitable and contributing significantly to our nation's economy.

The Effects of 409A: An Example

Suppose Rural Medical Practice has several family practice doctors, and one, Dr. Senior, wants to be able to slow down but not fully retire. Rural Medical Practice values Dr. Senior, who is a valuable resource for the community, and would like for him to continue working. On the other hand, to economically survive, the practice needs to limit his pay based on productivity. By contrast, Dr. Senior would like to supplement his reduced income during his slow down period (e.g. phased in retirement). Rural Medical Practice is obligated by agreement to pay its retired doctors an amount of money based on the doctor's 3 average years of income over the last 5 years and it pays this obligation to the doctor in equal amounts over a 5 year period.

Before 409A:

As an incentive to encourage Dr. Senior to continue working as a doctor, Rural Medical Practice would propose to allow Dr. Senior to begin receiving a portion of the payments that Rural Medical Practice usually pays to its doctors once they retire, while still employed with the practice. Assume that Dr. Senior has decided that he will work one-third of his regular workload

and Rural Medical Practice would begin to pay him his "retirement" payments immediately (the medical practice would waive the requirement that Dr. Senior must retire to begin receiving payments) and in exchange for beginning to make payments prior to actual retirement, Dr. Senior would agree to have the payments made over a seven year period rather than five. Rural Medical Practice would fund these payments at least partly with the collection of Dr. Senior's accounts receivable, particularly those received by the practice after his actual retirement. This arrangement would permit Dr. Senior to work a reduced work schedule (which not only benefits him but perhaps more importantly his patients who rely upon his valuable medical service to the community) and be able to afford the slow down. This type of arrangement is very common with small business owners today and will become more common as the baby boomers approach traditional retirement age while the average life expectancy has moved well into the 80's. Many experts on the Hill have been working on how to encourage exactly this type of phased in retirement.

After 409A:

If Rural Medical Practice has sophisticated tax advisors, they hopefully would warn Rural Medical Practice that the proposed arrangement could violate 409A, and the payments made to Dr. Senior could be subject to both the imposition of current tax and the significant penalties imposed by this code section. This is because Dr. Senior would be working at a 33 1/3% level which, under the regulations, would give rise to a facts and circumstances determination (presumably by the IRS) as to whether Dr. Senior has separated from service thereby allowing the payment of the severance payments in compliance with 409A. Once Dr. Senior's performance (that is, the level of services performed by him) decreased to a level equal to 20% or less of his average level of performance during the 36-month period immediately preceding the commencement of the deferred compensation arrangement, Dr. Senior would be presumed to have separated from his service with Rural Medical Practice and at that decreased level of performance there would be no penalty.

Thus, Rural Medical Practice and Dr. Senior would be forced to try to fit Dr. Senior's phased in retirement goals into a tax code provision which should have NO application to the situation described. Neither Rural Medical Practice nor Dr. Senior has deferred any income from Dr. Senior in a prior year to a later year, and even more peculiar, by changing the existing arrangement, Dr. Senior would be actually accelerating income into an earlier taxable year – nevertheless under 409A this would be prohibited and significant penalties would attach. Worse, it is very likely that Rural Medical Practice would have no idea that 409A applied to this type of situation so that Rural Medical Practice would have walked into a trap for the unwary while doing exactly what was best for the surrounding community desperately in need of qualified doctors.

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