# THE CHALLENGE OF RETIREMENT SAVINGS FOR SMALL EMPLOYERS

## HEARING

BEFORE THE

## COMMITTEE ON SMALL BUSINESS
## UNITED STATES
## HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

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# THE CHALLENGE OF RETIREMENT SAVINGS FOR SMALL EMPLOYERS

**WEDNESDAY, OCTOBER 2, 2013**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
*Washington, DC.*

The Committee met, pursuant to call, at 1:00 a.m., in Room 2360, Rayburn House Office Building, Hon. Sam Graves [Chairman of the Committee] presiding.

Present: Representatives Graves, Chabot, Coffman, Luetkemeyer, Mulvaney, Tipton, Hanna, Huelskamp, Schweikert, Bentivolio, Collins, Rice, Velázquez, Payne, Meng and Kuster.

Chairman GRAVES. Good afternoon. I will call the hearing to order. Today we are going to meet to examine the challenges small employers face in saving for retirement.

Americans have always found it difficult to save. In June, a bankrate.com survey found that 76 percent of Americans were living paycheck to paycheck. Our workforce is aging, life expectancy is increasing, and the future of the Social Security program still remains in doubt. With that, saving for retirement seems more important than ever.

Small employers understand the importance of providing good benefits, including retirement savings options, to attract and retain quality employees. However, in today's economy that can be very challenging.

The Government Accountability Office recently reported that only 14 percent of small employers sponsor a retirement savings plan for their employees. Some small business owners have said offering retirement plans is just too complex or too time-consuming. Surveys by the Transamerica Center for Retirement Studies, whose president is testifying today, have found that small businesses continue to lag behind large companies in sponsoring retirement options. Small business confidence polls have shown that the economic recovery is still uneven, and entrepreneurs and their employees may not be saving more for retirement.

We look forward to the new data that Transamerica is releasing at today's hearing, and during this hearing we will explore the state of retirement savings by small businesses and their employees, the barriers they face, and how we can encourage more small businesses to offer these important benefits.

I do want to thank all of our witnesses for being here today. Some of you traveled a long way, and we appreciate that very much.

And with that, I will turn to Ranking Member Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Retirement security is a universal goal for most Americans. As part of that retirement plan, most Americans rely on employer-based retirement plans. As the baby boomer generation ages, it is critical that small employers and their employees have financial security as they enter their retirement years. But the program remains that only 14 percent of small firms offer such a benefit. With 99 percent of all businesses in this country being small businesses, if we are truly going to make retirement security a reality, we must address their needs.

Small firms not only face the challenge of offering a retirement vehicle, but enrolling their employees. Roughly 50 percent of the private-sector workforce participates in an employer-sponsored pension plan. While much of the problem can be attributed to a lack of employer offerings, nearly 20 million workers actively choose not to participate in plans offered by their employers. Improvements to the retirement system must meet the needs of business owners, while also encouraging more workers to participate.

It is clear that small firms face many obstacles when setting up a retirement plan. First, there is the cost of selection and administration. The costs do not stop there either, since employers are required to make much in contributions much of the time.

Finally, small firms face ongoing fiduciary duties, such as reviewing investment and running discrimination tests, all while trying to run a business. Our system seems to almost discourage small businesses from offering retirement packages, and helps explain the inequity in coverage rates for workers of small and large companies.

It is clear that to encourage small businesses to start offering plans, something needs to be done to address this obstacle. Small employers face too many challenges and simply will not offer a retirement plan if they perceive that the burdens outweigh the benefits. Understanding these challenges can help us better address the solutions to low participation rates among small entities.

One approach may be to offer increased tax incentives to small business owners who choose to sponsor a plan. Another method to encourage workers to participate is to create an automatic enrollment IRA.

These and other ideas merit further discussion, but one thing is absolutely clear: We must act soon to help small businesses and their employees plan for their future. For these reasons we need to make sure that retirement plans are attractive for small businesses as their retirement savings is integral to our Nation's, and that—our Nation's future, and that is why we are here today. This hearing would allow members of this Committee to discuss the kind of vehicles that many small businesses use to provide retirement benefits and ways in which they can be improved upon. With the proper tools America's small firms can sustain the economic growth currently under way simply by investing in their futures.

And with that, I thank all the witnesses for being here today, and I look forward to your comments.

Thank you, Mr. Chairman. I yield back.

Chairman GRAVES. All right. Our first witness today is Catherine Collinson, who is the president of Transamerica Center for Retirement Studies in Los Angeles, California. She is a retirement and market trend specialist and oversees all of Transamerica research and outreach activities, including its annual retirement survey, which is being released today at our hearing.

We appreciate you coming all this way; thanks for being here.

**STATEMENTS OF CATHERINE COLLINSON, PRESIDENT, TRANSAMERICA CENTER FOR RETIREMENT STUDIES, LOS ANGELES, CALIFORNIA; PAULA A. CALIMAFDE, BETHESDA, MARYLAND, ON BEHALF OF THE SMALL BUSINESS COUNCIL OF AMERICA AND THE SMALL BUSINESS LEGISLATIVE COUNCIL; C. ROY MESSICK, III, CPA, QPA, TPP RETIREMENT PLAN SPECIALISTS, LLC, OVERLAND PARK, KANSAS; AND RAY RUCKSDASHEL, CHIEF FINANCIAL OFFICER, QUEST-TEC SOLUTIONS, INC., HOUSTON, TEXAS**

## STATEMENT OF CATHERINE COLLINSON

Ms. COLLINSON. Well, thank you, and good afternoon. I am Catherine Collinson, president of the Transamerica Center for Retirement Studies, or TCRS.

Today TCRS released new research as part of its 14th Annual Transamerica Retirement Survey of 750 employers and more than 3,600 workers, including those from small companies of 10 to 499 employees.

Employer-sponsored retirement plans in small business play a critical role in facilitating savings among American workers. TCRS research findings underscore the importance of these benefits in helping workers prepare for retirement. Eighty-eight percent of small-company workers value retirement benefits as important.

I would now like to share four key findings from our research. Number one, plan sponsorship rates offer room for growth. Plan sponsorship rates, which may come as a surprise, are already relatively high. Seventy-one percent of companies with 10 to 99 employees offer a 401(k) or similar plan, such as a SIMPLE or SEP, and nearly 9 out of 10 companies with 100 to 499 employees do so, but more can be done, especially for the smallest of companies.

Nearly one-third of small companies that do not offer a plan say they would be likely to consider to joining a multiple employer plan, which is a type of group plan offered through an entity that handles many of the fiduciary and administrative functions.

Key finding number two. Plan sponsorship often does not lead to coverage for part-time workers. Plan sponsorship is not necessarily synonymous with plan coverage. A critical component of expanding coverage is encouraging employers to extend eligibility to their part-time employees. At small companies only 36 percent of part-time workers are offered a plan compared to 68 percent of full-time workers.

Key finding number three. Few companies use automatic enrollment. Automatic enrollment is widely recognized as one of the most effective ways to increase plan participation; however, only 19 percent of small companies take advantage of it. The median default contribution rate is just 3 percent of annual salary, which is insufficient to ensure a participant's secure retirement.

Key finding number four. Most small business workers need to save more. The majority of small-company workers plan to work past age 65, and the majority plan to continue working after they have retired, mostly for income-related reasons to bridge savings shortfalls.

Perhaps the ultimate measure of a worker's retirement outlook is his or her level of savings. In 2013, the estimated median household savings in retirement accounts among baby boomers, which the generation closest to retirement, is just $92,000 for small-company workers.

It is clear that small business workers need to save more, and tax incentives are powerful motivators for saving, yet few small-company workers are aware of the saver's credit, which is available to low- to moderate-income tax filers who save in a qualified plan or IRA.

In light of these research findings, TCRS offers the following five recommendations: One, expand tax incentives to help offset the cost for small employers to establish a new retirement savings plan. The current start-up tax credit only allows small businesses to claim up to $500 for 3 years.

Two, for small businesses in which a stand-alone 401(k) plan is not feasible, make multiple employer plans, or MEPs, more attractive to small employers. MEPs should be simple to administer and provide safe harbors from fiduciary liability for each employer. In addition, small employers should be protected from liability-related errors by other employers who are participating in the plan, and tax incentives should be provided to encourage participation in these plans.

Three, create additional tax incentives and safe harbors to encourage plan sponsors to expand coverage to their part-time employees.

Four, increase the default contribution rates in plans using automatic enrollment. The current 3 percent minimum default contribution rate sends a misleading message to plan participants that savings at these levels is sufficient for a secure retirement. A new automatic enrollment Safe Harbor under which employees who are enrolled at 6 percent with increases up to 10 percent, coupled with a tax credit for adopting it, could drive up plan sponsorship rates as well as participant savings rates.

And number five, increased savings along low- to moderate-income workers by promoting the saver's credit and expanding it so that more tax filers are eligible.

In conclusion, TCRS commends Committee Chairman Graves and Ranking Member Velázquez on their consideration of the particular challenges and needs of small business. We appreciate the opportunity to share our views and research.

Ms. VELÁZQUEZ. Mr. Chairman, it is my pleasure to introduce Ms. Paula Calimafde. Ms. Calimafde is a principal at the law firm of Paley Rothman, which is located in Bethesda, Maryland. She chairs the firm's retirement plans, employee benefits, and the government relations practice groups. Ms. Calimafde is testifying today on behalf of the Small Business Council of America and the Small Business Legislative Council.

Welcome, and thank you for coming back to our Committee.

## STATEMENT OF PAULA A. CALIMAFDE

Ms. CALIMAFDE. Well, thank you, Chairman Graves and Ranking Member Velázquez, for having these hearings today.

As I think we all recognize, this is an extraordinarily important topic. The success of the private retirement plan system means the difference between a comfortable retirement and a not comfortable retirement, and so the work you are doing today, I can think of not many things that are more important than what you are doing.

I will be citing a number of statistics and data that will show that the small business retirement plan system is far healthier than people believe—so, for instance, the 14 percent number, I think, the data that has been just released from the Social Security office is much more in line with the data that you just came up with—but the system is precariously balanced on tax benefits. And right now those tax benefits are in line so that when a small business owner or owners decide whether they want to sponsor a retirement plan or not, they go through a cost-benefit analysis, and they determine what are the benefits to be derived to the owners and the business, and they compare it to the costs and burdens that they will have to undertake to sponsor that plan. And one of the costs, by the way, are the costs of making contributions for the employees of the company, because the Tax Code forces significant contributions to be made to those employees.

Because of this, any significant cuts to the benefits that can be derived by the owners will cause small business plan formation to either be stopped, plans frozen, or new plans will not be formed. So, it is critically important that steps that are taken by you—all assist in that cost-benefit analysis by not overburdening the costs and increase the benefits, or at least leave the benefits alone.

There are places where the system can be simplified. We have set forth a number of ideas in the back of our testimony. I hope I can get to them today. If not, I am more than happy to discuss them with you. For instance, one idea is that we could come up with some kind of lottery system inside a small business, for instance. So any employee who is willing to make a 3 percent contribution into the plan is entered into a lottery, and the names of the non-highly compensated employees only are put into this hat. One name gets brought out, and that employee would get maybe $500 or $1,000 put into their plan or maybe made as a cash bonus to them. It sort of brings some excitement of why we want to save, kind of get people more excited about it.

I think many times employees look at this as sort of almost like autopilot, and, in fact, one of the things I will talk about is that autoescalation and autoenrollment, which is where employees are literally just put into a 401(k) plan, they can opt out, but the numbers are startling. Very few opt out, and why? Well, we think it is because of inertia. It is easier to just stay in than take active steps to get out, and autoescalation increases the amount that employee is putting in on this automatic basis, and, again, the data is startling. People just let the amounts keep building up, so even at a 6 percent contribution level, so this is 6 percent being taken out of their compensation, they just stay in and let the 6 percent go in. And putting in 6 percent into your plan and letting it grow tax free is a very good way to save for your retirement.

In fact, it is such a good way that EBRI was asked to do some work for the ASPPA, the American Society of Pension Professionals and Actuaries, and what they found is that workers are 14 times more likely to save in a retirement plan that is offered by their employer than they are to go and put money into an IRA. And that is a pretty significant statistic, 14 times more likely to save.

I think we are all sort of brought up and know that we—our retirement security in this Nation rests on a three-legged stool. The first leg is Social Security, a very fixed system, a defined-benefit system, you can't outlive it, very little flexibility in that system, and for many people it is a major portion of their retirement. For others, it is a safety net. It is working. I think that you all are going to have to fix it a little bit, but basically it is working.

The private retirement system, even though highly regulated by Department of Labor and IRS, is much more flexible, and plans can be designed to fit a company structure and what they perceive is will be giving—will be most—they can design it so that the employees will appreciate it the most or it will fit best with their own employees, and that system is working extremely well actually.

Part of it is payroll deduction. As I said, it is automatic. Employees don't have the money in their pockets. They can't spend it. They don't have to do anything. It just comes out of their payroll. It works really well. In the 401(k) and 403(b) environment, once the money is in the plan, it is difficult to get your hands on that money, which is one reason why the account balances tend to grow. If people are putting their money into an IRA, they can walk into that IRA and into the bank and take money out. It is much harder in the 401(k) or 403(b) environment.

So, I think I have gone past my time, but I will be happy to take questions. Thank you.

Chairman GRAVES. Thank you very much.

Our next witness is C. Roy Messick, who is a certified public accountant and qualified pension administrator with TPP Retirement Plan Specialists in Overland Park, Kansas.

Mr. Messick has been a CPA for over 30 years, and he is responsible for coordinating TPP's retirement plan recordkeeping, consulting, and administrative services. His firm is a small business serving a lot of small business clients.

Thank you for being here.

## STATEMENT OF C. ROY MESSICK, III

Mr. MESSICK. Thank you.

Chairman Graves, Ranking Member Velázquez, and members on the House Committee on Small Business, I appreciate the opportunity to be here. It is an honor and my pleasure to have some input into the process.

Like Representative Graves said, I am a CPA and a qualified pension administrator as recognized by the American Society of Pension Professionals and Actuaries, or ASPPA for short. I head up our retirement plan division, TPP Retirement Plan Specialists, which is a subsidiary of TPP Certified Public Accountants located in Overland Park, Kansas, also with an office on Long Island, New York.

We administer approximately and/or recordkeep 400 plans across the country, primarily 401(k) and 403(b) plans. Probably 90 percent of those are under 100 employees, so I understand small businesses and the challenges they face in setting up these plans.

In my written testimony I did summarize the types of plans that are commonly offered to small businesses, primarily 401(k) plans. I am not going to go into that in detail. But in my over 30 years of experience, I have seen—there is a lot of reasons why employers do set up plans and a lot of reasons why they don't, some of which have been touched upon already.

Well, why do they set them up? Let us talk about that first. First of all, employee retention and recruiting. It is a huge benefit. If you have a 401(k) plan, you need to go out there and get talent, you got to have a 401(k) plan. And I also think a lot of the businesses, it is really kind of a paternalistic/maternalistic instinct. I mean, they want—they want their employees to have a good retirement. I want our employees to have a good retirement. So I think that is a huge reason why these plans are offered, tax incentives, of course. So much easier to see—you know, defer on a pretax basis. It is just easier to save that way.

The other nice thing about employer-sponsored plans is the contribution limits are higher than IRAs. You can put more away into a 401(k) plan than you can into an IRA, so that is good, too, for retirement. So that is another reason why they do.

Payroll deduction makes it easy to save, I think we talked about that, but it is so much easier if that money is coming out of your paycheck versus you have to sit down on April 15 and write a check to your IRA. Much easier.

Now let us examine why employers don't offer plans necessarily to their workforce. One, these things are complicated, subject to a lot of Department of Labor and IRS rules and regulations, and with complexity comes expense. So that can be daunting for some small employers.

And it is also all about proportionate cost. For example, if you have a million-dollar 10-person plan versus a $50,000 10-person plan, same number of employees, totally different asset size, who is going to get the better deal? I mean, the recordkeeping and administrative cost is really about the same, whether it is the 50-grand plan or the million-dollar plan, so it is all about proportionate cost.

Same thing with investment advice. Now, our firm doesn't provide investment advice or do investments, but that is a huge component to a plan. The person who has to advise these 10 people takes the same amount of time whether there is 10 of them, you know, with 50 grand or 10 with a million. So that proportionate cost is a huge reason why some employers don't offer those.

Not enough tax savings. Some employers won't offer a plan unless the tax savings more that offset the contribution for the employees. They just won't.

Another reason might be why the business owner personally can't defer enough into the plan. In a traditional 401(k) plan, the amount that the business owner can defer is typically limited to 2 percentage points more than the average of the rank and file. So, for example, if the rank and file is deferring 4 percentage points on average, the business owner gets 6, that person makes 100 grand a year, they can only defer 6,000, they may say, hey, that is not worth it, not going to set up a plan.

Now, in a Safe Harbor plan, that is a variation on a 401(k) plan, that makes that test go away where the business owner can defer the maximum allowed by law, which is $17,500, but the trade-off is a required contribution of 3 to 4 percent of pay for the employees. They may not be able to afford that. Their finances may not be such that they can afford that. So that would be another reason why a small business may not offer those plans.

Well, how can we get more participation? I think those tax credits, that has been alluded to already, that is huge. If we can expand that tax credit, maybe target more towards smaller business somehow, some way to get these people to help start a plan, I think that would be great.

I think that the 401(k) and 403(b) deferral should actually be increased from the 17,500. I know it is a tax deduction, but it might spur some business owners to say, okay, hey, now I can put more away. Yeah, I think I will do that. So, I think that is something worth considering.

Maybe another type of Safe Harbor 401(k) plan that doesn't mandate that 3 or 4 percent; maybe something a little bit less in return for maybe a lesser deferral limit for that business owner, kind of a compromise, maybe that something like that would help.

So, with that, those are my thoughts, and I appreciate the opportunity to be here and welcome any questions you may have.

Chairman GRAVES. Thank you, Mr. Messick.

Our final witness today is Ray Rucksdashel, who is the chief financial officer with Quest-Tec Solutions, Incorporated, in Houston, Texas. He has over 40 years of wide-ranging financial and general operations experience with closely held and publicly held companies.

Thank you for being here.

## STATEMENT OF RAY RUCKSDASHEL

Mr. RUCKSDASHEL. Thank you, Chairman Graves, Representative Velázquez, members of the House Small Committee, thank you for inviting me to testify today.

As said, I am here to testify to let the Committee know that retirement savings for the small business employees is not just a necessity, they are a critical component of my company's ability to attract and retain skilled employees.

As a representative of small business, we offer a 401(k) benefit to our employees since the company's founding in 2001. We are not alone in using 401(k)s as a recruiting and retention strategy. According to a survey conducted by Sharebuilder 401(k), 89 percent of small business owners that offer 401(k) plans state that their benefit is an important factor for attracting and retaining the best talent.

So why is this benefit so critical to Quest-Tec? Quest-Tec is competing for employees in a marketplace where skilled workers are hard to find. These skilled workers are not just used in Houston, they are used in any place where the oil and gas industry is growing, west Texas, North Dakota, and they will move for higher salaries or better benefits. And so we are competing with companies all over the country, some of which are much larger than us.

Quest-Tec learned early on in its 401(k) benefit was easy to sell to prospective employees since we were matching 50 percent of their contributions. So why is Quest-Tec so generous with its 401(k) plan? It is simple. The cost is much less than training, attracting, and keeping good workers. Why? While 401(k) plan is important to Quest-Tec, there is a drawback to small businesses. 401(k) administration is very complicated. I have 40 years of experience in financial operations in small companies, and I don't have the time or the experience to manage 401(k)s. They are just too complicated.

In addition, there is significant risk in managing 401(k) plans, and that risk and exposure can serve as a detriment for small business to offer a 401(k) program. To avoid this risk and complexity, I have contracted with a professional employer organization to manage and administer my 401(k) plan.

A PEO is a company that provides payroll, human resources, and employee benefit solutions to small and midsized companies. One of the services a PEO can provide to its small-business clients is access to its 401(k) benefits. By using a PEO to access 401(k) benefits, Quest-Tec no longer has the administrative burden associated with a 401(k). My personal risk associated with being the administrator is minimized, and Quest-Tec is able to offer benefits that are competitive with much larger companies.

I think it is important for the Committee to understand that, in my view, administrative complexities of the 401(k) plan administration are the biggest obstacles to small businesses offering employee retirement services. I understand that the deferment of income for tax purposes is the primary reason for the 401(k)'s complexity, I understand the need for strong fiduciary standards, and I understand the need for strong oversight, but this protection and this disclosure comes at a price, and that price is complexity and a significant burden for plan administrators.

Congress should look at ways to both encourage smaller companies to offer retirement benefits to their employees and at the same time look to simplify and streamline the administration of such benefits. Education, outreach, and improvement to access of the retirement program, like the 401s, is very important.

I also hope that this forum helps bring to the attention of the policymakers the challenges facing small businesses who want to provide these benefits to their employees and begin discussions on how to make these plans for small businesses to offer to their employees more successful.

Thank you again for the opportunity to testify, and I welcome any questions you may have.

Chairman GRAVES. Thank you all for your testimony.

We are going to start with Mr. Coffman.

Mr. COFFMAN. Thank you, Mr. Chairman.

I was a small-business employer with 20 employees and offered a healthcare plan, but we did not have a 401(k) plan with a match.

For those firms, to me, small business start-ups particularly in the services industries that have 25 employees or less, that is a pretty daunting process. And so what kind—I think you mentioned some tax incentives to offset the administrative cost. Could you all go into what kind of incentives that you would see for the really small firms of 25 or less employees?

Mr. MESSICK. Sure. Why not? Yeah, the $500, I think that is nice. I mean, it is a nice start for 3 years, but——

Mr. COFFMAN. Doesn't seem like a lot.

Mr. MESSICK. It is just not enough to, you know, jump-start the bandwagon, if you will. It would be one of those things you might want to try to maybe even double it, maybe even more than that, phase it down maybe, because, you know, if you can get them into the plan, they are not going to terminate it after a year or two, probably not, unless they really have some kind of adverse business situation. So maybe make it tiered, start off high, kind of tier it down a little bit, get them hooked, if you will. So, just my thought off the cuff.

Mr. COFFMAN. Anyone else? Yes.

Ms. CALIMAFDE. Well, I would say not so much the tax credit, though I—it is not like I am against it. I think it is a great idea—but there are things you can do with the law which would actually help, too. So, for instance, only small businesses are hit with these laws called the "top heavy" rules.

Mr. COFFMAN. Uh-huh.

Ms. CALIMAFDE. Today—I mean, this is really an accurate statement. Today they are like an appendix in the human body. They don't serve any purpose, but they cause problems. And that is in the defined contribution area; I don't want to speak to the defined benefit area. But that is an extra additional cost on administration for small businesses that is truly unnecessary.

Another thing would be to simplify the 401(k) test, which is what you were saying. They can be made more simple. There was a proposal years ago called the ERSA. Simplified, it would work out really well.

A third idea would be sort of to go through the Code and take out things which are aimed at small businesses exclusively. And in this regard I am thinking of like required minimum distributions where only small-business owners are required to take money out while they are working from a plan at 70-½. You know, just blatant discrimination to small-business owners.

So my answer would be work with the tax credit, but there is things where you could simplify that would really help.

Mr. COFFMAN. Ms. Collinson.

Ms. COLLINSON. Okay. One thing I would like to add to this, especially for these small companies of, say, 25 employees, is the need to create greater opportunities for them to join a multiple-employer plan, which is a—conceptually it is a group plan with a plan sponsor that is in an entity who is well versed in retirement plans that can handle the fiduciary and administrative duties and take that off the small-business owners' shoulders. So to facilitate the offering of those types of plans and then even a tax credit for joining it could help go a long way towards inspiring plan sponsorship among the smallest of companies.

Mr. COFFMAN. Okay. Mr. Rucksdashel.

Mr. RUCKSDASHEL. I have worked with small businesses my whole career, and the majority of the issues that come to bear for me when I have conversations about starting a 401(k) with a business is inertia. These businessmen don't get into business to run business; they get in business to buy something, sell something, manufacture something, provide a service. It is not to run a business. And so the talk about 401(k)s, they don't understand it. And so the risk involved far exceeds the benefit to their—what they perceive as their employees. They would like to help them with their retirement, but the risk to them. And so if we can minimize the regulation, the hurdles that are—that they view as getting them into this process, is going—would go a long way.

Mr. COFFMAN. Thank you, Mr. Rucksdashel.

I want to thank you all for testifying here today. I think it is a—you know, as a former small-business owner, and I think small businesses across the country, we really do need to have incentives for the owners and their employees to save for retirement, and so I thank you all for what you are doing, for testifying here today.

I yield back.

Chairman GRAVES. Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Ms. Collinson, your study noted that more than half of all workers feel less confident in their ability to achieve a financially secure retirement, and that 54 percent of workers plan to work after retirement.

Given that all the workers have been more adversely affected by the recession, would allowing other workers the ability to make larger catch-up contributions be something to be considered?

Ms. COLLINSON. Thank you for asking. Anything that we can do to help older workers save more for retirement, especially understanding that many will not be able to retire at 65, can only help better prepare them, help them to help themselves better prepare.

Ms. VELÁZQUEZ. And does your data indicate that all the workers will make those larger contributions despite the decreased confidence in the financial market?

Ms. COLLINSON. That is an excellent question, and the first key to it is awareness. And I spoke in my testimony about awareness of the saver's credit, which is still low. Among small company workers it is 23 percent are aware of it. So to offer some sort of catch-up contribution above and beyond the current catch-up contribution or incentives, one of the first things is to make sure that people know about it so that they can take advantage of it, and also look at it in the context of when they will conceivably be collecting Social Security, because many workers plan to work past 65, past 70, are going to look to generate income from part-time work and may encounter some sort of conflict with Social Security if they need to start collecting benefits.

Ms. VELÁZQUEZ. Thank you.

Paula, one of the biggest challenges, and I believe it was Mr. Messick that made reference to that, is worker retention. And we know that many small businesses want to provide a full range of benefits for their employees. What we find is that employers realize that health care is generally more important to the employees and can be more attractive to potential hires.

How often do you experience a small-business owner allocating their limited employee-benefit dollars to offering or improving health benefits in lieu of retirement savings?

Ms. CALIMAFDE. Well, it is an excellent question, and it is probably one of the biggest hurdles for small business owners.

Ms. VELÁZQUEZ. Uh-huh.

Ms. CALIMAFDE. I think most of us who have been in the small-business world know that the first 5 years of a small business' life is fraught with difficulty, and, in fact, the Small Business Administration has told us back—I think using 2012 data, that 50 percent of all new small businesses don't make it through the first 5 years. So, you know, the first 5 years are critical to getting stability.

Then, as soon as a company can, it usually goes into the health insurance market. One reason why is the employees appreciate that benefit more than retirement plans. And one of the things I have been trying to figure out is how do you get employees to appreciate retirement plans more than they do today, because, particularly if you talk to younger employees, they would prefer a cash bonus.

Ms. VELÁZQUEZ. Or how can we avoid creating an either/or situation for small-business workers when it comes to these two priorities?

Ms. CALIMAFDE. Right. I think that——

Ms. VELÁZQUEZ. Would any of the other witnesses like to comment?

Ms. CALIMAFDE. I think health care usually just wins, and then once the business gets a little more stable, a little more profitable, then the retirement plan. But this is an area where education across the board would be really helpful with employees realizing the younger they save, the better off they will be.

Ms. VELÁZQUEZ. Yeah.

Mr. Messick.

Mr. MESSICK. I will talk about that a little bit, too. There is no doubt that health care is number one. It is the big elephant in the room. There is no doubt. That will always be number one.

As far as being able to integrate a plan, too, it is that issue is like you got to take care of the health insurance for your employees first, and then the qualified plan comes second, so that the issue is is there something we can do to maybe take some of that burden for starting it up off that employer so that they say, yeah, you know what, I can do this, I can do both, start off small, and it gets better once you get some dollars into it, but that start-up is tough.

Ms. VELÁZQUEZ. Okay. I guess they are calling.

Chairman GRAVES. No.

Ms. VELÁZQUEZ. I have time for 1 more minute.

Mr. Messick, borrowing against retirement is not always a good first option. Yet for small businesses having difficulty accessing loans, it might be their only option to invest in their business or create cash flow during difficult times, hard times. In your experience, does the ability to borrow from 401(k) plans and not in SEP and SIMPLE plans affect a small business decision to offer a retirement plan?

Mr. MESSICK. I think it does somewhat. I mean, there is no doubt that people like that—or a lot of employees like the ability to borrow from their account. And one of the things is, yeah, you can borrow up to half of your invested account balance, 50 grand is the cap, and that is nice.

The issue becomes, though, with the employees that borrow. I mean, you obviously have to offer that to them, too. I mean, that is only fair. But the problem is is when they leave employment, they never pay those loans back, and then taxwise they get crunched. You know, they are always under 59-½, so they have the 10 percent penalty. They are paying the Federal tax and the State tax. They don't have much left for retirement. So, I am more concerned about that than the business owner being able to borrow to maybe help start his business.

Ms. VELÁZQUEZ. Thank you.

Yes.

Ms. CALIMAFDE. One way of looking at loans is that the key is to get employees to save in their retirement plan, because we know that works. When you have the ability to borrow money, I think, psychologically it makes employees think, I will put in a little bit more because if hard times come, I know I can get back—get this money back. So I think it actually is something that increases the amount of savings is having the ability to borrow it if you really needed it, and borrowing from a plan, there is usually a cost involved.

You know, most of the small-business plans run through either a TPA or an institution, and there is usually, you know, $50, $100 fee to borrow. So you are not going to go in and try to borrow $500 for something that is sort of not that critical when you know $100 is going to go right off the bat.

So, the money doesn't get—it is usually not spent frivolously, I don't think.

Ms. VELÁZQUEZ. Thank you.

Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Tipton.

Mr. TIPTON. Thank you, Mr. Chairman, and thank the panel for being here.

Ms. Calimafde, could we maybe explore a little more in what the ranking member's question was in regards of either/or when it comes to health care versus a retirement plan. Do you see a real challenge as we continue to see government regulations increasing costs on small businesses? Out of the small business department, we have the statistics that we $10,585 per employee in just regulatory costs alone that are being assumed by businesses. We are seeing the hourly wage right now of Americans actually being hurt based off of rules, regulations, and law redefining the workweek in America from 40 hours to 30 hours. You know, there was a time in this country when we fought to have a 40-hour workweek, and now we are trying to fight to get a 40-hour workweek back in this country.

So do you see some opportunities? Do you have some advice for Congress to help get out of the way of business so that they can actually not be in that either/or sort of a situation, but actually to be able to take some of the resources that government is demanding to meet government regulations, government rules, and actually get it in the pockets of people that are working hard and struggling right now?

Ms. CALIMAFDE. There is no question that the cost of regulation in the qualified retirement plan system is significant and could definitely be reduced. So, for instance, there is a number of groups that are trying to persuade Department of Labor that we should be able to have electronic delivery of notices. We are still—you know, right now we are still doing paper delivery of notices. And if you were to see the amount of notices that a small business is supposed to give employees not just in the qualified retirement plan area, but that alone is enough, but then when you get into health insurance and these other areas, I mean, literally there is like hundreds of notices required and all different dates.

[1:45 p.m.]

Ms. CALIMAFDE. And unfortunately most of these notices are very long, complicated types of notices that most employees don't even read. So it would be far more effective to have electronic delivery. You could have big boxes and colors and, you know, dollar signs, put money in the retirement plan; would get far more than 10 pages of fee disclosures, for instance. So absolutely there could be a lot done to help us out here.

Mr. TIPTON. Great.

Ms. Collinson, you deal with a lot of people. Are you seeing a trend now, given expanded rules, expanded regulations, and law now, to where we are seeing more and more people become part-time employees, actually hurting the American workforce, that this is going to really be discouraging employers and employees as well because they aren't going to be able to get a 40-hour workweek anymore, it is now 30 hours, from really participating in a retirement program?

Ms. COLLINSON. Well, one thing that our research found is that in small business in our survey sample population, the workforce was more likely to be a part-time employee compared to large companies. So part-time employees are widely used among small business, and so that is something to be very mindful of.

We have not yet seen the trend that you are alluding to, will employers start moving employees to part time.

Mr. TIPTON. Yeah, this is brand new coming in.

Ms. COLLINSON. We are on the lookout for that, have not seen that yet, but that is something that we are monitoring for in our research, given all of the news reports of it.

Mr. TIPTON. Great.

Well, Mr. Messick, you were alluding as well when small businesses—and we just heard great testimony—that are struggling, having a tough time particularly those first 5 years, trying to do the right thing. Because I am a small business guy. Your employees become your family. You spend more time with them than you do with your family actually. But when they are trying to do it, we are actually seeing government rules, government regulations, government law that is just making it prohibitive and complex to actually even put a program together to incentivize savings. Is that accurate?

Mr. MESSICK. Well, it is tough. I mean, there are a lot of rules and regulations, and you really have to hire somebody like me to figure it out, and I am appreciative of it, thank you very much. But it is rough, and that is why I was—I talked a little bit about maybe streamlining, some kind of a simplified, you know, Safe Harbor 401(k), you know, maybe make the required contribution a little bit less, maybe take some of the fiduciary liability off the table by just saying if you just invest in target date funds, you are good to go.

I mean, there are some things you could do that would encourage small business, I think, to maybe offer some of these plans without it being hugely burdensome, you know, maybe a simplified 5500 reporting for that type of plan, you know, a one-pager, you know, and people will charge less then. I mean, we will. I mean, the marketplace will force us to, and I think that would be good for these small employers.

Mr. TIPTON. We will hold you to that charging.

Mr. MESSICK. Well, yeah. We will talk. We will talk. Okay.

Mr. TIPTON. Thank you, Mr. Chairman.

Chairman GRAVES. Ms. Kuster?

Ms. KUSTER. Thank you very much, Mr. Chairman, and thank you for your testimony.

I am also a small business—was in small business, and I am very appreciative of the opportunity that we had for retirement savings. Particularly with two sons in college and the expenses that you have in life, it is important.

I wanted to delve into an issue that you may be aware of, and this is the Department of Labor finalizing a proposal for a new definition of "fiduciary investment advice" under ERISA. It sort of gets at, Mr. Messick, what your role is. But I wanted to probe a little bit further, because I am concerned about an additional hurdle for the type of people that can provide the information that small businesses need for their employees.

So if this new definition prohibits plan providers from assisting small-business plan sponsors in selecting and monitoring investment options, how would that impact your ability and willingness to offer a plan? And specifically would it increase costs?

What this new proposal is about is that they are changing the definition on "fiduciary investment advice" and making it more stringent so that people can't—they would have to be highly regulated if they were offering that kind of advice.

Yes, Mr. Messick?

Mr. MESSICK. Well, we don't offer investment advice. I mean, we are just third-party administrators and recordkeepers. But intuitively—I might defer to some of my colleagues here, but intuitively that just may not—I don't think you want to make it harder on small businesses. It sounds like it might make it harder, and then they are just going to say, well, gosh, you know, if I can't get any help, any assistance, and these things are expensive, it is just going to make it worse potentially. But like I said, I am not totally an expert in that specific area.

Ms. KUSTER. Right.

I didn't know if any of the other witnesses had anything to add to that.

Ms. CALIMAFDE. I have a thought on this, which is I think the problem the Department of Labor is getting at is if you have a plan with an institution, and you are dealing with a broker, it is probably human nature, or it may be human nature, that that broker would try to steer some of the employees in the plan more to the institutional's products than some other institution's product because the broker will get a greater commission.

So I think that is the issue, and the question is is this the best way to go about it, and my guess is it probably is not. It is a difficult issue, and I know like if every small business could afford to have an independent adviser, investment adviser, that would be the best way, but I would go at it almost completely the opposite way. I would say that a small business that has gone out and has found an institution that has X amount of assets under its investment, or—that they should not have fiduciary responsibility at all at that point. You know, so for instance if I go out to, you know, Vanguard or Fidelity, or name any of them, that that is—just by definition that institution should be releasing me from fiduciary responsibility versus me going to my uncle who has, you know, $1,000 under his own management and I say, here, manage my fund. Well, clearly I have breached my fiduciary responsibility if I am an owner sponsoring a plan.

Ms. KUSTER. Thank you very much.

Any other comments?

That was the gist of my concern, and I am concerned about this rule, that it will make it more difficult, more expensive for small businesses to be able to offer plans.

So on that I yield back and thank you, Mr. Chairman.

Chairman GRAVES. Mr. Rice.

Mr. RICE. Thank you, Mr. Chairman, and thank you, panel, for being here today. A lot of you came a long way, and appreciate your expertise.

I spent my professional career as a tax lawyer and a CPA. I set up a couple of these plans, but this area is so very complex, that it got to where I would just refer these people out rather than setting these things up. It is a specialty under tax law, and even people who practice, tax lawyers, are such nerds that normal lawyers don't even want to do that. So it is a very, very complex area, and just my observation would be anything we can do to relieve that complexity and liability on small employers is what we need to do.

Do you see these—a lot of breaches of fiduciary duty in your practices? Just curious. Do you see that as a big problem, employers stealing from or mismanaging these funds? Do you see that?

Ms. CALIMAFDE. I will start, but I am sure more—everyone should join in on this. And the answer is a resounding no in the small business area because this retirement plan is the primary way that that owner or owners are going to be able to save for their own retirement, because most small businesses can't be sold, or certainly not sold for enough money that they are going to be able to retire on it. And the whole world of nonqualified deferred compensation plans is not available to small business owners because of the Tax Code, so that means the retirement plan is their way to save for their own retirement. They have invested a lot of money into that plan. Why would they do anything that would jeopardize that—those investments? So, to me, I have always sort of felt like if you want to look at fiduciary issues, you are in the wrong place when you are in the small-business world.

And sometimes I kind of bristle when I hear about the sort of notion that these small-business owners are sort of these clueless blobs just out there without any idea what is going on with their money, or their plan, or, you know, any of this, and I just—to me it is—these are the folks who are running our entire economy to a large extent. These are people who have put their life on the line to start this business. Many of them have put their houses on the line to start this business. What makes us think that these people are incapable of understanding that they have got a lot of their savings in a retirement plan, and that they are not going to take care of it?

So I just start from the entirely opposite premise. We have—I can't think of a time that I have ever heard or seen in my practice any issues with fiduciary responsibility.

Mr. RICE. Nor I.

Mr. Messick?

Mr. MESSICK. Oh, I concur. I mean, we work with lots of quality investment advisers, and they are picking the fund line-ups from, you know, various places, and it is a total nonissue. Never an issue. And I think every business owner is smart enough to know that, you know, I don't think I am just going to offer a precious metals fund, and that is it, we will be fine. So it is really a nonissue.

Mr. RICE. And Ms. Collinson?

Ms. COLLINSON. The thing I would like to add is we are talking about small businesses and encouraging them to sponsor retirement plans. Our research has found that cost, administrative complexity, and concerns about the potential fiduciary liability are deterrents to them, and anything that we can do to help alleviate that is going to encourage them to sponsor plans and help their workers to save.

Mr. RICE. I totally agree, you know, and I think one of the problems we suffer from here in this job as legislators is we think that we need to issue all these laws to protect people from things that just aren't real problems, and that creates all these strict guidelines and creates jobs for you and myself as a tax lawyer and a CPA. And I think anything we can do to relieve all these strict requirements and regulations is what we need to do if we really want people to participate in this on a broader scale.

Thank you very much for being here.

Chairman GRAVES. Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman.

Ms. Calimafde, you noted in your testimony that about half of new businesses survive their first 5 years, and only about a third of new businesses survive for 10 years or more. You also said that no matter how much a small business owner cares about his or her employees, and we know that they tend to end up being like family, offering a retirement plan is often a secondary concern.

Do you or any of the other panelists know the percentage of new small businesses that offer retirement plans? And has a connection been found between the business' retirement plan offerings and its longevity?

Ms. CALIMAFDE. Well, we have some data. We don't have—anecdotally I can tell you in my practice it is clear that once a business—it is not longevity as much as once a business becomes profitable and stable, then right away they move into the retirement plan area if they can.

But we do know from this study that was done by Social Security, and it is cited in my testimony, that the size of the company makes a difference in how much coverage—how many of those businesses sponsor retirement plans, which is not surprising because the smaller the company, the more likely they are to be in that start-up phase. So we know that 46 percent of small businesses with more than 10 employees, but less than 25 offer a retirement plan. And we know 60 percent of small businesses with 25 employees, but less than 50 offer a plan. It moves up to 70 percent when you have 50 employees, but less than 100. It goes to 84 percent when you have 100. What we don't know in this particular study, we don't know the breakdown after 100, and most people think of small business as going up to 250 employees or 500 employees. So my guess is once you get up to the 250, you are at a level that is very similar to larger businesses.

So that is sort of a half answer for you, but there is no question if a business owner feels like he or she or they are fighting for their lives and can't make payroll, it is just probably not a good time to start talking to them about setting up a retirement plan.

Mr. PAYNE. Right.

Any of the other panelists?

Ms. COLLINSON. Yes. In our research, when we asked small-business owners why they don't plan to offer a plan in the next couple of years, the subject of business stability also comes up in terms of they are encountering difficult business conditions, which is a deterrent from setting up a plan. They are focused on staying afloat.

Mr. PAYNE. Okay. Please?

Mr. RUCKSDASHEL. Yeah, it has been my experience that the entrepreneur, the guy that starts the business, when he gets profitable enough to start generating his own cash flow, he is going to want to save it, and that is going to be when he realizes the best way for him to save it is through this retirement vehicle. And that is when he begins thinking about spreading this across to all his employees not only because of the regulations, but because, like it was said before, these are really his family. You know, they think about their employees as their family. And so it is not until they reach that profitability level that many of the people that I have been associated with really get into this opportunity. It takes a while to get to there.

Mr. PAYNE. Okay. You know, also in addition to incentives, how do we build awareness and support so that small-business owners make retirement offerings a priority?

Ms. CALIMAFDE. I have one idea. This is once we have got a stable company. The folks who pretty much bring the idea of the plan and the understanding of the plan to the small-business owners are very often the small-business advisers. So it could be a CPA, it could be their attorney, it could be an insurance fellow that they work with. But to the extent we can educate these advisers about how important it is to set up the plan as soon as they can, and how it brings along the employees and employees' savings to the 401(k) plan or the feature, that is really an audience we need to target is those small-business financial advisers or their CPAs, attorneys, saying, hey, you really need a plan; this is how you can do it.

And, you know, there is this sort of—the laws surrounding the plans are almost ridiculous, and I can say that working with them for years and years, but a small-business owner doesn't have to be an expert in retirement plans. They can go to an institution, and they can find a 401(k) plan and work with somebody to get that plan set up, or they can go to a TPA or their accountant. So it is not like we are requiring the small-business owners to become experts in retirement plan law. If that were the case, there would be no small business plans.

Mr. PAYNE. Thank you.

I yield back, Mr. Chairman.

Chairman GRAVES. Mr. Hanna.

Mr. HANNA. Thank you, Mr. Chairman. I want to ask about "vestages" rules. What do most of you consider, and how are they handled within the plans that you have?

Mr. MESSICK. I will answer that. Vesting, that applies where the employer makes a contribution, either a matching contribution or a profit-sharing contribution. They will subject that money to a vesting schedule, and what that usually means is—the most common one we see is like what we call a graded 6; zero, 20, 40, 60, 80, 100, so that after 6 years of employment that person is 100 percent vested in that money. If they leave early, 5 years, 80 percent. So they leave 20 percent on the table.

So it is designed to encourage some longevity with the employer. You know, it is that employee retention component. So it is a good thing. Now, in a Safe Harbor plan, money is 100 percent vested day 1, and that is just one of the deals.

Mr. HANNA. Right. I understand what is going on. What I want to get to, though, is if an employee—is it appropriate for an employer to use someone's vestages—vestage plan to create longevity, and if they earn the money the day they get there, shouldn't all plans perhaps be treated as Safe Harbor plans, especially in a climate where people change their jobs seven or eight times as opposed to, you know, my father and myself?

I want to ask another question, Ms. Calimafde. You mentioned that the top heavy rule, you thought, was biased. I don't know if that was the exact word you used, but I am very familiar with that. Why do you think that?

Ms. CALIMAFDE. Well, for starters it is based on the mathematical test, as you know. So if you—a small business generally has a significant amount of owners compared to employees, and so they almost always become top heavy. And, I mean, once you are top heavy today, nothing much happens, because the way the other rules in the Tax Code operate, you still have the same vesting schedule. If you are a Safe Harbor plan, you are basically at the same 3 percent level. So it is like—the reason why is because it is a mathematical test.

Mr. HANNA. But you said it was biased. I take exception to that. I mean, I think that what it really does is it guarantees that a single ownership, one boss, two bosses own the company, are put in a position where they can't treat themselves disproportionately better than their employees.

And in terms of we talked about things like fiduciary responsibility, there has to be some law there to protect the employee, because this is all they have for their life as they save it going through. I reference back to vestage rules.

The other thing is that we all remember Bernie Madoff. I know that he didn't have a lot of small companies perhaps or a lot of individuals, but the world is replete with fees in that particular business. Everybody looks good in that business; they all have the jargon down.

So if you don't like that, if you would like clean fiduciary responsibility rules, what do you do to save and protect the average guy who is working day to day, 8 hours a day, turns 55 years old and expects it to be there, and his employer borrowed that money out? Because we see every day the IRS going after the—for people who take FICA money, don't keep it in a separate account, and spend it, go broke, and there is no recourse. So people can borrow money out of a retirement plan, spend. If an individual can go broke, you said leave their job and not pay it back, what about a business that uses it, and can't pay it back, and borrows it because they are already in trouble?

Ms. CALIMAFDE. Well, very good questions, but let us go all the way back to the top heavy rules, because if your point is you need some kind of rules to make sure that the employees get contributions in the retirement plan, the Tax Code does that without the top heavy rules. That is why I say the top heavy rules are just like an old appendage that aren't needed. So the protection is built into the Tax Code, but it is built in in a number of different discrimination tests today. So 401(a)(4) provides that kind of protection, and 401(k) provides that kind of protection. So the Tax Code does protect non-highly compensated employees.

Mr. HANNA. It provides it if you use it, but you don't have to use it.

Ms. CALIMAFDE. Well, now, if you are positing what happens if you have a small business owner who doesn't pay attention to the brokerage house, or the insurance company, or the TPA and says, I am putting in whatever I want to—and, by the way, employers are not allowed to borrow against their retirement plans; that is a prohibited transaction. Employees are allowed to borrow against their own account balances if it is at certain limits. But, you know, if you are positing if a group of owners does everything wrong, well, are there folks out there? I am sure there are bad apples out there. Surprisingly, you would be, I think, I was surprised how much DOL is all over that. Employees can call the Department of Labor and say, I don't think my company is running this correctly, and very often that will trigger an audit.

But in my practice—and it may be because if owners are coming to me to say, how do I run my plan, then clearly they are not going to waste their money coming to me and then do just what they want. They just would skip coming to me and save my fees, so—and I think that is probably true of everyone on this panel, you know. Owners are not going to be coming to TPAs to find out what the rules are and then completely ignore them.

Mr. HANNA. My time has expired. Thank you, ma'am. Thank you all.

Chairman GRAVES. Mr. Collins?

Mr. COLLINS. I want to thank everyone for coming. And, Mr. Messick, I think you articulated that business owners make a calculation as to, in some cases, their benefits of participating, and certainly that is one of the incentives you get into a profit-sharing or a Safe Harbor contribution especially.

But I just want to share a story and see if you have heard anything like this. The medical device tax part of Obamacare took place January 1. It is 2.3 percent of sales, not profits. We talk about a 401(k) profit-sharing plan. If there is no profits, there is no 401(k) profit-sharing plan, 2.3 percent of revenue in many cases exceeds the profits of the company and has wiped the profits out. So you could have a fairly profitable company making 2-½ percent of sales in profits. Now all the profits are gone.

There is one local company in the Buffalo, New York, area that terminated their 401(k) plan the first of the year as a direct result of Obamacare, of the medical device tax. They had no choice; they have no more profits. Now, we are early on the first year of this. I am just wondering, would you see the sense of a company like that terminating their 401(k) when their profits are gone, call it an unintended consequence of Obamacare, but a consequence nevertheless?

Mr. MESSICK. I will answer that, not that we have any of those type of clients that I can think of, but it is obvious. If you are taking 2.3 percent right off the top, and that is obviously impacting your cash flow and your profitability, you are going to look for cost-cutting measures, period, and one of the first things you are going to do is you are going to look at the match in the 401(k) because that is low-hanging fruit. You are going to say, well, yeah, we were matching 50 cents on the dollar up to 6 percent or whatever. Well, at a minimum we are going to knock that back to 25 cents on the dollar versus spend it entirely.

But you are right, the law of unintended consequences is a huge law and one I am a firm believer in.

Mr. COLLINS. Yeah. Ms. Collinson, do you have——

Ms. COLLINSON. Yes, thank you.

In the work that we do, our annual survey of employers, we also do trend analysis in addition to the snapshot that I presented earlier, and looking at what happened with employer-sponsored retirement plans during the worst of times, from 2007 to 2012, there was actually some good news in there that employers were very, very reluctant to terminate their plans. What we did see was a significant percentage suspending or reducing their matching contribution, which any reduction in benefits is clearly disappointing. However, they—we saw—we did not see evidence of terminating their plan unless the business itself was going out of business.

Ms. CALIMAFDE. Can I sort of take your question and turn it around a little bit?

Mr. COLLINS. Not a problem.

Ms. CALIMAFDE. Though I can say that both of the groups that I am representing today are not in favor of the medical device tax, but when you talk about unintended effects, one of the things that we are very concerned about is in the analysis of how to reduce the debt, folks have spent a lot of time looking at this concept of tax expenditures, and the qualified retirement field gets a really big price tag next to the tax expenditure. And one of the things we are concerned about is if the amount of contributions allowed to retirement plan were to be cut back, or contributions being put into the plan now became taxable if your tax rate was over a certain amount, that might seem like, well, that is not going to have much of an effect, but in the small business-world that will have a tremendous impact.

And it is because of what we have been talking about when the owners are going through this analysis if—you know, folks sort of forget that the owners own the profit, and they don't have to give it to their employees. They could take it out as compensation, they could put it back in the business, or they could do some mixture of those. Well, if the cutback to contributions in the retirement plan area is significant, and you still have all the same costs and burdens, most owners, I think, would say, okay, we will take out the money as compensation, or we will put more money back in the company, but we are not going to put it in that plan, because the plan costs too much. It is just not a good deal for us.

And so what I am worried about is on one hand saying, well, we are going to get all of this revenue because the tax expenditure number is so high, and at the other hand you end up with the retirement security of millions of small business employees being affected; not the owners, the employees. And meanwhile, I think those numbers are really skewed because of the budget, that—the budget time period they are looking at, and if you ran out knowing that all that retirement plan money ends up coming back into the system again as taxable, I think you would find that the real cost is the cost of the time value of money and not that enormous price tag they are putting on it.

Mr. COLLINS. That is a point well made. I appreciate your comments and yield back, Mr. Chairman.

Chairman GRAVES. Mr. Huelskamp.

Mr. HUELSKAMP. Thank you, Mr. Chairman. I appreciate you having this hearing today. There are some folks that think we are not working. We certainly are on the House side. There might be some misimpressions based on perhaps the other Chamber.

But thank you, gentlemen, for being here. I appreciate the gentleman from Kansas. I might take exception with Overland Park being a suburb of somewhere in Missouri, but I will visit with the Governor about it. I hope you do live in the State of Kansas. The tax rates are very different, Mr. Chairman, as you know. But with that, a couple questions.

I think it was mentioned about the regulatory burden on what you all do that are in the business of advising and helping out, give a few examples. Can you repeat a few of those examples and others that you say, hey, this is a significant burden to limiting what small businesses are willing to do, and the cost, and the type of paperwork, and things that—as they always say, the longer the paperwork, the less likely folks are to read it. You probably see that. Could you give a few more examples and describe more, and I will ask at the end that you provide that stack of stuff that is required for the employer and the employee later to the Committee. So if you could share some more information on that front, whoever would like to answer that.

Ms. CALIMAFDE. Well, I will give you one example, and I am sure the folks to the right and left of me will be able to give you some more. One is this thing called interim amendments, and right now we are not getting hit with them that much, but that is simply because there hasn't been a number of laws recently in this area.

But what has happened is you all would pass a law, and IRS would then do—make—you know, do their regulations on it. And then IRS would say, okay, you have to go amend your plans now to incorporate the changes we just did in our regulations, which then meant in the private-practice world—and this goes to, you know, the huge institutions as well. So they may have 20,000 plans, they are sending out 20,000 of these interim amendments, you end up with an amendment going to the company that is, frankly, just gobbledygook. I mean, I could line up a bunch of ERISA experts, and they would say, who knows what this means. I mean, it is that bad.

So, you know, we are dancing on the head of a pin. This amendment gets sent out to the owners. There is usually a price tag with that amendment, because everyone can't do this for free, and you end up with owners saying to the TPAs or the institutions, what does this mean? Why are you giving this to me? And I am supposed to hand this out to my employees, and they are supposed to make sense of this?

So this was happening year after year after year, and the costs were getting significant, and you had a number of small-business owners who don't like notices to begin with, let alone nonsensical notices, and it was really getting bad.

Now, IRS is trying to figure out how to work their way around this, but one easy way is for you all, anytime you pass a bill where you are trying to help us out, which you do on a fairly regular basis in this area, it would be great to have something that says, and, by the way, no amendments are required to plans until the next time there is a restatement or for 3 years at least, or something, so that at least we have some breathing room from this kind of churning of crazy amendments.

Mr. HUELSKAMP. I will follow up on that. On the issue of paper versus electronic, that all has to be paper or in this particular instance?

Ms. CALIMAFDE. Well, right now the default is paper, and the default should today be electronic. And I don't know how many of you have looked at the required fee-disclosure notices that were handed out to employees. I mean, what a waste of trees. And it is just a shame because, you know, 10, 15, 20 pages of a notice, well, there is very few employees around who are going to be wading through that. If it had been done electronically with maybe a chart right in the front that someone could look at, we had a chance of them looking at it.

Mr. HUELSKAMP. Other comments?

I had one other general question. Do you see from the folks you work with any difference, generational differences? You know, if you are 30 and under, 40 and under, if you aren't doing this, you are out of luck. I mean, is the message getting there yet? Where are we at for younger folks which are going to be having to heavily rely on this, given the incapacity for Washington to meet these promises they have made? Yes?

Ms. COLLINSON. Okay. One thing that we found in our research of workers, comparing and contrasting the retirement outlook of different age ranges, and something that is really quite startling is workers in their twenties share very similar levels of retirement confidence as people in their fifties, which are presumably mathematically right about their parents' age. And what seems to be happening is workers are inheriting their parents' gloomy outlook. And part of the messaging that we need to work together to do is they have years, they have decades to plan and save, and they can change their retirement destiny; however, they, one, need to be shown the possibilities as well as have the ability to learn from their parents' successes as well as missteps so that we can change the course of history.

As we are looking towards legislative and regulatory changes that can help facilitate that, the clock keeps ticking, and it is up to each and every one of us to take greater levels of ownership of our own retirement outcomes.

Mr. HUELSKAMP. Thank you. I would be happy if you would provide a link to that summary, those attitudes. I would be very interested personally in looking at those.

I yield back. I thank you, Mr. Chairman.

Chairman GRAVES. Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Just kind of curious. You know, one of the statements that was made in one of the testimonies today, and I think it was Ms. Collinson, if I am not mistaken, with regards to people working past 65, there was some kind of interesting numbers there. It was like 59 percent people anticipate working past 65; is that correct?

Ms. COLLINSON. Of the small-company workers, yes.

Mr. LUETKEMEYER. Okay. Is this—do you have a reason for that? Are they just—they need the extra money? They are not ready to retire yet? They just enjoy working? All of the above?

Ms. COLLINSON. In most cases it is because they need or want the income or benefits.

Mr. LUETKEMEYER. Okay. So at this point the retirement benefit is not something that is attractive to them, not a reason to retire?

Ms. COLLINSON. They can't afford to retire.

Mr. LUETKEMEYER. Can't afford to retire, okay.

It is kind of interesting from the standpoint that, you know, we have a retirement program sitting there, and they are not wanting to take advantage of it because it is not good enough to retire on.

Ms. COLLINSON. Well, just to be clear, that is all small-company workers regardless of whether they are offered a plan or not. And even those who are offered a plan, the majority of workers in small companies and large companies are expecting to work past age 65 or not retire simply because they are afraid they haven't saved enough. And looking at account balances, I referred to the $92,000 median among baby boomers of small companies, they need to keep working.

Mr. LUETKEMEYER. With regard to the small businesses, I mean, they are taking a pretty good hit over the last 3 or 4 years. A lot of them probably can't financially afford to build into their business plans retirement benefits for their workers. I am just kind of curious, am I right in that? Is there a trend toward less retirement benefits for their workers, or are they being able to maintain that or—sir?

Mr. RUCKSDASHEL. Yes, I can speak to that. It goes back to profitability. It is not a desire to not offer it to employees. It is when I am being asked to match in a time when the business economy is slowing down, and my sales are going down, my margins are going down, I have got 1 or 2 percent to begin with. So it is no different than your question about the employees, why are they not taking advantage of retirement when they are worried about their retirement? It is because today is more important than tomorrow. So these workers can't—you know, they get to the end of the month, they don't have enough money, so let us put $100 or $50 away, well, that is just going to have to wait. It is the same thing with the employer. My profitability is going down, and so my contributions to my employees' retirement is going to have to go down.

Mr. LUETKEMEYER. So what you are saying is retirement benefits are great things as long as you can afford them, whether it is the employer or the employee?

Mr. RUCKSDASHEL. That is exactly right.

Mr. LUETKEMEYER. Thank you.

I will yield back. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Mulvaney.

Mr. MULVANEY. Thank you, Mr. Chairman.

I want to ask a little bit different line of questioning. Just out of curiosity—I ran, I have run several small businesses before I came here. Some of them did well enough, to your point, sir, about being able to offer these types of benefits to the employees. Others didn't; they weren't big enough, they didn't make enough money. I ran a restaurant, for example; we didn't offer retirement. And I would see these young people especially, but also we had folks at the upper end of the age scale, but young people especially coming in who weren't saving, and I didn't offer them anything, couldn't afford to do it.

How can we, as small-business people or as a small-business community, outside of the realm of an ordinary employer-sponsored plan—how could we encourage younger folks to start participating in these plans on their own? I throw that open to everybody because I don't know the answer to that question. I am curious about it.

I will ask the same question, by the way, while you are thinking about it, for older folks. We had folks come in who were near retirement, wanted to work just a little bit more, and they didn't participate either. They wanted to save a little bit extra, but figured, well, it is not worth it because I can't put enough away in a short period of time to help.

So I am curious about both ends of the spectrum just if anybody has any thoughts on that. Yes, ma'am?

Ms. CALIMAFDE. We have one thought, which is we call it the KidRoth, and the idea is today for people to make Roth contributions, there has to be earned income, and if you took away the earned income requirement for people, let us say, who are under

21, and you allowed—so, you know, a 2-year-old is allowed to have a Roth, and you could have grandparents and parents and aunts and uncles making small contributions into this KidRoth for that person. And you would have some special rules, so you couldn't take money out of this plan until you are 65, let us say, or maybe you modify it somewhat, but once you reach 65, you could take money out of it and get only capital gains treatment instead of ordinary income. You know, just sort of ways of using the Tax Code to inspire people instead of buying, you know, the latest, newest toy, I am going to put some money into this KidRoth. So that is an idea.

Mr. MULVANEY. Ms. Collinson?

Ms. COLLINSON. Well, one thing that we can do if a qualified plan or retirement savings plan is not available to the employee is most employers now use a payroll service that offers direct deposit——

Mr. MULVANEY. Correct.

Ms. COLLINSON. And direct deposit into multiple accounts. Well, what we can do is help educate people on the need to save, and, better yet, save for retirement, and, when they set up their direct deposit instructions, to set aside a certain amount that goes to savings, that goes to a savings account or an IRA, and the balance of their paycheck to go to their checking account. And by virtue of that, they are automating a certain element of savings, setting it aside every paycheck, and for many people, once that money is in a savings account or an IRA, it is much safer from withdrawals than in a checking account where, for many, it is fair game. That is just a very simple trick to get in the habit of saving.

Mr. MULVANEY. That is available now, and that is legal. What you mentioned, ma'am, is not. It was just an idea going forward.

Ms. CALIMAFDE. Right. It would require some changes to the laws.

Mr. MULVANEY. What about letting the kids opt out of Social Security? What about letting new folks who come in say, look, I am going to waive my rights to Social Security, but I am going to take that same 6, 7 percent, I am going to put that into an IRA for myself, under the theory that, historically speaking at least, they would be better off over the long run, plus they can choose when they want to retire; 62, 72, 82, it doesn't make any difference. What do you think about that? I would address you by name, but I have no idea how to pronounce it, so I am not going to try and embarrass myself.

Mr. RUCKSDASHEL. That is fine.

Mr. MULVANEY. I sit next to Mr. Luetkemeyer, and my name is Mr. Mulvaney. We feel your pain.

Mr. RUCKSDASHEL. They pronounce it Rucksdashel.

We have seen that already. In Texas, the teachers society opted out years ago from Social Security. They had their own Texas teacher retirement. They have their retirement plan, and they cannot benefit from any Social Security. Of course, my wife is bitter about that that she gets none of my Social Security, but that is another issue.

But in that particular case, if they can see—they can take that money that probably to a young employee today is skeptical that they will ever see it in Social Security. If they can see they are directing it, I think that is a very strong possibility.

Ms. CALIMAFDE. I would—I mean, I understand what you are saying, and it certainly has some merit, of course. The problem with it is that Social Security is a defined-benefit system, it is an annuity system, so you can't outlive those payments. And the qualified retirement plan system today is largely a defined-contribution system. So the two are sort of dovetailing quite nicely right now. I could see some people being concerned that if you went only to a Social Security system where it was based on contributions going in and not a guarantee that you would be getting annuity payments throughout your lifetime, that we would have removed a safety net for some people.

Mr. MULVANEY. Thank you very much. Appreciate your participation.

Thank you, Mr. Chairman.

Chairman GRAVES. I want to thank all of our witnesses for being here today. Obviously saving for retirement is always going to be a challenge, for Americans, and with an aging workforce and the uncertainty in Social Security, I think it is more critical than ever.

We appreciate the new data and everyone bringing in your ideas and thoughts, and we are going to continue to monitor this issue. And with that I would ask unanimous consent that all Members have 5 legislative days to submit statements and supportive materials for the record. Without objection, that is so ordered.

And with that, the hearing is adjourned. Thank you.

[Whereupon, at 2:31 p.m., the Committee was adjourned.]

# APPENDIX

TRANSAMERICA CENTER
FOR RETIREMENT STUDIES®

**Testimony of Catherine Collinson**
**President, Transamerica Center for Retirement Studies® and Transamerica Institute℠**
**before**
**The U.S. House of Representatives Committee on Small Business**

**Hearing on**
***The Challenge of Retirement Savings for Small Employers***

**October 2, 2013**

The Transamerica Center for Retirement Studies® ("TCRS") appreciates the opportunity to provide this written testimony in connection with the hearing of the U.S. House of Representatives Committee on Small Business on the issues related to retirement benefits provided by small business. TCRS commends Committee Chairman Graves and Ranking Member Velazquez for focusing on the particular concerns of small business and their employees.

TCRS is dedicated to educating the American public on trends, issues, and opportunities relating to saving and planning for retirement and achieving financial security in retirement. Its research focuses on how to educate and effect positive changes among the American workforce toward achieving greater levels of financial security in retirement. TCRS emphasizes savings trends among American workers and segments within the workforce, trends of employer-sponsored retirement plans and their participating employees, and the implications of legislative and regulatory changes.

TCRS® is a division of the Transamerica Institute℠ (The Institute), a nonprofit, private foundation. The Institute is funded by contributions from Transamerica Life Insurance Company and its affiliates and may receive funds from unaffiliated third parties. For more information about TCRS, please refer to www.transamericacenter.org.

***Pertinent Facts About Small Business***

Small businesses, firms with fewer than 500 employees, are the cornerstone of the United States economy. In 2010, small businesses represented more than 5.7 million employer firms, accounting for 99.7 percent of U.S. employer firms; approximately 55 million employees, representing 49 percent of private-sector employees; and 64 percent of net new private-sector jobs. From mid-2009 to 2011, small firms, led by the larger ones in the category (20 to 499 employees), accounted for 67 percent of net new jobs.[1]

***Role of Small Business Employers in Providing Workplace Retirement Benefits***

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.

[1] U.S. Small Business Administration, Frequently Asked Questions, September 2012, http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.

Employer-sponsored retirement savings plans play a critical role in facilitating and simplifying the savings process , making it attractive for American workers. The benefits of saving in an employer-sponsored plan (investment education, tax-deferred savings, the potential for employer contributions, fiduciary oversight), combined with the convenience of automatic payroll deduction, make American workers more likely to save for retirement through participation in an employer-sponsored plan versus contributing to an IRA.

Historically, public policy has supported employers in providing retirement savings plans to their employees, evidenced by the tax incentives passed by Congress both for employers to sponsor retirement plans and for employees to accumulate long-term savings through those plans. Today's tax system also helps to ensure savings will be available for retirement by placing restrictions on pre-retirement distributions and imposing tax penalties for most early withdrawals.

TCRS has completed its 14th Annual Transamerica Retirement Survey ("Transamerica Survey") of 750 employers, including 450 small companies (10 and 499 employees); 3,651 full-time and part-time workers, including 1,764 from small companies; and 610 unemployed or underemployed workers, including 332 from small companies.[2]

The Transamerica Survey found that small companies are less likely than large companies to offer a 401(k) or similar plan (e.g., SEP, SIMPLE). Additionally, small companies that offer plans tend to have fewer plan features. In order to better understand the gaps, the survey segments small companies (10 to 499 employees) into micro companies (10 to 99 employees) and small non-micro companies (100 to 499 employees). It also offers comparisons with large companies (500 or more employees).

The survey findings underscore the importance of workplace retirement benefits in helping small business workers ("workers") prepare for retirement. The vast majority of workers (88 percent) at small companies value retirement benefits as important. Of the small-company workers surveyed, 36 percent expect 401(k), 403(b) accounts, and/or IRAs to be their primary source of income when they retire. Other workers indicated that they plan to rely on Social Security (28 percent), followed by other savings and investments (20 percent), company-funded pension plan (seven percent), inheritance (three percent), home equity (two percent), and other (five percent).

The survey also found that 76 percent of small business workers who have access to workplace retirement plans participate in their company's defined contribution retirement plan.

***Small Business Retirement Plan Sponsorship Versus Coverage Rates***

Policymakers, experts, and the retirement industry seek to increase plan coverage among workers, specifically those of small companies. Much of this discussion has focused on encouraging more employers to offer a plan. However, the research shows plan *sponsorship* is not synonymous with plan *coverage*.

Plan sponsorship rates have been resilient and, in some cases, flourished in an extremely difficult economy. During the challenging years between 2007 and 2010, the number of firms with fewer than 100 employees declined by 5.6 percent,[3] while the number of defined contribution plans at companies of that size declined by only 1.5 percent.[4] During that same time period, the number of SIMPLE IRA plans increased by 11.3 percent.[5]

Calculating plan sponsorship rates can be elusive. Much of the reporting is derived from the IRS Form 5500 database, a tax form that is required by employers who sponsor qualified plans (e.g., defined contribution

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[2] Transamerica Center for Retirement Studies®, the 14th Annual Transamerica Retirement Survey. Employers, Workers, and Unemployed/Underemployed, 2013. www.transamericacenter.org.

[3] U.S. Census Bureau, Statistics of U.S. Businesses, 2010. http://www.census.gov/econ/susb/index.html.

[4] U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin Historical Tables and Graphs, June 2013. http://www.dol.gov/ebsa/pdf/historicaltables.pdf.

[5] Investment Company Institute. 2013. "The U.S. Retirement Market, First Quarter 2013" (June). http://www.ici.org/info/ret_13_q1_data.xls.

including 401(k), defined benefit, or other). However, many small businesses offer SEPs or SIMPLE IRAs, which are not required to file a Form 5500, and therefore, do not get counted.

The Transamerica Survey asked employers if they sponsored a 401(k) plan or a similar employee-funded plan (e.g., SEP, SIMPLE, other). Consistent with other studies, fewer small companies offer retirement benefits than large companies. However, the degree of the gap may be smaller than expected. The survey found:

- Seventy-two percent of small companies offer a plan, including:
  - Seventy-one percent of micro companies, and
  - Eighty-nine percent of small non-micro companies, compared to
- Ninety-five percent of large companies offer a plan.

Among the 28 percent of small companies that do not offer a plan, only 22 percent are likely to do so in the next two years. The most frequently cited reason for not planning to do so is cost (64 percent). In contrast, nearly one-third (32 percent) indicate they would be likely to consider joining a multiple employer plan offered by a vendor who handles many of the fiduciary and administrative duties at a reasonable cost.

A key to expanding coverage among workers of small companies is increasing plan *sponsorship* rates for micro companies. A key to expanding *coverage* among workers of all company sizes is encouraging existing plan sponsors to extend eligibility to their part-time workers.

TCRS' analysis revealed a pervasive gap in plan coverage: part-time workers. At small companies, only 36 percent of part-time workers say they are offered a 401(k) or similar plan compared to 68 percent of full-time workers. This coverage gap also persists among large companies.

As policymakers and industry seek to expand retirement plan coverage among American workers, it should be acknowledged that plan sponsorship rates are relatively high with room to grow and that part-time workers should be a special area of focus and attention.

***Plan Features Less Prevalent Among Small Business Plan Sponsors***

The Transamerica Survey found that plan features offered by small companies typically lag behind those offered by large companies. Increasing the availability of such features to small-company workers can help boost retirement security and their retirement outlook.

*Matching Contributions*

One of the most important features of a 401(k) plan is the employer's matching contribution, which incentivizes its employees to join the plan. Small companies (70 percent) lag behind large companies (86 percent) in offering matching contributions as part of their 401(k) or similar plan. In recent years, especially during the recession, there were widespread news reports of employers dropping their matching contributions. This year's survey found that while 14 percent of small companies had reduced or suspended their match, among them, six percent have subsequently reinstated it.

*Automatic Enrollment*

Automatic enrollment, a feature which automatically enrolls eligible employees into the plan with the ability for them to opt out, has been widely recognized as one of the most effective ways to increase plan participation rates. Small companies are far less likely than large companies to offer automatic enrollment:

- Nineteen percent of small companies have adopted automatic enrollment, including:
  - Eighteen percent of micro companies, and
  - Twenty-nine percent of non-micro companies.
- Forty-three percent of large companies offer automatic enrollment.

The median default contribution rate is three percent of annual salary among automatic enrollment plans offered by both small and large companies, which is consistent with the current safe harbor for automatic enrollment plans. It should be highlighted that three percent is low and sends a potentially misleading message to plan participants that it is adequate to meet retirement savings needs when, in most cases, it is not sufficient.

*Hybrid Funds*

Hybrid funds, such as target date funds, lifecycle funds, and strategic allocation funds, have become a staple in retirement plan investment options in recent years. These types of funds enable the plan participant to invest in a professionally managed fund that is essentially tailored to his/her years to retirement and risk tolerance profile. Forty-seven percent of small companies offer hybrid funds as part of their 401(k) or similar plan, including 46 percent of micro companies and 65 percent of small non-micro companies. In comparison, 79 percent of large companies offer hybrid funds.

*Retirement Transition Assistance*

Workers nearing retirement age face a myriad of difficult decisions regarding when and how they transition into retirement. Employers of all sizes share a tremendous opportunity to work with their retirement plan providers to offer resources and tools to these participants. While the majority of plan sponsors of all company sizes provide planning materials and information about distribution options, fewer than half offer financial counseling, pre-retirement seminars, or an annuity as a payout option as part of their plan.

***Post-Recession: The Retirement Outlook of Small Business Workers***

As the economy continues its recovery from the recession, savings rates among small business workers have remained steady while views and expectations about retirement have changed.

The majority of small-company workers (64 percent) said they are less confident about their ability to achieve a financially secure retirement since 2008. Many small-company workers (40 percent) now expect to work longer and retire at an older age, a slightly higher percentage than that of large-company workers (37 percent).

Fifty-five percent of small-company workers are confident that they will be able to fully retire with a comfortable lifestyle, including 11 percent who are 'very confident' and 44 percent who are 'somewhat confident.'

The majority of small-company workers (59 percent) plans to work past age 65 or does not plan to retire. Workers of micro companies (61 percent) are slightly more likely to plan to do so and those of large companies (56 percent) are slightly less likely.

The majority of small-company workers (55 percent) plans to continue working after retirement, 45 percent plan to work part-time and 10 percent full-time. Workers of large companies (52 percent) are slightly less likely.

Among the small-company workers who plan to continue working in retirement, two-thirds (66 percent) plan to do so because they want or need the income or health benefits.

Delaying retirement and/or continuing to work in retirement is an important way to continue generating income, bridge savings shortfalls, and stay active and involved. However, an alarmingly few small-company workers (20 percent) have a backup plan if retirement happens unexpectedly due to health issues, job loss, or other unforeseen circumstances. Fewer large-company workers (18 percent) have a backup plan.

***Retirement Savings Habits of Small Business Workers***

Among workers who are offered a 401(k) or similar plan, the participation rate of small-company workers (76 percent) is slightly less than for large-company workers (79 percent). However, there is a wide disparity between micro-company (71 percent) and small non-micro-company workers (83 percent).

This disparity in participation rates among workers of different company sizes may be explained, in part, by whether the employer utilizes automatic enrollment, a feature which drives higher participation. Larger companies are far more likely to automatically enroll employees than micro companies.

Among employees who participate, the median annual salary deferral rate is slightly higher among small-company workers (eight percent) compared to large-company workers (seven percent). This may be partly explained by the prevalence of automatic enrollment in larger companies, which in most cases, enrolls employees at a three percent salary deferral rate, thereby bringing down the median deferral rate.

Small-company workers (13 percent) are less likely than large-company workers (19 percent) to have taken a loan from a retirement plan. Of the small-company workers who did so, 41 percent cite paying off debt as the reason. Only four percent of workers of all company sizes took a hardship withdrawal in the past 12 months, with the most frequently cited reason being to prevent eviction from primary residence (31 percent). Among the unemployed and underemployed who had a 401(k) or similar plan at their most recent employer, 42 percent of small-company workers and 44 percent of large-company workers have taken withdrawals from their accounts.

Perhaps the ultimate measure of a worker's retirement outlook is his/her level of household savings in all retirement accounts. The 2013 estimated median household retirement savings among Baby Boomers, the generation closest to retirement, is lower among small-company workers ($92,000), including $94,000 among micro company and $88,000 among small non-micro company workers. Baby Boomers employed by large-company workers have saved more ($113,000). These 2013 savings levels represent a significant increase from 2007, when the estimated median household retirement savings among Baby Boomers was just $60,000 for small-company workers and $91,000 for large-company workers.

*Inspiring Small Business Workers to Learn More About Saving and Investing*

Workers reported what would motivate them to learn more about saving and investing for retirement would be simplifying the topic with a good starting point and educational materials that are 'easier to understand.' Larger tax breaks and incentives for saving in a retirement plan and a financial advisor were also frequently cited motivators among workers.

Tax incentives can be powerful motivators for people to save for retirement – but only if they know about them. Among workers of all company sizes, awareness of the Saver's Credit is low. Only 23 percent of small-company workers and 25 percent of large-company workers are aware of this important tax credit for low- to moderate- income tax filers who save in a qualified retirement plan or IRA. Awareness is lowest among micro-company workers at 20 percent.

The majority of small-company workers (56 percent) would like more information on how to reach their retirement goals, yet only 42 percent of employers believe this to be the case. There is an opportunity to close this disconnect: only 11 percent of small-company workers had spoken to their employer about retirement benefits and only 29 percent of small-company employers had surveyed their employees on the topic.

***Recommendations: A Seven Step Plan to Increase Retirement Security***

Small businesses they have diverse business circumstances, unique retirement plan-related needs, and differing concerns about costs. As policymakers seek to increase retirement security among workers, the most effective solutions are best accomplished by offering a variety of cost-effective solutions, within the context of the existing system and available to all plan types, to address these needs and concerns.

Seven steps toward increasing retirement security in small business include:

1. *Increase plan sponsorship rates*
   Plan sponsorship rates are lowest among companies with fewer than 100 employees and, therefore, should be an area of focus. Solutions to increase plan sponsorship rates include:
   a. Additional tax incentives to help offset the cost for small employers to establish new retirement savings plans. Increase the available amount and number of years for the start-up tax credit which currently allows small businesses to claim a tax credit of up to $500 for three years for establishing a retirement plan.
   b. For small businesses in which a stand-alone 401(k) plan is not feasible, consideration should be given to enabling and providing incentives for them to join a multiple employer plan (MEP). To be effective, a MEP 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 liability for the acts or failures to act of other employers participating in the plan, and (2) provide tax incentives for employers and employees to encourage participation. MEPs tend to provide standard plan terms, and therefore, employers that want plan design flexibility, such as by offering a more robust investment menu, should continue to offer their own plans.

2. *Expand plan coverage among part-time workers*
   Many employers who sponsor a retirement plan exclude part-time employees from being eligible to join the plan. Potential reasons for employers choosing to exclude their part-time employees include cost, administrative complexity, and difficulties in passing non-discrimination testing. Solutions to create incentives and/or reduce impediments include:
   a. Additional tax incentives and safe harbors from non-discrimination testing.
   b. Lower or eliminate required top-heavy minimum contribution for part-time workers.
   c. Provide relief from being a Form 5500 "large plan filer" if the reason that the plan has more than 100 participants is covering part-time workers.

3. *Increase default contribution rates in plans using automatic enrollment*
   The current minimum default contribution rate in the safe harbor, which range from three percent to six percent, sends a misleading message to plan participants that saving at those levels are sufficient to ensure a secure retirement. A new automatic enrollment safe harbor, under which employees are enrolled at six percent (increasing to eight percent, then 10 percent), which also provides a tax credit for adopting it, could drive up plan sponsor adoption rates and participant savings rates.

4. *Promote and expand the Saver's Credit*
   The Saver's Credit is a meaningful incentive for low- to moderate-income Americans to save for retirement. However, many are unaware of it. Recommendations include: promoting the Saver's Credit and expanding it by raising the income eligibility requirements so that more tax filers are eligible.

5. *Reduce leakage from retirement accounts*
   Extend the 401(k) loan repayment period for terminated plan participants and eliminate the six-month suspension period following hardship withdrawals.

6. *Illustrate savings as retirement income on retirement plan account statements*
   Require retirement plan statements to state participant account balances in terms of a lifetime income stream as well as a lump sum to raise awareness of savings needs. Such illustrations demonstrate that while lump sum amounts sound large, when translated into lifetime income, they are revealed to be much smaller. This can help participants realize that they need to save more. The illustrations also help educate participants about the importance of ensuring that their savings will last throughout their life.

7. *Facilitate retirement savings to last a lifetime*
   Proposals that help participants both manage their investment risk and ensure their retirement savings will last their lifetime are encouraged, including facilitating the offering of in-plan annuities and annuities as a distribution option. Investments such as annuities will enable an employee to shift the investment risk and risk of outliving his or her retirement savings to the annuity provider.

***Conclusion***

Workplace retirement benefits play a vital role in helping workers save for retirement. The workplace retirement savings system has succeeded in serving as the preferred method of saving for retirement for millions of workers. However, more work can and should be done by policymakers, industry, and employers to improve the current system.

There are many opportunities for enhancements to retirement plans that are well within reach and not necessarily time consuming and costly to implement. The notion that there could be a single solution for retirement security seems impossible. However, many meaningful steps can be taken and improvements made that have the potential to dramatically improve Americans' retirement readiness.

TCRS commends Committee Chairman Graves and Ranking Member Velazquez on their consideration of the particular challenges and needs of small businesses in providing and maintaining retirement savings plans for their employees as the economy continues to recover.

TCRS appreciates the opportunity to present its survey findings on the challenges faced by small business and its suggestions to help alleviate some of the issues.

SMALL BUSINESS COUNCIL OF AMERICA

SMALL BUSINESS LEGISLATIVE COUNCIL

# The Challenge of Retirement Savings for Small Employers

Statement of

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Member of the Board of Directors of the Small Business Legislative Council

Before the
United States House of Representatives
Committee on Small Business

October 2, 2013

The Small Business Council of America (SBCA) and the Small Business Legislative Council (SBLC) appreciate the opportunity to submit testimony to the House Committee on Small Business.

The 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 provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Advisory Boards, many of whom are the leading experts in employee benefits law and how that law impacts small and family-owned businesses.

The SBLC is a 35 year old permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

Mr. Chairman and Members of the Committee, I am Paula Calimafde, Chair of the SBCA and a member of the Board of Directors and past Chair of the SBLC. I am also a Principal at the law firm of Paley Rothman and chair of the firm's Employee Benefits and Retirement Plans practice groups. As Chair of the SBCA and a member of the Board of Directors of the SBLC, I am here to present our views as to how small business retirement plan coverage can be increased as well as how employees can be incentivized to increase their savings inside those plans so as to increase the retirement security of our country's employees. I would also like to thank Larry Eisenberg, Esq. for his ideas on how to encourage employee savings.

**Introduction**:

Longer life expectancies are requiring increased retirement savings. Individuals of all economic levels are far more likely to adequately save for their retirement if they participate in some form of retirement plan. According to research done by EBRI for the American Society of Pension Professionals and Actuaries (ASPPA), **workers are 14 times more likely to save in a retirement plan offered by their employer than to save through an IRA.**[1] By using payroll deductions, employer sponsored retirement plans encourage savings because they automatically remove the money before it ever goes into the employee's pocket.

The retirement security of our nation's employees is intended to rest primarily upon three sources – often referred to as the three legged stool – Social Security, the voluntary private retirement system and individual savings. As we know, Social Security is basically a defined benefit system and payments are based upon an annuity type of framework – i.e., one cannot

[1] The American Society of Pension Professionals and Actuaries, Tax Reform Shouldn't Harm Main Street's Retirement Plan (April 19, 2013), http://www.asppanews.org/2013/04/19/tax-reform-should-not-harm-main-streets-retirement-plan/

outlive payments from Social Security. By design there is very little flexibility in this system and it was primarily designed to serve as a safety net. The voluntary private retirement system is now primarily based on a defined contribution system and the methods of payments can include annuities, instalments (most often through an IRA), lump sums or a combination of one or more of these methods. The private retirement system, though highly regulated by the Department of Labor and the Internal Revenue Service, contains sufficient flexibility to allow an employer to design a retirement plan that fits the needs of the employer and its employees.

Today there is concern for the viability of the Social Security system, though most experts believe that with some relatively minor, but probably politically painful, shoring, it could be kept viable for the foreseeable future. Regardless, Social Security should not be solely relied on for retirement security. The Social Security Administration reported that, in 2012, the average annual social security benefit for a retired worker was $14,760.

Thankfully, the second "leg of the stool" – the private retirement system – is doing quite well. This success is primarily the result of a series of laws (sometimes referred to as the "Portman-Cardin" laws) which recognized that the system had become too complex and costly without providing enough upside for small and mid-size businesses to join it and largely corrected those problems. As reflected in the ASPPA statistic cited above, a significant portion of our individual savings are done inside a 401(k) plan, 403(b) plan or SIMPLE IRA. This fact holds true not only for wealthier individuals but also for the average American worker. 71.5% of individuals who make between $30,000 and $50,000 contribute to an employer plan when offered, whereas only 4.6% of individuals in the same income bracket contribute to an IRA.[2]

It would appear that there are at least three factors responsible for the success of employee saving in retirement plans. First, it is clear that payroll deduction is an "easy" or "painless" way to save. It is done automatically by the employer and thus, the employee does not have to do anything to get the money into the savings vehicle. Second, it is easier not to spend money or conversely to save it when one does not have it in his/her pocket. Third, with respect to the 401(k) and 403(b) plan, the employee does not have easy access to the saved money so that it continues to grow tax free.

The availability of retirement plans is therefore central to helping employees save. When an employer offers a retirement plan, most employees will participate. These high "take-up" rates are true regardless of the size of the employer. A recent study,[3] which used actual data from employees' W-2 forms, found that **81% of employees working for employers with 100 or more employees take advantage of an offered retirement plan and that 79% of employees working for employers with less than 100 employees take advantage of being able to make employee contributions into the qualified retirement plan**. Although these rates are good, maintaining and continuing to increase these numbers is important.

[2] The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, http://asppa.org/savemy401kfactsheet

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

Auto-enrollment, which automatically enrolls an employee in the plan unless they opt out, and auto-escalation, which automatically increases an employee's contribution to the plan unless they opt out, are important options that an employer can utilize to increase employee participation in a plan. The success of auto enrollment and auto escalation is somewhat startling.[4] Those of us in the trenches believe that inertia is the key to their success – i.e., an employee would rather stay enrolled in a retirement plan because it is easier to do so than to opt out and it is easier for employees to allow the amount of their contributions to increase over a number of years than to affirmatively take steps to decrease the amount. Additionally, educating the entire workforce, particularly the younger workers, of the importance of saving for retirement is key to maintaining the high take-up rates that we see today.

**Because employees save better in a retirement plan, and because employees are likely to participate in a plan when given the option, encouraging employers to sponsor retirement plans is critical in creating retirement stability.**

Small businesses face particular challenges when it comes to sponsoring retirement plans. Small businesses have long been at the heart of the American economy. However, small business owners are focused on the challenges of maintaining their businesses and the relative cost of sponsoring a plan is far greater for small businesses than it is for large companies. In 2012, the Small Business Administration reported that only about half of new businesses survive their first five years and only about a third of new businesses survive 10 years or more.[5] **No matter how much a small business owner cares about his or her employees, offering a retirement plan is often a secondary concern to the survival of the buinsess and the decision of whether to offer a plan comes down to a cost benefit analysis. Once small businesses survive the initial period of uncertainty and become more established they are far more likely to sponsor a retirement plan.**

Despite the challenges, many small businesses still offer plans and make meaningful contributions for their employees. Unfortunately, there is a problematic misconception that plan sponsorship among small businesses is very low. In fact, the small business qualified retirement plan system has been quite sucessful in providing retirement security for its workers. **In the study[6] which used actual data from employees' W-2 forms, the researchers found that 77% of all employees who work in companies with 10 or more employees are offered a retirement plan and that of these employees, 62% made 401(k) contributions.** The size of the company makes a significant difference. W-2 data reflects that 46% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that

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[4] Jack VanDerhei and Lori Lucas, The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy, Employee Benefits Research Institute, Issue Brief No. 349 (November 2010), http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No349_EBRI_DCIIA.pdf

[5] Frequently Asked Questions, Small Business Administration, Office of Advocacy (September 2012), available at http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf

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

60% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 70% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 84% of businesses with more than 100 employees offer a retirement plan. There is no further breakdown given for over 100 employees so we do not know how many small to mid-size businesses – often defined as up to 500 employees offer plans compared to the larger businesses.

It is interesting to note that the reason why this study shows higher retirement plan coverage than is reflected in other studies is because this study relied upon actual W-2 data to determine if an employee was covered by a plan. Most other studies have relied upon surveying employees to find out if they were covered by a retirement plan. Once again, those of us experienced in this area are not surprised by the marked discrepancy between employees who report they are not covered by a plan compared to the actual data. One would think that an employee would know if he or she was making employee contributions into the plan but this is not the case. Perhaps even more obscured for many employees is that their employer is making contributions for them whether through a match or by a non-elective employer contribution (aka profit sharing contribution).

**In light of the cost to a small business of offering a plan and the large number of employees who are actually covered by the qualified small business retirement plan system, any changes that would make plan sponsorship more costly or burdensome, or otherwise motivate employers to freeze or eliminate the plans could have significant and detrimental long term repercussions. This is highlighted by considering the demographics of the employees who participate in retirement plans – nearly 80% of all plan participants make under $100,000 per year and 43% of all participants make less than $50,000 annually.**[7]

**What Motivates Small Businesses to Sponsor Plans?**

There are a number of elements that small business owners weigh when deciding whether to sponsor a plan. Small businesses have a unique place in the qualified retirement plan system. Unlike large businesses, most small businesses are closely held and most small business owners do not anticipate being able to sell their businesses as a means of funding their retirement. Also, the non-qualified deferred compensation plan heavily utilized for key management employees in larger businesses is not available to smaller businesses because of unfavorable tax treatment. **Because of this, one of the primary motivations for small business owners to sponsor a plan is that participating themselves is the best way to save for their own retirement. Most small business owners view the costs of sponsoring a plan and the meaningful contributions that are made for the non-key employees as the price of admission to be able to save in a qualified retirement plan for themselves. Employee recruitment, retention and morale are also positive factors that the owners take into account when deciding whether to sponsor a plan.**

There are, however, significant costs for a small business to sponsor a plan. Thus, a small business owner's decision of whether to create or continue to sponsor a plan often comes

[7] The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, http://asppa.org/savemy401kfactsheet

down to a cost benefit calculation. In short, the benefit to be derived by the business owners must equal or exceed the costs and burdens of sponsoring the plan in order for the owners to decide to adopt a qualified retirement plan. Some of the factors taken into account by small business owners when deciding to sponsor a retirement plan include the employees' preference for cash or health care coverage (i.e., lack of appreciation by the employees for contributions made by the employer into the retirement plan for their benefit), the uncertainty of the business' revenue from year to year, the costs of setting up the plan and the ongoing costs of administering it and the amount of the required company contributions. When asked what could break down these barriers, the following answers are often given by small businesses: repeal the top-heavy rules, reduce administration, and change the lack of employee demand by educating employees about the need to save for their retirement now. Some small business owners report that until they are more profitable and stable, nothing will convince them to sponsor a retirement plan. We consistently hear from our members **that any decrease to the owners' and key employees' level of benefits would significantly affect their cost-benefit analysis and cause many to walk away from sponsoring a retirement plan.**

Some small business owners engage in this calculus on their own, while many rely on accountants and other financial advisors to help them weigh the pros and cons of sponsoring a plan. **The success of the small business retirement system is largely dependent on federal tax laws. The contribution limits for both employees and employers and the tax deferrals are usually central to tipping the scale in favor of plan sponsorship.**

A criticism sometimes aimed at the retirement plan system is that the contributions for the non-highly compensated are not significant. Practitioners who work with qualified retirement plans know better, at least as far as small businesses are concerned. If the highly compensated employees, including the owner, are going to receive meaningful benefits, the rules governing the qualified retirement system require the employer to also make meaningful company contributions for all non-highly compensated employees. Since a major goal of a retirement plan is to provide retirement security for the owners (and in most cases, is the only way they can save for retirement through their company), it is not at all unusual for a small business to contribute in the range between 3% and 10% of compensation for the non-highly compensated employees. This means that it is not unusual for a small business employee to, in effect, receive a bonus, albeit one given to the retirement plan, in an amount of at least 3% of their annual compensation but often equal to 5%, 7.5% or even 10%.

**In the recent discussions on how to raise revenue (and conceivably lower tax rates through tax reform), the deduction for retirement plan contributions has been treated the same as other tax expenditures in the tax code. This is a mischaracterization because retirement plan contributions are eventually brought into income, along with any earnings.**[8] There are approximately 670,000 private-sector defined contribution plans covering

[8] A study prepared for the American Society of Pension Professionals & Actuaries reflects the value of the retirement plan tax expenditure to be roughly 55 – 75% lower than estimates by the Joint Committee and the Treasury. This study assumes that people will enjoy lower income tax rates during retirement than when contributions are made to the retirement plan. This assumption, increases the value of the "tax expenditure." Many experts believe, however, that tax rates are going to be higher for most taxpayers in the future and that the "real" cost of the retirement plan tax expenditure is even lower than that set forth in the ASPPA report. Xanthopoulos and Schmitt, Retirement Savings and Tax Expenditure Estimates, ASPPA May, 2011.

approximately 67 million participants and over 48,000 private-sector defined benefit plans covering approximately 19 million participants. The U.S. private retirement plan system paid out over $3.824 trillion in benefits from 2000 through 2009 and U.S. public sector plans paid out $2.651 trillion during the same period. All of this money was brought into income and subject to regular income tax rates (the only exception would be money that was contributed on an after-tax basis). **The only loss to the government with respect to the deduction for retirement plan contributions and tax free growth inside the plan is the time value of money. But the potential detrimental impact on savings by Americans due to a reduction on contributions to retirement plans could be huge.**

<u>Simplifying the Retirement Plan System to Motivate Plan Sponsorship</u>:

**A major disincentive for a small business owner to sponsor a plan is the heavy administrative requirements (such as notice requirements, top-heavy rules and discrimination testing) which can often be very burdensome for the employer and tip the scales against sponsoring a plan. Many of these administrative requirements could be eliminated or simplified without negatively impacting the participants.**

***Repeal or Revise Top-Heavy Rules***

One of these areas which is ripe for simple and meaningful changes is the top-heavy rules for defined contribution plans. When first enacted the top-heavy rules imposed additional minimum contributions and accelerated vesting on small and mid-size retirement plans which were almost always top-heavy due to the mathematical tests used to determine such status. Over the years, the rules have changed so significantly that the top-heavy rules are now an archaic appendage similar to that of the appendix in the human body – they do nothing but cause problems.

Nevertheless those who are not immersed in the technicalities of retirement plan law insist that the top-heavy rules still operate so as to benefit non-highly compensated employees. This inaccurate, but persistent, view has resulted in inertia on the Hill when it comes to repealing these unnecessary and complicated rules. Because this is unlikely to change, the following proposals have been developed so as to try to ameliorate the more negative aspects of the top-heavy rules. However, these ideas would not accomplish the goal nearly as effectively as outright repeal of these obsolete rules for defined contribution plans.

**One way to improve the system would be to eliminate top-heavy contributions for plan participants with less than one year of service so that employees are allowed to make 401(k) contributions during their first year.** Because of the top-heavy rules, small and mid-size plans that are top-heavy cannot allow recent employees into the 401(k) portion of their profit sharing plan without these employees receiving an employer contribution even though they have not met the requirements for the regular "profit sharing contribution." Thus, even though from a policy viewpoint we would want to encourage new hires to start saving for their retirements as soon as possible, the top-heavy rules do not allow this result. Enactment of the change above will result in more participation in the 401(k) plan sooner rather than requiring employees to be at the company for a year before being able to enter the 401(k) portion of the retirement plan.

The one year wait is the "typical" wait for eligibility for entry into small retirement plans and this is because of the top-heavy rules. Eliminating the wait would allow more small business employees to start participating in the 401(k) portion of the plan sooner.

401(k) plans are a tremendous success story. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much does the employer contribute. Employees meet with investment advisors to be guided as to which investments to select, employees have 800 numbers to call or websites to visit to see how their investments are doing and to determine whether they want to change investments. 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 probably not an exaggeration to say that the 401(k) plan brought Wall Street to main street and that it has provided employees with the education needed to effectively invest.**

The forced savings feature of the 401(k) plan cannot 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. Some retirement plans allow savings to be removed by written plan loan which cannot exceed 50% of the account balance or $50,000 whichever is less. Savings can 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 or a SIMPLE IRA (an employer sponsored IRA program) where the funds can be accessed at any time for any reason. True, funds removed will be subject to an early withdrawal penalty (which is also the case for a hardship distribution from a 401(k) plan), but anecdotal data suggests that individuals freely access IRAs and SEPs (also an employer sponsored IRA program) and that the early withdrawal penalty does not seem to represent a significant barrier. Nevertheless, there is a distinct difference between asking the employer for a loan or a hardship distribution and having to jump through some statutorily and well placed hoops versus simply removing money at whim from your own IRA.

**Another change would be to allow small and mid-sized companies to sponsor employee pay-all 401(k) plans without the 401(k) contributions made by key employees triggering the top-heavy rules.** Under current IRS regulations, when a key employee makes a 401(k) contribution, that employee contribution is deemed to have been made by the company and the company is then required to make top-heavy contributions for the non-key employees. Because of this rule, small to mid-size employers who would like to offer 401(k) plans must either commit to make company contributions to non-key employees or to exclude key employees from participation in the 401(k) plan. Many companies cannot afford to make company contributions and most owners will be unmotivated to offer plans in which they, and other key employees, cannot participate. Thus, from a policy viewpoint, employees who might have made 401(k) contributions are not given the opportunity because of the significant barriers that stand before small to mid-size company offering this type of plan. **Many members of Congress seem to not understand that most small business owners are not interested in incurring additional expenses and administrative burdens if there is no upside for them. Employees of small or mid-sized employers would certainly be far better off having an employee pay-all plan, in which both key and non-key employees could contribute without**

**creating a required contribution for the company, than having no plan at all.** Under such a scenario, the regular anti-discrimination tests would still apply to offer protection for non-key employees. Larger companies (which because of the mathematical tests are never top-heavy) can sponsor employee pay-all 401(k) plans. This rule unfairly discriminates against small businesses and their employees. A change to this rule would allow more small business employees access to a 401(k) plan and level the playing field between larger and smaller business entities.

***Simplify ADP Testing***

Another area ripe for simplification is the 401(k) discrimination testing, known as the "ADP" tests. The anti-discrimination rules for 401(k) plans (the ADP tests) are more complicated than needed. For instance, the tests set forth in the proposal referred to as the "ERSA" (Employer Retirement Savings Accounts) would satisfy the policy goals of the ADP while reducing some of the complexity currently inherent in these tests. This could be an optional ADP test so that companies who are able to deal with the current ADP tests are not required to change retirement plan documents, software and procedures.

The ERSA proposal calls for the contribution percentage for eligible highly compensated employees (HCEs) for the plan year not to exceed 200% of such percentage for the non-highly compensated employees (NHCEs) if the contribution percentage of the NHCEs does not exceed 6%. If the contribution percentage of the NHCEs exceeds 6%, then no testing would be required. The proposal also has two safe harbors to avoid the simplified nondiscrimination test which are similar to the current 401(k) safe harbors.

***Eliminate Safe Harbor Notices for 401(k) Safe Harbor Match and 3% Non-Elective Safe Harbor Notices***

These notices, both required by statute, are costly and burdensome. The match safe harbor notice does serve a policy purpose in that it can affect the amount of 401(k) deferrals an employee may choose to make in order to receive the match. However, rather than yearly notices, the notice could stay in effect unless and until revoked. The notice could be part of the Summary Plan Description.

The safe harbor notice for the 3% non-elective safe harbor serves no policy purpose at all and should be eliminated as soon as possible. Eliminating these unnecessary notice requirements would reduce the burdensome paperwork that pose a barrier to small businesses sponsoring a plan.

***Eliminate Required Minimum Distributions (RMDs)***

It makes no sense to require individuals to remove funds from an IRA or retirement plan prior to their retirement or when not needed. **Presently the law requires small business owners (*and only small business owners*) to start receiving RMDs *while they are working.*** The demographics of the group comprised of small business owners are such that money saved in a plan or an IRA will be crucial to their retirement security.

Further, all IRA owners must start removing money from their IRAs whether needed or not by the April 1st following the calendar year in which they attain the age of 70 ½. Life expectancy appears to be increasing dramatically, particularly for the oldest sectors of our population. There is no reason why the tax code should be forcing people to remove money that is intended to provide retirement security before it is needed. Worse, it is likely that the withdrawn money will be spent rather than growing tax deferred inside the IRA. It is essential that the money be available to the IRA owners when they reach the ages of 85, 90 or beyond.

**Eliminating required minimum distributions and allowing participants more control after the age of 59 ½ will also help to simplify the tax code. At a minimum, the lifetime RMD requirements should be eliminated with RMDs required post-death (similar to Roth IRAs). If the RMD rules are not eliminated, the 70 ½ beginning date should at very least be pushed back to 75. All of the ideas above would help to ensure that individuals will have enough savings for their retirement taking into account increasing longevity so they will not have to rely upon the government for their welfare. The goal is to keep the money in the IRA or plan for as long as possible until needed. One way of encouraging people to keep their money in the plan or IRA for as long as possible would be to have RMDs taxed at capital gains rates.**

***Incentivize Employee Contributions via Lottery Contributions***

With a few legal changes, one way to increase participation by non-highly compensated employees in a retirement plan would be to allow employers to run lotteries which would encourage participants to save in the plan. These employers could offer cash awards in the form of additional employer contributions or direct bonuses to randomly selected winning employees. Non-highly compensated employees could become eligible for selection by contributing to the 401(k) plan at certain minimum rate (for example 3%). The "lottery" would be open only to non-highly compensated employees and the "winnings" would be non-forfeitable and, if paid in cash, would be taxable as income but not treated as subject to a cash or deferred arrangement. The prospect of winning would encourage employees to make 401(k) contributions and would allow employers who may not have enough funds to offer a match for every employee, or who simply have additional money that can be allocated to the plan, to incentivize plan participation. The idea behind this proposal would be to make savings more "fun" and to piggyback off of the success of the current lottery system.

In order to allow for such a "lottery" the law would need to be amended to make it clear that Code Section 415 limits do not apply and do not cause other contributions to violate Section 415 limits (similar to catch up contributions). Further, it would be important to make clear that these lotteries are not subject to Code Section 401(k)(4)(a)'s contingent benefit prohibition. On the other hand, an employee's winnings would be taken into account when performing the 401(k) discrimination testing.

***Eliminate the 401(k) Contingent Benefit Prohibition for Non-Highly Compensated Employees***

The law currently prohibits employers from offering benefits that are contingent on 401(k) deferrals. However, there is no compelling reason for having this rule apply to non-highly compensated employees. If this restriction was eliminated, employers could encourage non-highly compensated employees to make 401(k) deferrals by providing non-401(k) benefits, such as vacation days or stock options, based on how much the non-highly compensated employee contributes to the plan.

***Allow "KidRoths"***

Considering the amount of money that an individual must put away to have adequate retirement savings when the time comes, it is important to encourage retirement savings to commence as early in life as possible.

Theoretically children are allowed to fund IRAs, however, in order to do so these children must have earned income, which most do not. Eliminating the earned income requirements for individuals under the age of twenty-one would permit these children to begin saving early in Roth IRAs and would allow parents, grandparents and other friends and family to make gift contributions up to the Roth IRA contribution limit to fund the child's IRA.

In order to ensure that the money contributed to a "KidRoth" is truly saved through the child's retirement, the law could be structured so that no distributions are permitted from KidRoths until the child attains age 65, except for in the case of death or disability. Alternatively, the law could permit early distribution but require that the entire distribution be taxable and subject to a 20% early distribution penalty, if made before 21 and a 10% early distribution penalty if made before 65. Any funds in the KidRoth when the individual attained age 65, would be distributed tax free (and otherwise subject to the Roth IRA distribution rules.

***Bring Interim Amendments Under Control***

Small plans (actually all plans) have in the last five to six years been getting hit with almost yearly amendments that are costly, and by and large unnecessary. This has placed a huge burden on the small business retirement plan system. When making any changes in the retirement plan area Congress should include a direction to the IRS that no amendments are to be required on the new law, including regulations on the new law, for a period of at least 3 years, or better until the next required restatement of the plan document. Summary of material modifications would still be required for changes requiring such notice to the plan participants. This change would make plans less expensive and burdensome to maintain while imposing no hardship on the plan participants.

***Eliminating the Independent Audit Requirement for Plans with Assets Under $5 Million***

Even if a plan has relatively few assets, it may still have a large enough group of participants to trigger the independent accountant audit requirement. These audits generally cost between $10,000 and $20,000 annually. This cost is a disproportionate and expensive burden for the plan sponsor when the plan's assets are relatively small. It also discourages smaller employers from forming or maintaining a plan once it has more than 120 participants. The measure of the plan participants that can trigger the audit requirement is performed at the beginning of the year before any testing can be performed to identify if this is an issue.

The independent audit requirement already includes an exemption for plans with a relatively small number of participants. There should also be a comparable exemption for plans with a relatively small amount of assets, not to exceed $5 million.

***Modify the QPSA Rules so that the Age 35 Requirement is Eliminated***

The law now provides that a plan participant subject to the survivor annuity requirements of section 401(a)(11) generally may only waive the Qualified Pre-retirement Survivor Annuity (QPSA) benefit (with spousal consent) on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver (with spousal consent), provided that a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th birthday occurs. If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death. This provision does not promote any particular policy goals and is exactly the type of unnecessary provision that should be eliminated.

**Conclusion**:

The sine qua non of small businesses is private ownership with any year end surplus revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and "grow" the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the top-heavy and anti-discrimination rules set forth in the Internal Revenue Code and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners are likely to forgo the retirement plan option.

Employer sponsored retirement plans are critical to ensuring widespread retirement security. Although small businesses face greater costs and barriers to sponsoring a retirement plan, the small business retirement system has been largely successful at helping employees save. This trend should be encouraged by promoting laws which simplify the system and cut down the costs on small businesses and rejecting proposals to eliminate the tax deductions and other benefits that motivate small businesses to sponsor plans.

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# The Challenge of Retirement Savings for Small Employers

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Before the

**Committee on Small Business**
**United States House of Representatives**

October 2, 2013

The Honorable Sam Graves (R-MO), Chairman
The Honorable Nydia Velazquez, (D-NY), Ranking Member

## Introduction

Chairman Graves, Ranking Member Velazquez and Members of the House Committee on Small Business, I thank you for the invitation to participate in today's hearing on the challenges facing small business owners in offering retirement plans to their work force. It is an honor to participate in the governing process by offering my thoughts on this issue to the Committee.

My name is C. Roy Messick III. I am a partner in the accounting firm of TPP Certified Public Accountants, LLC located in Overland Park, KS which is a suburb of Kansas City, MO. We also have an individual working in West Hempstead, NY. I am a CPA licensed in the states of Kansas and Missouri. I am also a QPA which is a Qualified Pension Administrator as recognized by the American Society of Pension Professionals and Actuaries (ASPPA).

I began my over 30 year career at KPMG (formerly Peat, Marwick, Mitchell & Co.) with four years in the audit department and two years in the tax department. I spent another six years at BKD CPA's before joining TPP in 1991, and becoming a partner in 1993. During my career, I have had the enjoyment of working with both large Fortune 500 companies and with small business owners.

Our Company works primarily with small businesses and most of them are located around the Kansas City, MO metropolitan area. I lead TPP Retirement Plan Specialists, LLC which is a wholly owned subsidiary of the accounting firm. We have about 400 clients across the United States and our task is to provide third party administrative and/or recordkeeping services for retirement plans, primarily 401(k) Plans and 403(b) Plans, to the business and not-for-profit community. For clarification, TPP Retirement Plan Specialists, LLC does not sell investment products or provide investment advice. Our plan sizes range from a handful of plan participants up to 2,000+ plan participants, though 95% of our clients have fewer than 100 employees.

My testimony today is based on my practical experience in working with small employers and their retirement plans.

## Types of Retirement Plans for the Small Business Employer

Small businesses are typically family owned companies that operate most often as Sole Proprietorships, Limited Liability Companies (LLC) or Subchapter S Corporations (S-Corp). Generally, small business does not operate as a C Corporation due to double taxation issues.

**Defined Contribution Plans versus Defined Benefit Plans**
There are two main types of retirement plans that small business owners can offer. These are Defined Benefit Plans and Defined Contribution Plans.

*Defined Benefit Plans* (also known as a Pension Plan) are *employer only* funded, define a benefit at normal retirement (generally 65), and require the use of an actuary. For example, a Defined Benefit Plan might provide for a lifetime payout benefit at age 65 in the amount of 50% of the employees final annual pay. This type of plan is becoming increasingly rare because of the cost to the employer to fund contributions. Most employers want their employees to participate in their own retirement savings, and to provide an entirely employer funded plan is cost prohibitive to the company.

*Defined Contribution Plans* dominate the small business landscape as the retirement plan of choice. In today's environment, the majority of plans offered have a component to allow their workforce to defer a portion of their wages into the plan on either a pretax (current tax deduction but taxable when withdrawn) or Roth (no current tax deduction but not taxable when withdrawn) basis. Over sixty million American workers now participate in Defined Contribution Retirement Plans according to the Employee Benefit Research Institute. In this plan, the employee and/or the employer contribute a dollar amount into the plan, and that dollar amount is invested. At retirement age, the employee is eligible for the balance in the account that includes investment earnings, and has several retirement payout options.

**401(k) Plan and 403(b) Plans**

A 401(k) Plan or 403(b) Plan is a subset of the Defined Contribution Plan which allows employees to have a part of their wages payroll deducted and contributed to the plan for investment. In the 35 years since 401(k) Plans have gained acceptance, they have become the most popular defined contribution savings arrangement by far. Employee Benefit Research Institute data shows trillions and trillions of dollars have been contributed to these plans over the years. 403(b) Plans are the dominant plan type for not-for-profit organizations.

> ***Employer Matching***
>
> Many of the 401(k) Plans and 403(b) Plans will have a match component in which if the employee contributes, they will receive some kind of "matching" contribution from the employer into their account. This means that if the employee does not defer any money from their payroll check into their retirement account, they receive no employer contribution to their account in the plan.
>
> ***Profit Sharing***
>
> Some 401(k) Plans may have a profit sharing component in which the employee could receive an employer contribution even if they don't contribute personally to the plan.
>
> Generally, employers choose to do a match contribution or a profit sharing contribution, but not both.

**Safe Harbor 401(k) Plan**

For purposes of this discussion, the committee needs to be aware of a type of 401(k) Plan called a *Safe Harbor 401(k) Plan.* This plan type is very important for small businesses and is quite common. The distinction from a traditional 401(k) Plan is how Highly Compensated Employee (HCE) contributions are treated, and the resulting mandatory employer contributions.

In a traditional 401(k) Plan, what the IRS refers to as a HCE is someone with more than 5% business ownership or someone making more than $115,000 per year regardless of ownership. Personal contributions made by HCE's are limited by an Actual Deferral Percentage (ADP) test.

This test generally states that a HCE can defer, on average, only two percentage points more than the employees that are not HCE's. For example, if the non-HCE's defer on average 4% of their compensation into the plan, the HCE's can only defer on average 6% into the plan, which severely limits the amount of their personal contribution in relation to their income.

In a Safe Harbor 401(k) Plan, the Actual Deferral Percentage (ADP) test is eliminated if the employer agrees to a *mandatory employer contribution* based on one of the two most commonly used formulas below. If the small business is able to structure their finances and afford the mandatory contributions, the Safe Harbor 401(k) Plan is the best solution under current law.

a. They agree to contribute at least 3% of compensation to the employees account regardless if the employees defer any money into their own account.
b. They only contribute to employees who do contribute to the plan based on a "matching" formula which is $1 for $1 on the employees first 3% of deferrals and then $.50 on each $1 of their deferrals from 3% to 5%. Thus, if any employees defer at least 5% of their compensation into the plan, the employer would contribute 4%. If an employee doesn't contribute anything to the plan, they get nothing from the employer.

When one of these conditions are met, the small business owner is now able to contribute the maximum allowed by law which is currently $17,500 per year, with a $5,500 catch-up allowed if the owner is age 50 or over.

## Who Participates and Why

### If There is an Employer Provided Plan

The *primary factor* in determining whether an employee will save for retirement is whether they have a retirement plan at work. For example, data prepared by the Employee Benefit Research Institute shows that over 70% of workers earning from $30,000 to $50,000 participated in employer sponsored plans when a plan was available, while less than 5% of those without an employer plan contributed to an IRA.

#### *Payroll Deduction*

The convenience of a payroll deduction plays a big part in employee deferrals. After the deferral amount is set up, it is automatically contributed to the employees account. Many employees enjoy the 'set it up and forget it' convenience.

#### *Matching*

Employers who offer matching contributions provide more incentive to employees to contribute to their own retirement accounts. "Free money" is a common expression heard from employees speaking about their appreciation that their employer cares about their participation in the retirement plan, and that they show it by making a matching contribution.

*Tax Advantages*
Depending upon how the employee contributions are deferred, they either reduce their current taxable income by making pretax contributions, or they will receive tax free payouts (Roth contributions) at retirement.

*Vesting Schedule*
The employer defines a timeframe when the employee has full ownership of employer contributions. (Employee contributions are always at full ownership.) In my experience, the most common vesting schedule covers a six year period with the employee ownership of employer contributions increasing by 20% each year. This schedule may encourage participation and employee retention, especially when there is an employer match.

**Predominantly Middle Class Participation**
Roughly 80% of participants in 401(k) Plans and 403(b) Plans make less than $100,000 per year, and 43% percent make less than $50,000 per year according to the Internal Revenue Service Statistics of Income Division.

**The Challenge**
The challenge for America is to increase the deferral rates of employees who are offered retirement plans, and to encourage small business employers who do not currently offer retirement plans to do so.

## Why Small Employers Do or Don't Offer Retirement Plans

**Why They Do**
There are a myriad of reasons why small employers will offer a retirement plan to their workforce. I summarized the reasons that I see in my practice below.

*Employee Retention and Recruiting*
It is the second most important benefit for employees after health insurance. Small business owners want to take care of their employees, and be able to recruit great talent, because without your employees you have nothing.

*Tax Incentives*
Tax incentives are clearly a critical component in a small business owner's decision to set up and maintain a retirement plan. Tax incentives motivate small employers to not only offer a retirement plan to their employees, but to also make contributions on their own behalf.

*Contribution Limits Higher than IRA's*
Contribution limits for employer sponsored retirement plans are higher than for IRA's. Currently, the deferral limit allowed in a 401(k) Plan or 403(b) Plan is $17,500 with a $5,500 catch-up additional contribution allowed if the employee is age 50 or older. IRA limits are only $5,500 with a $1,000 catch-up.

***Payroll Deduction***

The beauty of payroll deduction makes it so much easier for an employee to save for retirement versus writing a check for an IRA contribution before April 15th each year.

**Why They Don't**

There are unique challenges for small employers to offer retirement plans for their work force. Once again, the reasons that I see in my practice can be summarized as follows.

***Recordkeeping and Administrative Cost***

Because plans are complex, the cost of setting up the plan, tracking the employees' account balance on a daily basis (recordkeeping), administering the plan (making sure it complies with the myriad of rules that are under the governance of the IRS and DOL) and preparing the annual tax filing (Form 5500) can be daunting. Let's examine why.

From my perspective as a practioner, it costs the same amount to do the legal work to set up a plan for a 10 person company as it does a 1,000 person company. Obviously, the cost is more easily borne by the 1,000 person company than the 10 person company.

In terms of recordkeeping and administration cost to the employer, it's all about the asset size of the plan and average account balance. Recordkeeping costs are primarily driven by the number of plan participants. Plans with many participants, but small average account balances, will be more expensive to run relative to the total assets in the plan. For example, a 20 person plan with $1,000,000 already in the plan is going to get a proportionately better price relative to the total assets in the plan and the number of participants, than a 20 person plan that is just starting out and doesn't have any assets in the plan yet.

***Investment Management Cost***

Once again, the economies of scale are huge in this business. A Fortune 500 company's retirement plan is going to pay proportionately less for investment management expense and advice than a plan starting from scratch. Individually, the participant with $5,000 in assets will be paying proportionately more than the participant with $100,000 in assets for the same assistance.

***Not Enough Tax Savings***

Some employers, even if they could afford the contribution for the employees (discussed previously), will not do so unless the tax savings more than offset the contribution for the employees.

***Employer Cannot Afford a Company Contribution***

In a Safe Harbor 401(k) Plan, the business owner must be able to structure their finances to afford the mandatory employer contributions. If they cannot, their only option is a traditional 401(k) Plan. If they can't contribute enough of their own compensation into a traditional 401(k) Plan because of the ADP test discussed previously, they may not offer a plan at all.

***Limits on Employer Contributions***
Some small business employers may feel it's just not worth it to offer a retirement plan for their employees when they can personally only defer $17,500 per year.

***It's Too Complicated***
I believe many small employers that do not currently offer a retirement plan actually could afford it, and want to offer a retirement plan to their employees, they just haven't gotten around to it. Most likely, it's because of the general feeling about the complexity of starting it, combined with the unknown complications of administration and expense, along with questions about how to choose solid investment advice.

## How to Encourage More Small Employers to Offer Retirement Plans

It is important for American society to encourage more small employers to offer retirement plans. Based on my experience over the years, I am sharing some personal thoughts and considerations on how that might be accomplished.

***Tax Credits***
I would explore the expansion of the current tax credit for companies to start new retirement plans. An increase in this tax credit would help defray the startup cost of the plan. I would also add a tax credit of some amount based on the number of employees enrolled. The expanded tax credit could be "capped" at some amount based on the size of the employer.

***Increase Contribution Limits***
I would consider increasing the current limit that employees can defer into the plan from the current $17,500. With the potentially looming problems of Social Security, we need to encourage more private saving – not less. The increase in deferral limit might help small business owners decide to start a retirement plan for their employees.

***Add Another Safe Harbor 401(k) Plan Type***
Consider another type of Safe Harbor 401(k) Plan for smaller businesses that somewhat reduces the employer mandated contribution. This may make the required contribution a little less daunting and encourage the business owners to actually do something. I see the biggest need in the types of workforces where the employees have lower incomes.

## Conclusion

The country needs to encourage more small businesses to offer retirement plans to their work force. It is vastly important for Americans to start saving more of their own compensation for retirement. It is not only important for them individually, but also important for society as we will not be able to "bail out" a significant portion of society if they do not save for themselves.

I sincerely thank the Committee for the opportunity to discuss this important topic. I hope I have sufficiently presented the challenges, and perhaps a few solutions, for the Committee to consider.

Sincerely,

C. Roy Messick III, CPA, QPA

## Testimony of Ray Rucksdashel, Chief Financial Officer, Quest-Tec Solutions

### The Challenge of Retirement Savings for Small Business

### Before the House Small Business Committee

### October 2, 2013

I would like to thank Chairman Graves, Representative Velázquez, and the House Small Business Committee for inviting me to testify today.

My name is Ray Rucksdashel, and I have 40 years of wide-ranging financial, operational and general management experience as a partner in charge of consulting. Chief Financial Officer and Chief Operating Officer for businesses from closely held companies to publicly held companies at the senior executive level. I have worked and consulted in a variety of industries including manufacturing, sales and distribution, mortgage banking, and financial institutions. My consulting experience encompasses clients across the country and Canada, and includes working in and consulting with virtually all operational areas including sales, operations, human resources, information technology, treasury, accounting, and finance.

Currently, I am the Chief Financial Officer for Quest-Tec Solutions ("QTS"), located in Houston, Texas. QTS specializes in the development, engineering and manufacturing of products used primarily in the oil and gas industry, such as magnetic level indicators, liquid level gages and valve product lines. We also manufacture, steam level indicators, and liquid level gage accessories. QTS is a privately owned business that employs 38 people, primarily skilled employees in trades such as welders, CNC machinists, engineers, draftsmen, instrumentation specialists, and shop foremen. QTS is on track to do about $12 million in sales this year.

I believe that the subject of today's hearing is very important and I am pleased and honored to testify on this matter on behalf of small businesses. I am here to tell the committee that retirement savings are not just a necessity—they are a critical component of my company's ability to attract and retain skilled employees. QTS has offered a 401(k) from the very beginning. In fact, there was a 401(k) in place with the predecessor company to QTS when I joined that company in 1996. It has long been part of our strategy to attract and retain skilled employees. QTS is not alone in using this strategy. According to a survey conducted by Sharebuilder 401(k), 89 percent of small business owners that offer a 401(k) plan state that this benefit is an important factor for attracting and retaining the best talent.

So why is this benefit so critical for QTS? QTS is competing for employees in a marketplace where the skilled workers the company needs are in high demand, not only in the Houston area, but in other parts of the country where the oil and gas industry is growing, such as North Dakota and West Texas. Individuals with these skills will move for higher salaries and better employee benefits. QTS needs attraction and retention tools such as a 401(k) in order to compete for these highly skilled employees. The 401(k) plan that QTS offers is something we use to distinguish our company from others.

QTS learned early on that our 401(k) benefit was easy to sell to prospective employees since we were matching part of their contributions. It not only encourages our employees to save for their own retirement, it gave us another benefit to help us edge out our competition in hiring the best prospects. QTS matches 50 percent of an employee's contribution, up to a company maximum contribution of three percent. So, if an employee contributes six percent, it's the same as giving him tax-deferred income of 3 percent of his salary.

So why is QTS so generous with its 401(k) plan? It's simple. It costs the company far less to offer generous 401(k) benefits than it does to hire and train a new skilled employee. Turnover is a significant yet hidden expense that can be overlooked by managers. In addition, long-term employees are more loyal and enjoy greater satisfaction in their jobs with these benefits. That, in turn, leads to more productive and engaged employees. Moreover, offering retirement benefits to our employees is the right thing to do, as it allows them to secure their futures. We show our employees that when an average 45 year old contributes to their retirement plan along with our contribution on his behalf, by the time they reach retirement age, they would have saved $150,000.

All QTS employees are eligible to participate in our company's 401(k) plan. I would classify 23 of QTS' employee as "skilled"—people who are welders, CNC machinists, engineers, draftsmen, instrumentation specialists, shop foremen, sales personnel and management. These are the employees QTS has a hard time finding and the company does whatever it takes to keep them. Of these employees, more than 60 percent (14) participate in our 401(k) plan.

While our 401(k) plan is important to QTS, there are drawbacks for a small company like mine that wants to offer retirement plans to their employees. Administering these plans is extremely complicated. As I mentioned earlier in my testimony, even though I have 40 years' experience in financial operations in small companies, there is no way I have the time or expertise to understand all of the rules governing the operation of a 401(k). In addition, there is significant risk in managing a 401(k) plan, and that risk and exposure can serve as a deterrent for a small business to offer a 401(k) program.

To avoid this risk and complexity, I have contracted with a professional employer organization (PEO) to administer my 401(k) plan. A PEO is a company that provides payroll, human resource, and employee benefits solutions to small and mid-sized companies. One of the services a PEO can provide to its small business clients is access to 401(k) benefits. By using a PEO to access 401(k) benefits, QTS no longer has the administrative burden associated with a 401(k), my personal risk associated with being a plan administrator is minimized, and QTS is able to offer employee benefits that are competitive with larger companies. And we are not the only ones: According to a new study by McBassi and Company, PEOs offer retirement plans to small businesses that would be unlikely to sponsor them otherwise, and their employees participate at much higher rates than small businesses that do not use a PEO.

I think it is important for the committee to understand that, in my view, the administrative complexities of 401(k) plan administration are the biggest obstacles to small businesses offering employee retirement benefits. As a CFO, I understand that the deferment of income for tax purposes is the primary reason that 401(k) plans are complex. I understand the need for strong fiduciary standards to protect those who invest their earnings into these plans. And I understand the need for oversight and rules ensuring that participants understand their rights and are fully informed of the risk associated with investing their money in these plans. But these protections and disclosures come at a price, and that price is complexity and a significant administrative burden on plan administrators.

The Government Accountability Office (GAO) found that there are 43 million people who work for businesses that employ 100 or fewer people, and only 14 percent of those companies offer retirement benefits to their employees. This data is clear evidence that there are obstacles preventing small companies from offering retirement plans. The GAO and private surveys have found reasons such as complexity, legal liability, and cost as the obstacles to small companies offering retirement benefits. Because of these obstacles, many working Americans do not have access to retirement savings programs. The fact that I have to use an outside administrator speaks to the complexity and administrative burden of retirement plans.

Congress should look at ways to both encourage smaller companies to offer retirement benefits to their employees and at the same time look to simplify and streamline the administration of such benefits. Education, outreach, and streamlining regulations are just a few steps that have been suggested to improve access to retirement programs like 401(k)'s. I also hope that this forum helps bring to the attention of policymakers the challenges facing small businesses who want to provide these benefits to their employees, and begins discussions on how to make such plans easier for small businesses to offer to their employees.

I would be happy to answer any questions you have.

**The American Council of Life Insurers**

**Statement**

**"The Challenge of Retirement Savings for Small Employers"**

**House Small Business Committee**

**U.S. House of Representatives**

**October 2, 2013**

**ACLI Statement to the House Small Business Committee's Hearing on "The Challenge of Retirement Savings for Small Employers."**

## I. Introduction

The American Council of Life Insurers (ACLI) commends the House Small Business Committee (Committee) for holding a hearing on this important issue. We applaud Chairman Sam Graves (R-MO) and Ranking Member Nydia Velazquez (D-NY) for highlighting the challenges small employers have in offering retirement savings options to their employees. ACLI urges the Committee and Congress, first and foremost, to do no harm to the existing retirement system as it may be considered in the context of tax reform. Policy-makers should avoid disrupting a retirement savings system that helps millions of Americans save for retirement and instead focus on enhancing the system so that it reaches more Americans.

### The American Council of Life Insurers

ACLI is a national trade organization with more than 300 members that represent 90 percent of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including: defined benefit pension; 401(k), 403(b), and 457 arrangements; and to individuals through individual retirement arrangements (IRAs) and annuities. Life insurers actively market retirement plan products and services to small businesses (those with fewer than 100 employees). According to a 2012 survey of ACLI member companies, more than 25 percent of small employer defined contribution plan assets are held by life insurers, and one-third of small employer defined contribution plan participants are in plans funded by life insurers. Our members also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employer sponsors, life insurers believe that saving for retirement, managing assets throughout retirement, and utilizing financial protection products are critical to Americans' retirement income and financial security.

## II. Current Landscape

Our retirement system is based on three pillars: employment-based plans (including both defined benefit plans and 401(k), 403(b), and 457 arrangements); personal savings (including individual retirement accounts, individual annuities and regular savings and investment accounts); and Social Security. All three of these pillars are important and play a vital role in retirement security. This submission focuses on the many strengths of the current employer-based defined contribution system and IRAs, and proposes additional enhancements specifically aimed at encouraging small employers to adopt retirement savings options so that their employees can save for their retirement more conveniently.

### Access, Participation, and Accumulated Savings

Current tax incentives for retirement successfully help millions of American families accumulate savings and improve their retirement security. According to the U.S. Department of Labor's Bureau of Labor Statistics, almost 80% of full-time workers have access to a retirement plan, and more than 80% of workers with access to plans participate.[1] When one includes all part-time and seasonal workers, 68% have access to an employer-sponsored retirement plan, and 79% of workers with access participate.[2]

Among small employers, 49 percent of workers have access to a retirement plan. This is not altogether surprising given the fixed costs of providing any pension coverage, including the need for technical

[1] Bureau of Labor Statistics, Employee Benefits in the United States – March 2013
[2] Ibid.

expertise (e.g., legal and actuarial), time spent on plan design and administration, the production of plan documents, and so forth.

**III. Proposals that Adversely Impact Retirement Savings Arrangements**

Tax Reform - Guiding Principle "First, Do No Harm"

As Congress considers tax reform, we urge it–first and foremost–to do no harm. The House and Senate tax-writing committees have looked at various proposals that would negatively impact retirement savings. These proposals include limiting or capping amounts held in retirement plans; reducing the limits on retirement contributions; and replacing retirement savings exclusions and deductions with a refundable credit - to name a few. Placing further limits on retirement savings would be detrimental to both employers, especially small businesses, and workers.

Policy-makers should avoid disrupting a retirement system that helps millions of Americans save for retirement and instead focus on enhancing the system so that it reaches more Americans. Congress should rightly focus on policies that would encourage more small employers to offer retirement savings options to their workers.

**IV. Improvements to the System**

Individual annuities play a key role in helping small employers and their workers save for retirement, especially when small employers are unable to offer their workers a qualified retirement savings option. Annuities are insurance contracts that offer solution to both sides of the retirement equation: They provide ways to accumulate retirement savings and to turn those savings into a lifetime income stream. Additionally, ACLI supports a number of improvements that build on the current system to increase coverage, increase participation, provide for greater retirement education, and help Americans manage those savings over their lifetimes. ACLI urges this Committee to look at proposals that would enhance retirement and financial security.

Increase Coverage: Voluntary Auto-IRA and MEPs

Although the majority of full-time workers are covered by workplace plans, more could be done to expand coverage. ACLI supports proposals that would make it easier for employers to automatically enroll employees into private sector payroll deduction IRAs and simplify the process by which small businesses come together to participate in multiple employer plans (MEPs). Many small businesses do not offer a retirement savings plan for a number of reasons, but not for a lack of product offerings. The uncertainty of revenues is the leading reason given by small businesses for not offering a plan, while cost, administrative challenges, and lack of employee demand are other impediments cited by small business.[3] Legislation was introduced in the previous Congress that, among a number of provisions, would encourage employers without plans to enroll workers automatically in IRAs offered by the private sector, including SIMPLE IRAs.[4]

Another way to expand retirement plan coverage among small businesses is to reform and expand the private MEP system. MEPs can be an important tool in reducing the costs and administrative burdens of a stand-alone plan. Under a MEP, many small businesses can join together to achieve economies of scale and advantages with respect to plan administration and advisory services, making plans much more affordable and effectively managed. MEPs offer the same key protections and benefits of an employer-sponsored retirement plan, such as fiduciary protections, robust contributions levels, and employer

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[3] Jack VanDerhei, Findings from the 2003 Small Employer Retirement Survey, EBRI Notes 24, no. 9, Sept. 2003.
[4] H.R. 1534, the "Small Businesses Add Value for Employees (SAVE) Act," sponsored by Reps. Kind (D-WI) and Reichert (R-WA) in the 112th Congress.

contributions, without the cost and administrative burden that often deters an employer from offering a plan to its workers. An employer who participates in a MEP may be more willing to make a transition to a standalone employer-sponsored retirement plan. Legislation has been introduced that would expand the private MEP system.[5]

Together, these proposals would expand workers' access to retirement plan savings opportunities and encourage small businesses to offer a workplace savings solution.

Increase Participation: Auto-enrollment/Auto-escalation

Innovation in plan design is a key reason 401(k) plans have been able to reach more and more workers and improve the level of retirement benefits over time. One such innovation is automatic enrollment to get more workers into plans. Another change, auto-escalation, gradually increases the share of pay contributed each pay period. A joint study quantifies just how helpful auto-enrollment and auto-escalation can be in improving overall participation and total retirement savings.[6] The study uses a projection model to show the increases in replacement rates (how much a retiree will earn in retirement compared to the income he earned at the end of his employment) that can result from these plan design innovations. Legislation has been introduced that would improve the current rules on auto-enrollment and auto escalation.[7]

Guaranteed Lifetime Income

The need for lifetime income is well understood. Guaranteed lifetime income can help ensure that individuals have adequate income at advanced ages, even if they live to age 100 and beyond. These lifetime guarantees provide a source of income that cannot be outlived. By providing insurance against a drop in standard of living, guaranteed lifetime income is an important tool for retirement planning. Guaranteed lifetime income has the potential to provide a higher sustainable level of income than can be achieved with other financial assets. Guaranteed lifetime income is a unique and powerful tool that can help to protect retirees throughout their retirement. Eighty percent of annuity owners think that annuities are an important source of retirement security and make them feel more comfortable in times of financial uncertainty.[8]

As the first wave of the baby boomer generation reaches retirement age, it is important to educate American workers about the need to consider augmenting Social Security with additional amounts of guaranteed lifetime income. Annuities and other guaranteed lifetime income solutions provide insurance protection against longevity risk by pooling that risk and distributing it among the retiree population, shifting the risk of outliving one's savings to a life insurer. Only state-regulated and licensed life insurance companies can provide guaranteed lifetime income.

Legislation has been introduced that would help individuals think of their retirement plan savings as not only a lump sum balance, but also as a source of guaranteed lifetime income.[9] With this additional income information on a benefit statement, coupled with the Social Security income statement, workers can see

[5] Ibid, H.R. 2117, the "Retirement Plan Simplification and Enhancement Act," sponsored by Rep. Neal (D-MA), and S. 1270, the "SAFE Retirement Act," sponsored by Sen. Hatch (R-UT).
[6] Sarah Holden and Jack VanDerhei, The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement, *Investment Company Institute Perspective*, Vol. 11 No. 2, July 2005.
[7] H.R. 2117 and S. 1270.
[8] The Gallup Organization with Mathew Greenwald & Associates, 2009 Survey of Owners of Non-Qualified Annuity Contracts (survey of 1,003 owners of non-qualified annuity contracts, conducted on behalf of the Committee of Annuity Insurers).
[9] H.R. 2171 and S. 1145, the "Lifetime Income Disclosure Act," sponsored by Reps. Holt (D-NJ), Petri (R-WI), Kind (D-WI) and Reichert (R-WA) and Sens. Isakson (R-GA), Murphy (D-CT), Scott (R-SC) and Nelson (D-FL).

how much monthly income they could potentially receive in retirement. Workers can better decide whether to increase their savings, adjust their 401(k) investments, or reconsider their retirement date, if necessary, to assure the quality of life they expect in retirement.

Employers and plan sponsors have concerns that providing participants with information outlining the advantages and disadvantages of annuities and other lifetime income options could be construed as "advice" and thus subject them to additional fiduciary liability. To encourage plan sponsors to provide retirement income education, the Department of Labor should provide guidance on when information provided to educate employees about distribution options such as guaranteed lifetime income is educational in nature and not advice. This could be done by revising and extending Interpretive Bulletin 96-1.

The need to improve Americans' financial literacy has been recognized both on Capitol Hill and in the Administration. Policy makers should help Americans develop a basic understanding of financial risk, how to build savings, how to assess their retirement income needs, and where to find expert advice. ACLI supports efforts to increase Americans' level of financial literacy. As the Department of Labor continues to work on its re-proposed regulation on the definition of fiduciary, care must be taken that access to education and guidance to plan participants not be diminished.

The required minimum distribution rules should be modified to facilitate the use of deeply deferred payout annuities in retirement plans and IRAs. This type of deeply deferred payout annuity is often referred to as a "longevity annuity" or "longevity insurance" and is a payout annuity with payments commencing later in retirement, e.g. at age 75 or 85. The primary benefit of longevity insurance is the mitigation of "longevity risk." Individuals purchasing a longevity insurance contract at retirement age would know that guaranteed monthly payments would begin at age 85, for example, and that those monthly payments would be made for the rest of his or her life.

These deferred payout annuities are available, but are generally not used in plans or IRAs because of the application of the minimum distribution rules. Treasury has proposed regulations that would create qualified longevity annuity contracts (referred to as QLACs) and would facilitate their use in plans by modifying the required minimum distribution (RMD) calculation under Code Section 401(a)(9). ACLI supports this rule. We also support legislation that would further relax the application of RMD rules on longevity insurance by completely excluding the premium amount from the individual's RMD calculation. Since the Code's RMD rules apply only to tax-qualified retirement savings vehicles, this would encourage plan participants and IRA owners to use a portion of their account balance to purchase longevity insurance.

The portability rules should be expanded to maintain participants' access to lifetime income benefits. When the termination of a plan's annuity contract would lead to the loss of access on the part of plan participants to the contract's guaranteed lifetime benefits, participants need a means to maintain access to these benefits. Legislation has been introduced that would enhance the portability of guaranteed lifetime income products.[10] ACLI supports legislation and regulation that would permit the distribution of a participant's insured plan benefit when a guaranteed lifetime income product is no longer offered by the plan. The rules should permit the distribution to be made via a qualified plan distributed annuity contract or a direct rollover to an IRA or other eligible retirement plan.

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[10] H.R. 2117.

Over the long run, the nation will benefit when individuals address their long-term financial security needs today, because they will be less likely to rely on public assistance tomorrow. Government policies that encourage prudent behavior, such as long-term savings for retirement, should not only be maintained, they should be enhanced. Therefore, ACLI continues to urge policy-makers to support and build on the current retirement savings system and reject any proposals that would limit Americans' opportunity to save and prepare for their future.

We thank the Committee for consideration of our comments. We look forward to future opportunities to contribute to the debate on encouraging retirement savings options for small employers and their workers and provide you with information that would be valuable to the decision-making process.

AICPA®

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

October 9, 2013

The Honorable Sam Graves, Chairman
House Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

The Honorable Nydia Velazquez, Ranking Member
House Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

RE: AICPA Written Statement for the Record of the hearing on The Challenge of Retirement Savings for Small Employers, held on October 2, 2013

Dear Chairman Graves and Ranking Member Velazquez:

Attached is the American Institute of Certified Public Accountants (AICPA) written statement for the record of the October 2, 2013 hearing of the U.S. House of Representatives, Committee on Small Business on The Challenge of Retirement Savings for Small Employers.

The AICPA is the world's largest member association representing the accounting profession, comprised of over 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We welcome the opportunity to submit this written statement for the record and to answer any questions that you may have. I can be reached at (304) 522-2553 or jporter@portercpa.com; or you may contact Kristin Esposito, AICPA Technical Tax Manager, at (202) 434-9241, or kesposito@aicpa.org

Sincerely,

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: The Honorable Mark Mazur, Assistant Secretary for Tax Policy, Treasury Department
The Honorable William J. Wilkins, Chief Counsel, IRS

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

**WRITTEN TESTIMONY FOR THE RECORD**

**OF JEFFREY A. PORTER, CPA**

**ON BEHALF OF THE**

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**
**1455 PENNSYLVANIA AVENUE, NW**
**WASHINGTON, DC 20004-1081**

**COMMITTEE ON SMALL BUSINESS**

**U.S. HOUSE OF REPRESENTATIVES**

**PUBLIC HEARING ON**

**THE CHALLENGE OF RETIREMENT SAVINGS FOR SMALL EMPLOYERS**

**OCTOBER 2, 2013**

The American Institute of Certified Public Accountants ("AICPA") would like to thank Members of the Committee for the opportunity to submit this statement for the record of the hearing on The Challenge of Retirement Savings for Small Employers, held on October 2, 2013. I am Jeffrey A. Porter, Chair of the AICPA Tax Executive Committee. I am a sole practitioner at Porter & Associates, CPAs, a local firm in Huntington, West Virginia, which concentrates on providing tax planning and business advisory services for local businesses and high net worth individuals.

The AICPA is the world's largest member association representing the accounting profession comprised of over 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate the Committee's efforts to promote retirement savings and provide small businesses an opportunity to set up and maintain retirement plans for their owners and employees. Our remarks, which are supportive of this objective, focus on tax and simplification issues impacting many small businesses, specifically: (1) the various types of retirement plan options; (2) consolidation and simplification of the multiple types of tax-favored retirement plans and the rules governing them; (3) top-heavy provisions; and (4) repeal of the requirement that benefits become fully vested upon a partial termination of a qualified retirement plan.

## Retirement Plan Options

The Internal Revenue Code (IRC or "Code") provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles,[1] each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. Although some consolidation of the rules governing these options has been introduced in recent years, further simplification of the confusing array of retirement savings options should be undertaken.

When a small business grows and begins to explore options for establishing a retirement plan, the alternatives, and the various rules, can become overwhelming. There are too many options that businesses need to consider before deciding which plan is appropriate for them. Some plans are only available to employers with a certain number of employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings, discrimination testing, and an extensive list of notice requirements

[1] Currently the following plans are representative of the variety that may be sponsored by an employer: simplified employee pension (SEP), salary reduction SEP, savings incentive match plan for employees of small employers (SIMPLE), SIMPLE-401(k), profit sharing, money purchase pension, 401(k), 403(b), 457, target benefit, defined benefit, cash balance and the new defined benefit/401(k) combination created in the Pension Protection Act of 2006 (Pub. L. 109–280).

with associated penalties for failures and delays in distributing such notices to employees.

To determine which plan is right for their business, owners must consider their cash flow, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners. The choices are overwhelming, and many are too complex or expensive for small business owners.

**Consolidation and Simplification of Retirement Plan Options**

We recommend that the multiple types of tax-favored retirement plans currently available and the many rules governing such plans be consolidated and simplified to minimize the cost and administrative burden for employers.

Possible measures for simplifying the number and complexity of the various types of retirement plan vehicles include:

1. Create a uniform employee contributory deferral type plan. Currently there are four employee contributory deferral type plans: 401(k), 457, 403(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers. While we would like to see a more streamlined approach with regards to these types of plans, we also acknowledge that keeping a simple plan as well would benefit small businesses.

2. Eliminate the nondiscrimination tests based on employee pretax and Roth deferrals for 401(k) plans. These tests artificially restrict the amount higher-paid employees are entitled to save for retirement by creating limits based on the amount deferred or contributed by lower-paid employees in the same plan. They result in placing greater restrictions on the ability of higher-paid employees to save for retirement than those placed on lower-paid employees. Although the 403(b) plan is of a similar design, there is no comparable test on deferrals for this type plan.

There are currently two tests:

a) The actual deferral percentage ("ADP") test which limits the amount highly compensated employees can defer pre-tax or by Roth after-tax contributions by reference to the amount deferred by non-highly compensated employees. This test applies only to a 401(k) plan.

b) The actual contribution percentage ("ACP") test similarly limits the amount of employer matching contributions (which are based on employee contributions) and other employee after-tax contributions that highly compensated employees may receive. This test is applicable for both 401(k) and 403(b) plans.

An example of complexity in the rules is as follows: In the case of the traditional 401(k) plan, both the ADP and ACP texts would apply, while the same deferral and match formula in a 403(b) plan would result in only the ACP test being applicable.

3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to be used to determine basis in a distribu-

tion. For example, in a Roth individual retirement account (IRA), basis is considered returned first while in a traditional IRA or 401(k), including Roth 401(k)s, basis is distributed on a pro-rate basis, and distributed based on an algebraic formula if there are a series of payments. In addition, there are complicated rules concerning the aggregation of accounts. For example, traditional IRA accounts with pre-tax and after-tax (not Roth) contributions are aggregated separately from Roth IRA accounts. There are also special basis recovery rules in defined contribution plans that contain pre-tax, after-tax and Roth contributions.

4. Create a uniform rule of attribution. Currently, the rules of attribution are governed by different Code sections which each have subtleties and are used for different purposes:

a) Section 267(c)[2] referenced and modified in determining a disqualified person under prohibited transaction rules.

b) Section 318 for determination of highly compensated and key employee status.

5. Create a uniform definition for terms to define owners. Currently, there are different definitions for the terms "highly compensated employee" and "key employee." A defining factor of a "highly compensated employee" is a five-percent owner which is further defined as an individual with a direct or indirect ownership interest of more than five-percent. The ownership rules governing a "key employee" consider the five-percent ownership rule but also consider persons owning one-percent with compensation of $150,000 or more annually.

6. Eliminate the required minimum distribution rules. Participants must begin taking distributions beginning at age 70½ or be subject to penalties. In the case of qualified plans, a less than five-percent owner who continues employment may defer taking distributions until his or her subsequent separation from service. Additionally, in the case of a traditional IRA, the participant is entitled to consolidate multiple accounts, subsequently taking a required minimum distribution from a single IRA; however, in a qualified plan the required minimum distribution must be taken from each plan individually and consolidation is not permitted.

If full elimination of required minimum distribution rules is not possible, the age requirement of 70½ should be addressed. The rules would be better served if the distributions were required to begin on a specific birthday as opposed to the computation of the "half-year birthday" for purposes of these regulations.

7. Create uniform rules for early withdrawal penalties. There are currently different rules governing penalties depending on whether the account is an IRA or a qualified plan. An example of this complexity is a distribution for higher education expenses; for an IRA the distribution avoids the ten-percent excise tax, while a hardship distribution from a qualified plan is still subject to the excise tax.

[2] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the treasury regulations (the "Regulations" or "Reg.") promulgated pursuant to the Code.

The same is true for qualified first-time homebuyer distributions and medical insurance premiums.

**Top-Heavy Provisions**

The top-heavy rules were enacted under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), and subsequently amended, to protect employees when an employer offers a retirement plan which primarily benefits its "key employees."[3] Section 416 imposes a minimum vesting period of either six-year graded or three-year cliff and requires a minimum contribution of generally three percent for "top-heavy" plans. Retirement plans are considered top-heavy for a year, and therefore subject to the above rules, if the aggregate value of the key employees' accounts exceeds 60 percent of the aggregate value of all of the employees' accounts under the plan.[4]

Based on our members' experiences, the imposition of the top-heavy rules for retirement plans is causing some employers to (1) cease employer contributions to their plan, (2) terminate existing plans, or (3) not adopt a plan at all to cover their employees. This is primarily an issue with small and family-owned businesses sponsoring a 401(k) plan which consists of employee deferrals only, or employee deferrals and employer matching contributions.

Many small business retirement plans inevitably become subject to the top-heavy provisions for two reasons. First, most small businesses are owned by family members or a close group of individuals. Due to this type of ownership, it is common that the owners remain relatively static over the life of the business. As such, there is frequently very low or no turnover of its key employees. Second, in today's work environment, employee turnover is commonplace. It is not unreasonable for employees to change jobs multiple times over their working careers as personal goals change, their skills improve, or they move geographically. Due to the static ownership of small businesses and the increasingly transitory employee base, it is becoming a certainty that most retirement plans sponsored by small businesses will become top-heavy at some point during the life of the plan.

Some small businesses can satisfy the top-heavy requirements. These businesses adopt provisions for their retirement plans to meet safe-harbor designs, such that they either provide for a matching contribution that rises to a statutory level (i.e., four percent for a 401(k) plan) or they provide for a non-elective contribution of at least a statutory rate (i.e., three percent for a 401(k) plan).

Unfortunately, many small businesses cannot afford to meet the strict contribution requirements imposed by the top-heavy rules. Their profitability margins and financial situations are such that these contribution levels cannot be attained. During the recent economic downturn, retirement plan contributions—specifically match-

[3] Generally, a key employee is defined as an officer with compensation in excess of $130,000 (indexed annually), a 5%-or-more owner, or a 1%-or-more owner with compensation in excess of $150,000. IRC section 416(i)(1)(A).

[4] IRC section 416(g)(1)(A)(ii).

ing contributions—were an issue for many employers. Many employers which were able to satisfy the safe harbor requirements in the past were no longer able to continue making the same contributions. In too many cases, top-heavy rules become a financial burden by imposing an employer contribution for deferral only plans—where there was never intent for an employer contribution, or by requiring an additional contribution of three percent on top of the matching contribution the employer previously determined as being affordable to their budgetary and cash-flow constraints. As a result, the employers terminate the plan, which significantly diminishes the ability of their employees to save for retirement.

Prior to the top-heavy provisions, some employers terminated employees prior to vesting in order to use the forfeited dollars to reduce their contributions to the plan for current and future years. However, at the time these rules were passed, vesting schedules were 10-year cliff and 15-year graded. Employer plans are now subject to minimum vesting periods of either three-year cliff or six-year graded. The Pension Protection Act of 2006 changed the non-top-heavy defined contribution vesting schedule to generally coincide with the top-heavy schedule for contributions made after December 31, 2006. As a result, many defined contribution plans are unaffected by the top-heavy vesting requirements.

We recognize that the top-heavy rules were enacted to address the concern that employers will "churn" their employee base prior to the participants becoming fully vested. However, based on our members' experiences, smaller employers suffering from these top-heavy rules employ moderate matching formulas—less than those offered in safe-harbor 401(k) designs. Their actual cost of hiring and training employees is much greater than any benefit they might gain from this practice.

Although employees who find themselves not covered under an employer-sponsored 401(k) plan could contribute to an individual retirement account, the AICPA thinks that an employer-provided retirement plan is a better option for employees. First, the employees can contribute a higher amount to a 401(k) plan—up to $17,500 for 2013 (or $23,000 for individuals age 50 or older) for pre-tax contributions compared to the contribution limit for IRAs of $5,500 (or $6,500 for individuals age 50 or older).[5] Next, 401(k) plans generally offer access to more competitive investment alternatives than are accessible to an IRA investor. Finally, if an employer-sponsored plan the employer often pays at least a portion of the fees and the employee is part of a larger group that is likely to be charged a lower fee.

The AICPA supports the protection of employees and their ability to save for retirement. However, the top-heavy rules have become unnecessary due to the enactment of other provisions which protect the interests of employees. For example, section 401(k) plans are generally subject to special discrimination rules (the average deferral percentage test and average contribution percentage test, commonly referred to as the ADP/ACP testing) designed to prevent

[5] IR 2012–77, Oct. 18, 2012.

highly compensated employees[6] from receiving too much in contributions as compared to other employees.[7] These plans are also subject to general nondiscrimination rules designed to prevent qualified plans from covering too many highly compensated employees as compared to non-highly compensated employees.[8] As a result, the non-key employees are protected from employer discrimination regardless of whether the minimum contribution requirements for top-heavy plans are in effect.

The AICPA recommends an exception from the top-heavy rules for certain defined contribution plans. We think that retirement plans which provide for employee deferrals only and plans which provide for employee deferrals and matching contributions should not be subject to the strict minimum contribution requirements as other top-heavy plans.

**Vesting Upon Partial Plan Termination**

Section 411(d)(3) requires qualified retirement plans to provide for immediate 100% vesting upon a partial plan termination. In general, a partial plan termination may be deemed to have occurred when significant reductions in the workforce occur in a plan sponsor's business.

This section was added to the Code as part of the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"). At that time, most qualified retirement plans were primarily or entirely employer-funded, and permitted vesting schedules were much longer than schedules that exist today. In the 1970s work environment, the vesting rule was necessary to protect the workers' retirement balances. However, the funding of retirement plans has changed significantly over the last forty years. In the present 401(k) environment, most, and sometimes all, retirement benefits are funded by employees' own contributions which are by law immediately 100% vested and not affected by the vesting rules. In addition, the maximum permitted vesting schedules have been greatly shortened. As a result, to the extent there are employer contributions in a retirement plan most workers are partially or even fully vested by the time an issue of partial termination arises.

The immediate vesting rule unfairly punishes small businesses. It is not uncommon for all employers to face a certain amount of turnover in their employee population. Employees can change jobs multiple times over their working careers as personal goals change, their skills improve, or they move geographically. For some employers, their employee base is sufficiently large that their experience closely follows the statistical performance of the labor pool as a whole. However, for small businesses, normal turnover can inadvertently create problems with the partial termination rules.

Furthermore, employers have not been given a clear and specific definition of what constitutes a partial plan termination. Employ-

[6] A highly compensated participant is, in general, a more-than-5% owner in the current or preceding plan year or any employee who in the prior year earned in excess of $110,000 (indexed annually). IRC sections 401(k)(5) and 414(q).
[7] IRC section 401(k)(3) and m(2).
[8] IRC section 410(b).

ers must instead attempt to apply a series of narrow IRS rulings to their own situation, often by retaining outside counsel. The resulting uncertainty and expense creates an additional administrative burden when small businesses may lack the time and resources to resolve such a legally ambiguous situation.

We recommend an amendment to section 411(d)(3) to provide for an exception for "small plans"—under 25 participants—such that the partial termination rules do not apply.

* * * * *

We appreciate the Committee's efforts to promote retirement savings and are available to provide additional input on ways Congress can make further improvements in this area in general and with respect to small businesses.

FINANCIAL SERVICES ROUNDTABLE

**STATEMENT FOR THE RECORD**

**THE FINANCIAL SERVICES ROUNDTABLE**

for

The House Small Business Committee hearing entitled:

*"The Challenge of Retirement Savings for Small Employers"*

**October 2, 2013**

The Financial Services Roundtable represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

FSR SUPPORTS RETIREMENT SECURITY:

FSR shares Congress' and the Obama Administration's goal of increasing opportunities for Americans to save and plan for their retirement. It is our belief that providing these opportunities is important because savings increase domestic investment, encourage economic growth, and result in higher wages, financial freedom, and a better standard of living. FSR supports access to a wide-range of retirement products and vehicles to help employers, especially small employers, and employees plan for their retirement, including traditional pensions, 401(k), IRA, and similar retirement savings accounts. The financial services industry, which manages close to 20 trillion in retirement savings,[1] has played a key role in helping to increase the number of Americans who plan and save for their retirement. Although the U.S. retirement market is projected to grow to nearly $22 trillion by 2016,[2] more must be done to ensure the retirement security of every American.

TAX INCENTIVES HELP SMALL BUSINESSES OFFER PLANS:

The key to whether or not an employer, especially small employer, offers a plan in the first place is the availability of tax incentives. For instance, if a small business owner wants to use a tax-favored vehicle to save for his own retirement, the Tax Code requires that he provide a plan for his employees. It is critical to note that unlike other tax incentives, income contributed to 401(k) and traditional IRA accounts is not a permanent tax deduction or exclusion, it is only a deferral of taxes. When a distribution is made to a plan participant, all amounts (the original income that was deferred plus the investment gains on amounts deferred) are subject to ordinary income tax.

One thing we have learned over the last 30 years is that once the right incentives are in place, retirement savings will increase. The median salary deferral to a 401(k) plan is 7%. The median account balance for Baby Boomers rose 33% to $99,320 in 2012. Gen Xers (people born between 1965 and 1978) increased their median savings by 30% to $41,821. According to American Society of Pension Professionals and Actuaries (ASPPA), only 5 percent of employees save if their employer does not offer a retirement plan.[3] Thus, we know the keys to increasing retirement savings are:

a. Providing <u>incentives to businesses</u> to provide plans to their employees; and

b. Providing <u>incentives to employees</u> to take advantage of the plans offered to them.

REGULATIONS MAY DETER RETIREMENT SAVINGS:

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[1] FSR Research, http://www.fsroundtable.org/fsr/pdfs/2013/StrengtheningTheUSRetirementSavingsSystem-September.25.2013.pdf

[2] Margarida Correria, *U.S. Retirement Market Projected to Hit $22 Trillion by 2016,* BANK INV. CONSULTANT, Jan. 30, 2012, http://www.bankinvestmentconsultant.com/news/cerulli-predicts-retirment-market-will-exceed-22-trillion-by-2016-2677132-1.html.

[3] *Id.* at 2.

Small business owners rely on investment education and guidance from retirement professionals in choosing a plan investment menu to offer to their employees. If this education and guidance is effectively prohibited by the upcoming Department of Labor (DOL) fiduciary duty proposal small business owners will have to either a) select their own investments without the help of a retirement professional and assume fiduciary responsibility; or b) find and pay a third party expert to do that selection, which may be cost prohibitive. Thus, if DOL moves forward with its re-proposal, it is critical that the Administration ensures that the DOL and the Securities & Exchange Commission work together on the substance and the timing of their respective rulemakings, or risk confusing and overlapping regulations on small businesses and retirement professionals. FSR believes governmental policies preserve consumer choices—including the consumers' choice to select the retirement services product that fits their needs, and work with their preferred financial services provider.

CONCLUSION:

In closing, FSR urges Congress to build on the successes of the current retirement savings system. As a country we need to promote policies to encourage more retirement savings—not less. FSR supports maintaining the current tax incentives, which provide appropriate incentives for employers to offer plans and for employees to participate in the plans that are offered. The current system is working—the number of people saving via DB or DC plans is higher than at any time in history. Thus, there is no need to dismantle and rebuild the retirement system. FSR believes increasing retirement savings should be a national priority and is committed to working with Congress and the Administration on policies that promote retirement savings, and enable the financial services industry to better meet the long-term retirement needs of hard-working Americans.

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# Strengthening the U.S. Retirement Savings System

Nam D. Pham, Ph.D., Managing Partner
Alexander J. Triantis, Ph. D., Senior Advisor

**September 2013**

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## Abstract

The U.S. private retirement savings system has matured successfully over the past four decades. Asset growth has been significant, fostered by innovative products, features and services that have further incentivized retirement savings. Adapting to higher job mobility in the labor market and the desire for greater flexibility and customization, defined contribution plans have become increasingly dominant relative to defined benefit plans. In addition, the number of IRA accounts and the assets invested therein have increased substantially since their inception in the mid-1970s. The financial services industry, backed by supportive government policies, has introduced a number of products and services to further grow retirement savings. Plan sponsors and financial advisors have helped individuals become more familiar and comfortable with retirement savings products and investment strategies. As a result, more than two-thirds of American households have accumulated $19.2 trillion in retirement assets, investing across equities and fixed income securities in the U.S. capital markets. With higher life expectancy and an increasing standard of living in the U.S, sufficient replacement rates are needed during retirement years. Thus, policies that further incentivize retirement savings for all economic and demographic groups and ensure small businesses to be able to offer plans are needed. Furthermore, contribution limits should be increased and auto-enrollment and auto-escalation features should become more universal. Importantly, policymakers must be careful not to implement measures to achieve short-term fiscal goals at the expense of longer-term retirement security and economic growth. Since the U.S. retirement savings system is proven to work, policymakers, plan sponsors, and service providers should work together to implement additional measures to strengthen our retirement savings system.

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## Key Highlights of the Report

The retirement savings system in the U.S. has proven to be highly successful, with participation and retirement assets both rising steadily over time. The introduction of new products, the increase in contribution limits, the improvement in financial literacy, and the introduction of automatic enrollment and automatic escalation features have all contributed to this success. These features of our retirement system must be reinforced rather than reformed, with a goal of increasing access to savings plans, raising participation rates, and ultimately continuing to build the retirement savings base to ensure adequate replacement rates of income for retirees.

Three main highlights of the report are:

- **The retirement savings system in the U.S. has shifted from traditional employer-sponsored defined benefit (DB) plans to portable and flexible defined contribution (DC) plans and individual retirement accounts (IRAs) that are more suitable for a dynamic American labor force.**
  - Retirement assets of employees in both the public and private sectors in 2012 stood at $19.2 trillion, of which 54.7% of total assets are in DC plans (26.5%) and IRAs (28.2%), 38.2% in DB plans, and 7.1% in annuities.
  - DC plans have gained in popularity, accumulating nearly $5.1 trillion in assets in 2012, more than doubling in the last ten years. Annual contributions to DC plans have increased by a factor of six in the past 25 years to an estimate of more than $314 billion, accounting for 70.6% of total employer-sponsored plan contributions.
  - IRAs have accumulated $5.4 trillion in assets (as of 2012) from direct contributions and rollovers. Over 40% of households currently have some type of IRA, 8% of households have only IRAs, and 16% of households make annual contributions to IRAs.
  - In an international comparison, private retirement savings (70% of GDP) and annual tax deferrals for private retirement plans (0.8% of GDP) in the U.S. lag behind several countries but are above the OECD averages (33.9% and 0.6%, respectively).

- **The success of the U.S. retirement system can be attributed to a combination of supportive government policies, an innovative financial services industry, and an increasingly better informed American population.**
  - Government policies: Congress has enacted supportive retirement, revenue, and tax reforms to incentivize savers by adjusting contribution limits, withdrawal rules, and tax deferrals, as well as allowing for new product features such as automatic enrollment and automatic escalation.
  - Plan Sponsors and Financial services industry: Financial services companies and advisors offer innovative retirement savings products and services that are beneficial to both employers and employees. Investment education and customized retirement plans have become more readily available. Surveys show more than half of IRA-owning households consulted with an advisor for asset allocation, investment strategy, and withdrawals.

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- American workers: Employees have become more willing to save and are overall better informed through education provided by their employers. Workers have become more aware of the need and opportunities to save for retirement, as reflected through higher participation and take up rates and their typical choice not to opt-out of DC plans with auto-enrollment features.

➢ **Policies to incentivize greater retirement savings across all employee groups (full-time, part-time, different income levels, ages, and company sizes) are needed.**
  - Policies should focus on long-run economic benefits rather than targeting short-term fiscal goals. Incentivizing retirement savings not only reduces the risk of insufficient retirement income for a large part of the U.S. population and therefore reduces their dependence on government programs; it also supports long-term economic growth through greater investment in U.S. capital markets, given the increasing role of retirement assets.
  - Policies should broaden employees' access to retirement savings plans, and continue to support ways to increase take-up rates across all income and demographic groups in the private sector. In 2013, only 28% of the lowest wage earning quartile, 37% of part-timers, and 45% of workers in small businesses (1-49 employees) in the private sector have access to employer-sponsored retirement savings plans.
  - Policies should promote education and support programs to inform American workers of the benefits of retirement savings and the products that are available.

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# Strengthening the U.S. Retirement Savings System

Nam D. Pham, Ph.D. and Alexander J. Triantis, Ph.D.[1]

**Summary of the Report**

Participation in employer-sponsored defined contribution (DC) plans and in Individual Retirement Accounts (IRAs) has grown dramatically over the past several decades. For defined contribution plans, participation has increased from an average of 25.3% in the 1980s to 42.9% at the present time. The assets invested in DC plans have increased from $287 billion in 1984 to $5.1 trillion in 2012. Assets in IRAs have increased more than 100 fold since their early inception years to more than $5.4 trillion in 2012 contributed by over 40% of US households. DC plans and IRAs have become essential elements of the U.S. retirement system, complementing other vehicles for retirement savings, including defined benefit (DB) plans, Social Security, and personal investments in housing, businesses and financial assets held in non-tax-deferred accounts.

Employers have gradually shifted from sponsoring traditional defined benefit plans to offering more flexible and portable defined contribution plans. Given the rapid growth over the past thirty years, defined contribution plans in the private sector now make up 61.6% of total private sector employer-sponsored plans from an asset size perspective. This transformation has been driven by employers looking to decrease volatility in financial performance and to lower the cost of plan sponsorship, and also by employees looking for greater portability to match their mobile labor patterns, as well as the ability to directly control their investment portfolios.

Access to employer-sponsored plans and participation in these plans varies substantially across different segments of the labor force, with part-time workers, lower-income employees, and those working for small companies having the lowest access and participation rates. According to the U.S. Bureau of Labor Statistics's 2013 National Compensation Survey, the current access rate of all workers in 2013 is 64%, ranging from 28% in the lowest decile income group, and 37% among part-timers, to as high as 87% for those workers in large companies with more than 500 workers. The Survey also shows the participation rate for private sector workers averages 49%, ranging from 10% in the lowest decile income group, and 20% among part-timers, to 76% in large companies. As a result, the take up rate averages 77% for all workers, ranging from 36% in the lowest decile income group, and 54% in the part-time group, to 87% in

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large companies. Since there is a wide range of access, participation, and therefore take up rates, a large potential upside to promote greater retirement savings could come both from motivating more employers to sponsor plans, and from encouraging employees to enroll in these plans.

A recent innovative design feature of defined contribution plans is auto-enrollment, where enrollment in the plan is the default option, and employees must actively choose to opt-out. This feature has been shown to be very effective in nudging employees to save for retirement. Increasing the default contribution amount (for instance, from 3% of income to 6% of income) is a very effective mechanism to increase employees' retirement savings, and to reduce the risk of low income replacement during retirement. Furthermore, auto-escalation provides an opportunity to encourage savers to overcome their natural tendency for immediate spending by imposing a default increase in contribution amount every year.

In general, the "choice architecture" of a defined contribution plan, a term referring to how defaults are set to encourage savings behavior, which include automatic features and contribution levels, can have a profound effect on actual savings behavior and the probability of achieving a sufficient replacement rate of income during retirement. In addition, employers have been providing educational information to employees to help them understand the importance of retirement savings and the types of products that are available. For IRAs, financial advisors also play an important role in ensuring higher retirement preparedness, and increasing the confidence levels of investors. These advisors are subject to strict regulations that prevent conflicts of interest and ensure that investors receive informed and unbiased advice.

Over half of U.S. households are estimated to be unable to maintain their standard of living in retirement. This retirement risk level is even higher for lower-income individuals and those nearer to retirement following the recent the financial crisis. The U.S. currently lags many OECD countries in terms of level of savings in private retirement savings plans (adjusted by country GDP). It is critical that U.S. policy continues to support retirement savings by allowing for tax-deferred savings with higher limits (even higher than 10% of income) and greater flexibility in product design such as auto enrollment and auto escalation features to encourage retirement savings. In addition, policies that promote higher access and participation rates are clearly preferred to proposals that would scale back retirement savings merely for the myopic purpose of increasing short-term tax revenue. Since tax-deferred retirement savings are not tax-exempt, higher retirement savings today yield higher government tax revenues at the time of fund withdrawals. Furthermore, given that retirement savings in DC and IRA plans alone account for over $10.5 trillion and continue to grow, the impact of slowing down the growth of assets invested across all U.S. securities could well have a significant adverse effect of choking the financial markets and limiting economic growth at a time of a fragile economic recovery.

### Structure of the U.S. Retirement Savings System

There are three key savings mechanisms in the U.S. that are specifically designed to support individuals during their retirement years. The first of these three pillars is the Social Security System, which covers all households across all levels of earnings, and provides for the largest portion of retirement spending for lower-income households. The second is employer-sponsored retirement plans, which includes defined benefit and defined contribution plans. Defined benefit (DB) retirement plans provide employees with guaranteed retirement benefits based on the participant's retirement age, length of service, and preretirement earnings. Defined contribution (DC) plans, such as 401(k), 403(b), and 457 plans, are tax-deferred accounts that do not provide guaranteed payments, but rather accumulate funds over time based on each employee's investment decisions, which are then drawn down during retirement. The third pillar is individual retirement accounts (IRAs), which are tax-deferred accounts set up by individuals to accumulate investment funds for retirement. These include traditional, Roth, SEP, SAR-SEP, and SIMPLE IRAs.

In addition, individuals may use the capital accumulated in their homes to produce funds for retirement spending, since most homeowners have no or low mortgage debt by the time they reach retirement age.[2] Many individuals also accumulate other assets, including financial assets outside of retirement accounts, business equity, nonresidential property, second homes, vehicles, and consumer durables, all of which can support these individuals during retirement.[3] According to the 2010 Survey of Consumer Finances, financial assets accounted for approximately 37.9% of total assets of all households in the United States.[4] The Investment Company Institute (ICI) estimates that employer-sponsored retirement plans and IRAs account for approximately 80% of the retirement savings of households near retirement age.

This report thus focuses on the second and third retirement pillars, providing an overview of their development over time, and discussing ways to strengthen them further to positively impact the savings rate in the U.S. and the associated growth in our economy.

**Evolution of the Private Retirement Savings System in the United States**

The first private pension plan in the U.S. was established in 1875 by the American Express Company. At the turn of the 20th century, more than 75% of all males over age 65 were working as long as they could, and life expectancy was 49 years at birth and 72 for those who reached the age of 60. Life expectancy lengthened significantly during the 20th century, and more women entered the labor force. Over time, pension plans grew in popularity as corporations used them to attract workers, reduce labor turnover, and even as a mechanism to replace older and less productive employees.[5] The tax deferral of pension income became more attractive to the general population, and corporations, who were allowed to account pension costs as an ordinary business expense, offered more generous pensions to attract talented workers. By 1974, over 45% of all private-sector workers were covered by a pension plan. To protect the retirement assets of these millions of American employees, the Employee Retirement Income Security Act (ERISA) was enacted in 1974.

[2] The U.S. Census surveys that 81.1% of households of 65 years and over owns a home, compared to 74.4% in 1982. See U.S. Census. Housing Vacancies and Homeownership. Annual Statistics: 2012. http://www.census.gov/housing/hvs/data/ann12ind.html
[3] The Investment Company Institute (ICI) employs a five-layer retirement savings pyramid framework, as described in Brady, Peter, Kimberly Burham, and Sarah Holden. 2012. *The Success of the U.S. Retirement System* (December). Washington, DC.
[4] Federal Reserve System. 2013. *Survey of Consumer Finances*. Research Resources. http://www.federalreserve.gov/econresdata/scf/scfindex.htm
[5] Workplace Flexibility 2010. *A Timeline of the Evolution of Retirement in the United States*. Georgetown University Law Center.

Traditional employer-sponsored pension plans were defined benefit (DB) plans, where workers accrue a regular monthly payment from the date of their retirement until their death or the death of their spouse. The formulaic structure of the benefit, based typically on the employee's retirement age, pre-retirement salary, and years of employment at the sponsoring firm, is generally designed with the goal of replacing a specific percentage of an employee's terminal salary, often referred to as a "replacement rate." Employers are legally obligated to make the promised payments once funds have accrued and have been vested.[6] Furthermore, the Pension Benefit Guaranty Corporation (PBGC), created in 1974 by ERISA, provides limited backing for defined benefit pensions in the event of a sponsor default.

While defined contribution plans have existed in different forms for quite some time, the Revenue Act of 1978 established qualified deferred compensation plans which allow for pre-tax employee contributions to retirement plans that are established by the employer, but directed by the employee. Corporate 401(k) plans include traditional 401(k) including multiple employer plans, safe harbor 401(k), and SIMPLE 401(k). Employees contribute a portion of their pre-tax income into their account (subject to a prescribed limit), and this amount may be fully or partially matched by an employer contribution. The accumulated fund level at retirement depends on the contributions over the years as well as the performance of the investments selected by the employee. ERISA sets minimum standards for eligibility, contribution limits, benefit accrual, withdrawals, information distribution, and accountability of plan fiduciaries. Employees are permitted to withdraw their contributions after age 59 ½ or upon separation from service, or because of hardship or disability.

Employees of public education organizations and certain non-profits may contribute to 403(b) retirement plans, which are similar to 401(k) plans, particularly with regards to the tax-deferred nature of contributions and investment returns until withdrawals. Similarly, 457 plans are available for governmental (and certain non-governmental) employers, whereby employees defer their compensation into the plan on a pre-tax basis. Congress has enacted several retirement, revenue, and tax reforms over time to adjust the contribution limits, age for fund withdrawals, tax implications, and other features such as automatic enrollment and automatic escalation for these plans.[7]

ERISA also created the Individual Retirement Account (IRA) system with two objectives. The first objective is to provide a tax-deferred retirement savings vehicle for workers who may not be covered by retirement plans at work. The second objective is to provide a vehicle for individuals who are leaving jobs to preserve employer-sponsored retirement plan assets by allowing them to rollover the assets into an IRA. Since their inception, Congress has made various changes to the eligibility, tax implications, and contribution rules for IRAs. IRAs have emerged subject to different rules, including SEP IRAs (1978), SAR-SEP IRAs (1986), SIMPLE IRAs (1996), and Roth IRAs (1997). The combined assets of IRA accounts held at custodian institutions currently constitute the largest component of the U.S. retirement market.

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[6] Broadbent, John, Michael Palumbo, and Elizabeth Woodman. 2006. "The Shift from Defined Benefit to Defined Contribution Pension Plans – Implications for Asset Allocation and Risk Management." Working Paper Prepared for a Working Group on Institutional Investors, Global Savings and Asset Allocation established by the Committee on the Global Financial System.

[7] Workplace Flexibility 2010. *A Timeline of the Evolution of Retirement in the United States.* Georgetown University Law Center.

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**Comparing Defined Benefit, Defined Contribution, and IRA Retirement Plans**

The key differences between defined benefit, defined contribution and IRA plans relate to characteristics of the contributions, such as their source, annual limits, and tax deductibility, as well as the nature of the benefits, principally in terms of risk-reward profile and access prior to retirement or certain age thresholds. These differences are laid out at a high level in Table 1 below. Defined benefit plans involve contributions only from the employer, who bears the risk of making defined payments to retirees, which are only (fully) available upon retirement. With defined contribution plans, the employee bears the risk but has the potential for higher distributions in retirement and greater access to funds under special circumstances prior to retirement. Funds in defined contribution plans are portable when employees change jobs. IRAs are similar in these characteristics to DC plans, but with lower contributions, and the Traditional vs. Roth options provide alternative profiles with regard to the impact of taxes, and have income restrictions that impact eligibility and/or tax deductibility of contributions.

**Table 1. Characteristics of Employer-Sponsored Plans and IRAs[8]**

| | Defined Benefit Plans | Defined Contribution Plans | Individual Retirement Accounts |
|---|---|---|---|
| Contributors | Employers | Employees, with possible match by employers | Employees |
| Contribution Limits | Contributions by employers are based on actuarial assumptions and computations to provide definitely determinable benefits to plan participants after retirement. | For 401(k), 403(b) and most 457 plans: $17,500 maximum elective deferral by employee; $5,500 catch-up contribution for age 50+; $51,000 defined contribution maximum deferral (employer/employee combined). | $5,500 max combined, or $6,500 max for 50+ yrs old Contributions into Traditional only until age 70 ½; no age limit for Roth contributions. Eligibility for Roth depends on income level. Limits do not apply to rollover contributions from DC plans. |
| Tax Deductibility | For employers who contribute (treated as a corporate expense). | For both employees and employers who contribute. | From full to none, depending on marital status, income level, and access to an employer retirement plan. Traditional: pre-tax contributions, taxable withdrawals Roth: after-tax contributions, qualified withdrawals tax-free. |
| Benefits | Depends on age, job tenure, and salary. Cannot exceed 100% of the participant's average compensation of the highest 3 consecutive calendar years or $205,000 (in 2013 dollars). | Vested account balance accrues to retiree or beneficiary; can be larger than from DB plans, but no guarantee. | Vested account balance accrues to retiree or beneficiary. |

[8] Internal Revenue Service (various reports, based on 2013 rules); U.S. Department of Labor.

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| | | | |
|---|---|---|---|
| Mandatory distributions | At age 70 ½. | At age 70 ½. | Traditional: At age 70 ½. Roth: Not required for original owner. |
| Access to Funds | No access until retirement. | Often have limited access before retirement (under specific circumstances, or in the form of loans from plan). Funds are portable to new jobs. | Before age 59 ½, there is no penalty if for education, first home ($10,000), or hardship. After 59 ½, no restriction. |
| Withdrawals | Typically monthly payments based on DB formula. | Choose between lump-sum distributions, annuity, or rolling distribution into IRA. | Taxable withdrawals for Traditional IRA, and 10% penalty for early withdrawals before age 59 ½ for non-qualified distributions. |
| Investment Risks | Employers assume all investment risks and rewards; can be very costly if plan is underfunded. | Employees assume all investment risks and rewards. | Employees assume all investment risks and rewards. |

**Participation and Yearly Contributions to Employer-Sponsored Retirement Savings Plans**

Congress has authorized over the years a variety of tax incentives to encourage employers and employees to save for retirement. As a result, the contributions invested each year in retirement plans have grown significantly. This is particularly the case for defined contribution plans, in large part due to the increasing popularity of these plans relative to defined benefit plans, discussed in greater detail later in this report. Table 2 shows the number of defined benefit and defined contribution plans in the private sector over a thirty-year period.[9]

**Table 2. Number of Active Plans and Yearly Contributions, 1975-2010[10]**

| | Number of Active Plans (in thousands) | | | Pension Plan Contributions (in $ millions) | | |
|---|---|---|---|---|---|---|
| | Total Plans | Defined Benefit | Defined Contribution | Total | Defined Benefit | Defined Contribution |
| 1975 | 38,431 | 27,214 | 11,217 | $37,061 | $24,242 | $12,819 |
| 1980 | 48,986 | 30,100 | 18,886 | 66,157 | 42,626 | 23,531 |
| 1985 | 62,064 | 28,895 | 33,168 | 95,188 | 41,996 | 53,192 |
| 1990 | 61,545 | 26,205 | 35,340 | 98,792 | 23,026 | 75,766 |
| 1995 | 65,599 | 23,395 | 42,203 | 158,832 | 41,423 | 117,409 |
| 2000 | 73,092 | 22,218 | 50,874 | 231,907 | 33,369 | 198,538 |
| 2005 | 82,665 | 20,310 | 62,355 | 341,449 | 92,662 | 248,788 |
| 2010 | 90,601 | 17,172 | 73,429 | 445,325 | 131,055 | 314,270 |

[9] A participant may have more than one plan.
[10] Employee Benefit Research Institute. http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaqt14fig1

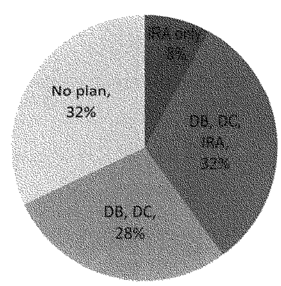
Table 3 explores further the trends in participation in these plans, showing clearly that few private sector employees participate solely in defined benefit plans any more, while an increasing number participate only in defined contribution plans. The percentage of employees participating in either of the two types of plans has increased only slightly from 46.0% to 47.5% over the past three decades, suggesting greater efforts are needed to move the needle on overall participation rates. During the same period, the participation rate of those in only a defined benefit plan declined from 20.7% to 4.6%, while the participation rate for those only in defined contribution plans increased from 11.7% to 30.7%. The participation rates of defined benefit (either only or with DC) dropped from 34.3% to 16.8%, while defined contribution (either only or with DB) increased from 25.3% to 42.9% during the same period.

**Table 3. Participation Rates in Employer-sponsored Retirement Plans, 1979-2011[11]**

| | Defined Benefit Only | Defined Contribution Only | Both DB & DC | Defined Benefit Total | Defined Contribution Total | Either DB or DC Total |
|---|---|---|---|---|---|---|
| 1979-1989 | 20.7 | 11.7 | 13.5 | 34.3 | 25.3 | 46.0 |
| 1990-1999 | 9.6 | 22.3 | 14.5 | 24.1 | 36.8 | 46.4 |
| 2000-2011 | 4.6 | 30.7 | 12.3 | 16.8 | 42.9 | 47.5 |

Most recently, the ICI reports in its 2013 Fact Book (Figure 1) that approximately 82 million of the 121.1 million U.S. households (68%) have employer-sponsored retirement plans, IRAs, or both (some households may have more than one individual with a retirement savings plan). Nearly 9.7 million U.S. households (8%) have only IRAs, while approximately 34 million U.S. households (28%) have only employer-sponsored DB or DC retirement plans. The 32% of households that have no tax-advantaged retirement savings present an important challenge to address.

**Figure 1. Percentage of Households with Tax-Advantaged Retirement Savings, 2012[12]**




[11] Employee Benefit Research Institute. http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaqt14fig1
[12] Investment Company Institute. 2013. 2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry. 53rd edition.

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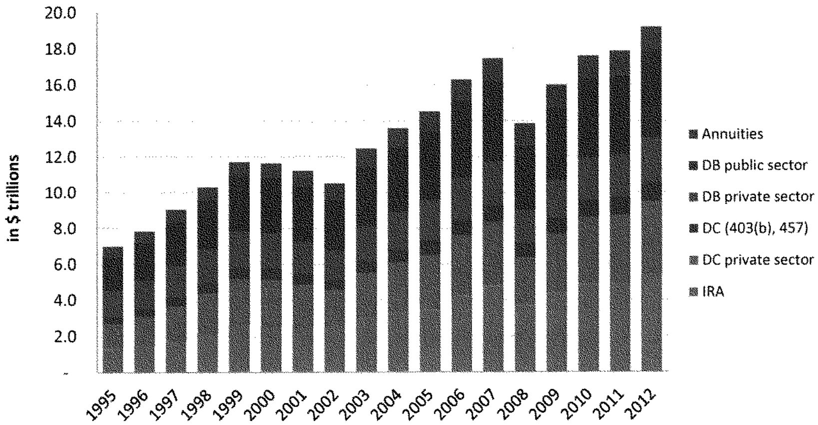
**Retirement Assets and the Breakdown across Types of Plans**

The assets that have accumulated in the U.S. across various retirement vehicles have grown from $7 trillion in 1995 to $19.2 trillion in 2012, an increase of 175% over this period (Figure 2). Total assets of private and public defined benefit plans became smaller than total assets of private and public defined contribution plans combined with IRAs. During this period, assets invested in IRAs grew 320% from less than $1.3 trillion to over $5.4 trillion, while defined contribution plan assets grew by 184%, from nearly $1.8 trillion to nearly $5.1 trillion. The combined assets of defined contribution plans and IRAs grew 241 percent from less than $3.1 trillion in 1995 to over $10.5 trillion in 2012.

**Figure 2. Retirement Assets by Type of Plan, 1995-2012**[13]

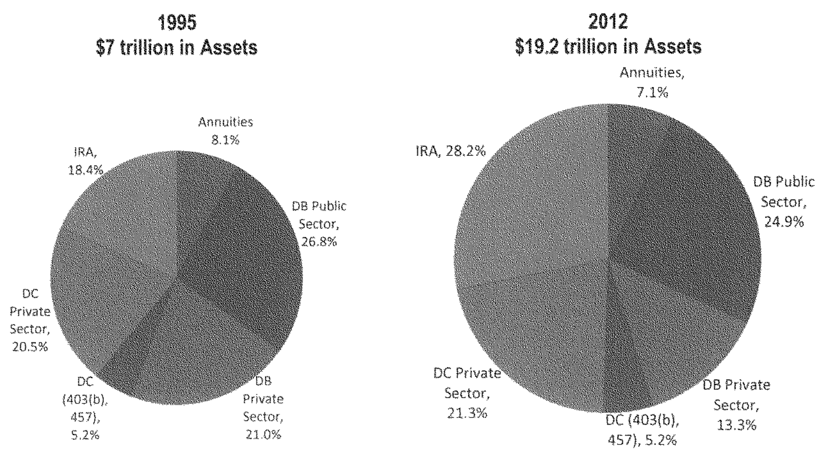



The composition of retirement assets has changed in some significant ways over the past two decades, shifting from DBs to DCs and IRAs. In 1995, nearly half of total retirement assets were in defined benefit plans, with 26.8% in public sector DB plans and 21.0% in private sector DB plans. Defined contribution plans represented about one-quarter of the retirement assets, with 20.5% in the private corporate sector and 5.2% in the public and non-profit sectors (403(b) and 457 plans). IRAs accounted for 18.4% of total assets. In 2012, assets in defined benefit plans dropped to 38.2% of total retirement assets (24.9% in public sector plans and 13.3% in private sector plans). The share of defined contribution plans increased to 26.5% of total retirement assets (21.3% in private sector plans and 5.2% in public and non-profit sector

[13] Board of Governors of the Federal Reserve System. 2013. Flow of Funds; Investment Company Institute. 2013. *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*. 53rd edition; authors' estimates.

403(b) and 457 plans). The share of IRA assets however increased from 18.4% to 28.2% of retirement assets (Figure 3).

**Figure 3: Composition of Retirement Assets in 1995 and 2012[14]**




### The Shift from Defined Benefit Plans to Defined Contribution Plans

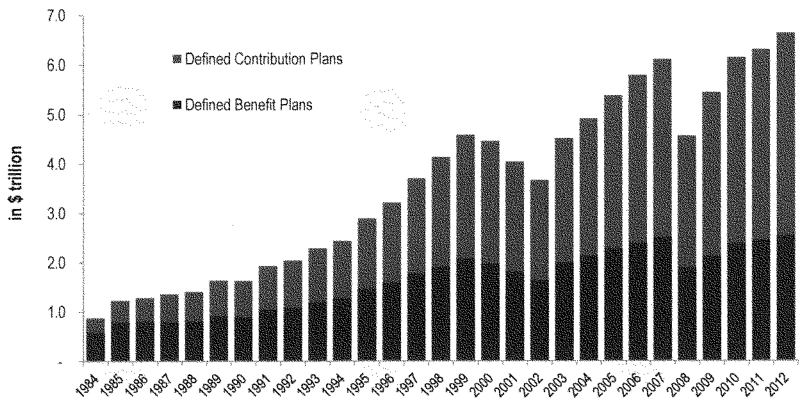
The most dramatic change in employer-sponsored retirement savings plans over the past several decades has certainly been the increasing tendency for employers to sponsor defined contribution plans rather than defined benefit plans. Total assets in private sector employer-sponsored plans were $876 billion in 1984, with $589 billion in defined benefit plans and $287 billion in defined contribution plans. By the end of 2012, total assets in these plans were $6.6 trillion, with $2.5 trillion in defined benefit plans and $4.1 trillion in defined contribution plans. During the 1984 and 2012 period, private defined contribution plans rose 14.2 times while defined benefit plans rose only 4.3 times (Figure 4, Panel A).

In 1984, assets of private defined contribution plans accounted for less than one-third of total assets of private employer-sponsored retirement plans. By the mid-1990s, assets of private employer-sponsored retirement plans were divided equally between DB and DC plans. By the end of 2012, assets of private

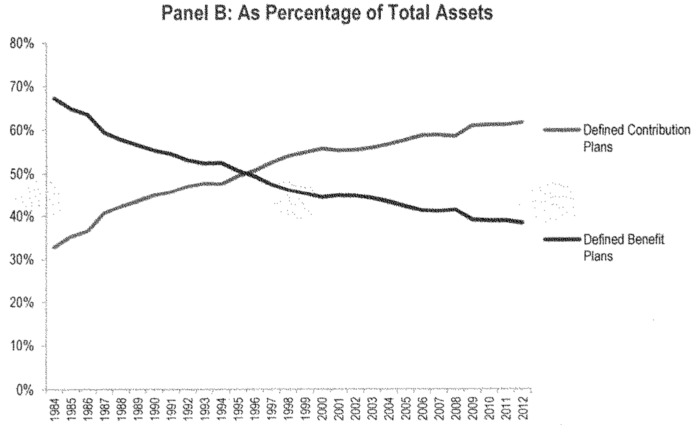
[14] Board of Governors of the Federal Reserve System. 2013. Flow of Funds; Investment Company Institute. 2013. *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*. 53rd edition; authors' estimates.

defined contribution plans accounted for 61.6% of total private employer-sponsored retirement plans (Figure 4, Panel B).

**Figure 4. Private Employer-sponsored Retirement Plans[15]**
**Panel A: Total Assets (in trillions of US$)**




**Panel B: As Percentage of Total Assets**




[15] Ibid.

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**Factors Contributing to the Shift from Defined Benefit to Defined Contribution Plans**

The gradual transition from employer-sponsored defined benefit plans to defined contribution plans reflects both employer and employee preferences. From the employer's perspective, defined benefit plans impose risk to the balance sheet if the plan becomes underfunded, and may also produce undesirable fluctuations in profitability due to pension accounting rules. For example, the recent financial crisis produced a dramatic reduction in the value of the assets in many employers' pension funds, and the sharp reduction in interest rates greatly increased the present value of future pension liability streams. The combined effects have caused many defined benefit plans to be significantly underfunded, resulting in the need for cash infusions into the plans, or other more severe remedies.

Defined contribution plans are also less costly for employers than defined benefit plans, when measured on a per-participating-employee-hour basis. The BLS 2012 Employer Costs for Employee Compensation data (ECEC) provides the average employer cost per employee hour worked in private sector industries. The cost is 43 cents in defined benefit plans, compared to 60 cents in defined contribution plans. However, the participation rate for defined benefit plans is only 17% compared to 41% in defined contribution plans. Therefore, the employer costs per-participating employee hour is $2.53 ($0.43/0.17) in defined benefit plans compared to only $1.46 ($0.60/0.41) per-participant in defined contribution plans. The BLS data also shows a similar pattern across management, sales, service, construction, and production workers, as well as across small and large firms (Table 4).

**Table 4. Employer Retirement Benefit Costs per Employee Hour Worked, 2012[16]**

| | Employer costs per employee hour worked | | Participation (%) | | Worker participation cost | |
|---|---|---|---|---|---|---|
| | Defined benefit | Defined contribution | Defined benefit | Defined contribution | Defined benefit | Defined contribution |
| All workers | $0.43 | $0.60 | 17 | 41 | $2.53 | $1.46 |
| Management and professional | $0.72 | $1.35 | 24 | 61 | $3.00 | $2.21 |
| Sales and office | $0.22 | $0.43 | 14 | 45 | $1.57 | $0.96 |
| Service | $0.09 | $0.13 | 6 | 16 | $1.50 | $0.81 |
| Construction and maintenance | $1.10 | $0.56 | 23 | 42 | $4.78 | $1.33 |
| Production and transportation | $0.44 | $0.37 | 21 | 38 | $2.10 | $0.97 |
| Company Size | | | | | | |
| 1-99 workers | $0.23 | $0.39 | 7 | 31 | $3.29 | $1.26 |
| 100-499 workers | $0.42 | $0.65 | 18 | 49 | $2.33 | $1.33 |
| 500+ workers | $0.99 | $1.10 | 42 | 61 | $2.36 | $1.80 |

Defined benefit plans were traditionally adopted by employers to attract and retain talented employees. The reward to an employee of being in a defined benefit plan depends on the employee's tenure in the company. Employees who do not intend to remain with a company for a long period of time prefer defined contribution retirement plans that are more easily portable. The BLS National Longitudinal Survey of Youth

[16] U.S. Bureau of Labor Statistics, National Compensation Survey.

shows the average person born in the latter years of the baby boom (1957-1964) held 11.3 jobs from age 18 to age 46 during the 1978 and 2010 period. The survey results also show 69% of employees between 18 and 24 years old ended their jobs in less than one year and 92.9% ended their jobs in less than five years. Presumably, many job changes also entailed moving from one institution to another, making portability an important factor. The patterns of high turnover rates and short employment duration are similar across gender and race (Table 5).[17]

**Table 5. Number of Jobs and Duration of Employment by Sex, Race, and Age[18]**
**Panel A. Average Number of Jobs for Persons Ages 18 to 46 in 1978-2010**

| | Total | 18-24 | 25-29 | 30-34 | 35-39 | 40-46 |
|---|---|---|---|---|---|---|
| Total | 11.3 | 5.5 | 3.0 | 2.4 | 2.1 | 2.1 |
| Men | 11.5 | 5.7 | 3.1 | 2.6 | 2.1 | 2.1 |
| Women | 11.1 | 5.3 | 2.8 | 2.3 | 2.0 | 2.1 |
| Race | | | | | | |
| White non-Hispanic | 11.4 | 5.7 | 3.0 | 2.4 | 2.1 | 2.1 |
| Black non-Hispanic | 10.9 | 4.6 | 2.9 | 2.5 | 2.1 | 2.2 |
| Hispanic or Latino | 11.2 | 4.9 | 2.8 | 2.3 | 2.1 | 2.2 |

**Panel B. Cumulative Percentage Distribution Of Duration**

| | 18-24 | 25-29 | 30-34 | 35-39 | 40-46 |
|---|---|---|---|---|---|
| Less than 1 year | 69.1 | 56.2 | 47.8 | 37.6 | 32.8 |
| Less than 2 years | 82.9 | 73.1 | 64.7 | 55.4 | 50.8 |
| Less than 5 year | 92.9 | 87.0 | 82.8 | 76.3 | 69.0 |
| Less than 10 years | 96.4 | 93.0 | 90.9 | 86.0 | -- |
| Less than 15 years | 97.5 | 95.1 | 93.5 | -- | -- |

While the evolution towards DC pension plans can be beneficial for both employees and employers, it nevertheless reallocates risk within the financial system. In DB pension plans, responsibility for funding and investment management rests with the firm sponsoring the plan. In DC plans, these tasks and the associated risks are assumed by employees. Individuals must understand risk-return tradeoffs associated with different investment strategies. They also need to be aware of products that can enable them to manage risk upon distribution of their funds from plans, such as using annuity products offered by insurance companies to provide guaranteed cash flows for the rest of their lifetime.

This underscores the importance for employees to be well informed for how to manage the risk in their DC retirement portfolios, as well as how to ensure that they are saving sufficiently over time to adequately replace their income during their retirement years. Employers are increasingly providing financial education as well as on-line calculators and other tools to help employees understand the need to save, calculate

[17] U.S. Bureau of Labor Statistics. 2012. "Number of Jobs Held, Labor Market Activity, and Earning Growth Among the Youngest Baby Boomers: Results from a Longitudinal Survey." July.
[18] U.S. Bureau of Labor Statistics. 2012. "Number of Jobs Held, Labor Market Activity, and Earning Growth Among the Youngest Baby Boomers: Results from a Longitudinal Survey." July.

how much they should save, and consider the relative benefits of different retirement products. For IRA participants, financial advisors have designed a range of different levels of educational programs to support beginners as well as sophisticated individuals with their retirement planning. Financial advisors are available to help IRA holders gain knowledge about available products, eligibility, risks and returns, and tax consequences.

**Access to Employer-Sponsored Retirement Plans and Take-up Rates**

Participation rates in employer-sponsored retirement plans are driven by two main factors: whether individuals have access to a retirement savings plan, and whether they choose to participate in the plan. Regarding the first factor, 64% of the private sector workforce and 89% of state and local public sector workers have access to either DB or DC retirement savings plans in 2013 (Table 6). According to the Bureau of Labor Statistics (BLS) 2013 National Compensation Survey, approximately 49% of private sector workers and 85% of public sector workers have retirement savings through an employer-sponsored plan. The take-up rate, which measures participation in a plan as a percentage of access to a plan, shows 77% of the private sector workforce and 96% of public sector employees chose to participate in savings plans sponsored by their employers in 2013.

The BLS Survey also shows full-time workers are different than part-time workers in terms of both their opportunities to save for retirement through employer-sponsored plans and their responses to these opportunities. As shown in Table 6, full-time workers in both private and public sectors in the U.S. currently have both higher access to DB and DC retirement plans and higher participation rates in these plans. In 2013, 74% of private sector full-time workers have access to retirement savings plans and 59% participate. Consequently, the take-up rate for full-time private sector workers is 80%. In contrast, only 37% of part-time workers in the private sector have access to, and only 20% participate, in these retirement plans, yielding a 54% take-up rate. This discrepancy between full-time and part-time worker participation also exists in the public sector, due principally to access to plans, with 99% of full-time workers having such access versus only 39% for part-time workers (Table 6).

**Table 6. Retirement Savings: Access, Participation, and Take-up Rates, 2013**[19]

| | Private Sector | | | State and Local | | |
|---|---|---|---|---|---|---|
| | Access | Participation | Take-up Rate | Access | Participation | Take-up Rate |
| All workers | 64 | 49 | 77 | 89 | 85 | 96 |
| Full-time | 74 | 59 | 80 | 99 | 94 | 95 |
| Part-time | 37 | 20 | 54 | 39 | 35 | 90 |
| Wage earning groups | | | | | | |
| Lowest 10% | 28 | 10 | 36 | 58 | 55 | 95 |
| Lowest 25% | 38 | 18 | 47 | 73 | 69 | 95 |
| Second 25% | 65 | 47 | 72 | 93 | 88 | 95 |
| Third 25% | 75 | 62 | 83 | 95 | 90 | 95 |
| Top 25% | 85 | 75 | 88 | 98 | 93 | 95 |
| Top 10% | 87 | 78 | 90 | 98 | 92 | 94 |
| Company Size | | | | | | |
| 1-49 workers | 45 | 32 | 71 | 69 | 66 | 96 |
| 50-99 workers | 63 | 43 | 68 | 89 | 86 | 97 |
| 100-499 workers | 79 | 58 | 73 | 87 | 84 | 97 |
| 500+ workers | 87 | 76 | 87 | 92 | 87 | 95 |

Table 6 also shows that the access, participation, and take-up rates are widely different among wage-earning groups. The BLS Survey shows only 10% of the lowest income decile working in the private sector participates in retirement savings plans compared to 78% of the top income decile. This large disparity becomes somewhat narrower after adjusting for access to these plans. Only 28% of the lowest earner decile in the private sector had access to retirement plans, compared to 87% of the top decile. As a result, the take-up rate for the lowest decile is 36% compared to 90% of the highest decile wage earners. Overall, these statistics suggest the need for both greater access to retirement savings plans for low-income workers, as well as tools to encourage higher participation in these plans. While overall access and take-up rates are higher for low income workers in the public sector, a large gap exists for this population as well.

It is also important to note in Table 6 that employees working for smaller companies tend to participate in retirement savings plans at a much lower rate. The 2013 BLS National Compensation Survey finds that about 32% of workers in the smallest companies (1-49 workers) participated in plans compared to 76% in the largest companies (500+ workers). The gap becomes significantly smaller when looking at take-up rates that adjust for access to plans: the take-up rate is 71% for the smallest companies, compared to 87% for the largest companies, and company size is in general not consistently related to take-up rate. Thus, workers appear to have similar propensity to save for retirement regardless of the size of their company. However, the data suggests workers in smaller companies do not have the same access to retirement savings plans as their counterparts working for larger companies. Therefore, policies that encourage smaller companies to make retirement plans available to their employees are needed.

[19] U.S. Bureau of Labor Statistics. 2013. National Compensation Survey, March.

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**Auto-Enrollment and Auto-Escalation**

The take-up rates in employer-sponsored plans shown in Table 6 indicate that many individuals are not actively engaged in saving for their retirement, particularly a large number of part-time and low wage earners in the private sector. Academic research in the area of behavioral economics has confirmed that individuals are predisposed towards spending in the short-run rather than saving for retirement. However, many exhibit a form of inertia that can be positively exploited to counter their myopic spending behavior. Specifically, many more employees will accept the default option of enrolling into a retirement savings plan even when given the ability to opt-out of the plan, as compared to proactively making the decision to enroll when there is an opt-in option.[20]

This "auto-enrollment" feature has now become increasingly commonplace since the passage of the Pension Protection Act of 2006. A default investment allocation option is specified which the employee may change if desired, though here too employees display inertia in sticking with the initial allocation choice. Another important innovation for defined contribution plans is the "auto-escalation" feature that increases the default amount that an employee puts into his/her DC plan each year (subject to an opt-out clause).

In a 2013 survey conducted by Putnam Investments of over 4,000 American workers who are eligible to participate in a 401(k) plan, 67% reported that they chose to stay in the auto-enroll plan. The study finds that auto-enrolled 401(k) participants exhibited a significantly higher Lifetime Income Score, which captures investor confidence for retirement income security, than those who need to opt-in. In addition, the survey shows the average plan deferral rates for auto-enrolled workers were higher than deferral rates for workers who opted in. The survey finds a similarly positive finding with regards to the effect of auto escalation on retirement preparedness. Individuals who enrolled in a plan with auto escalation had a higher Lifetime Income Score compared to those individuals who did not enroll in such a program across all income groups. Similar to the auto enrollment feature, average deferral rates for workers in plans with an auto escalation feature were higher than rates for individuals in plans that did not have such a feature.[21]

Findings of this recent Putnam survey confirm previous findings in a 2010 Charles Schwab analysis of an attitudinal survey of more than 1,000 401(k) plan participants nationwide. The 2010 study shows that employer matching contributions were the biggest motivating factor for individuals to participate in their 401(k) plans, employer-sponsored plans with an auto enrollment feature had a 15% higher participation rate than those plans without an auto enrollment feature, and 83% of individuals who enrolled in auto escalation programs remained at the increased contribution rate after a year of enrollment.[22]

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[20] B.C. Madrian and D. F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics (2001, Vol. 116, No. 4, 1149-1187. See also S. Benartzi and R. Thaler, "Heuristics and Biases in Retirement Savings Behavior," Journal of Economic Perspectives, Vol. 21, No. 3 (Summer 2007).

[21] Putnam Investments, "Lifetime Income Scores III: Our latest assessment of retirement preparedness in the United States," April 2013.

[22] Charles Schwab. 2010. "The New Rules of Engagement for 401(k) Plans." November.

A 2010 study from the Defined Contribution Institutional Investment Association (DCIIA) found that higher auto enrollment levels and higher automatic escalation rates are critical to increasing the chance of reaching at least an 80% replacement income level (including Social Security).[23] They find that while the average initial default rates for auto enrollment is currently only 3%, increasing this rate to 6% would not have a significant effect on the opt-out rate. Since over two-thirds of participants simply remain at the initial default contribution rate, setting this at a higher level would have a large impact on lifetime savings. Research from the Employee Benefit Research Institute (EBRI) further supports these findings. For instance, their simulations show that if all 401(k) plan sponsors were to adopt automatic enrollment using a 6% default contribution rate, the median replacement rate for the lowest-income quartile would increase from 23% to 52%.[24]

In a 2013 J.P. Morgan survey of 1,009 401(k) participants and plan sponsors, auto enrollment is offered in 43% of plans, and auto escalation is featured in 21% of DC plans. Larger plans (greater than $250 million in assets) were more likely to have higher auto enrollment (62% of plans) and higher auto escalation (42% of plans).[25] A parallel participant survey finds that 62% of respondents were either neutral or in favor of the auto features. Thus, it appears that many plans are not providing features that would be desirable (or at worse neutral) to participants. The JP Morgan survey also supports the need for auto enrollment minimums to be increased to at least 6%, and auto-escalation caps to be raised to at least a 10% recommended savings level.

In general, the choice architecture of a defined contribution plan, namely whether there are automatic features and how the defaults are set (while allowing opt-out choices for participants), can have a profound effect on actual savings behavior and the probability of achieving a sufficient replacement rate of income during retirement.

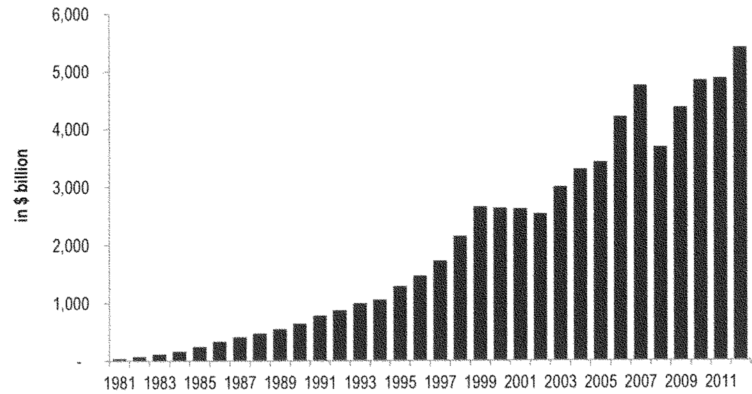
**Individual Retirement Accounts (IRAs)**

Since many individuals are not covered by retirement plans at work, the 1974 ERISA Act introduced opportunities for these individuals to have tax-deferred retirement accounts in the form of traditional IRAs. Traditional IRAs also give both retirees and active employees the opportunity to keep the tax-advantage status of employer-sponsored retirement plan accumulations by allowing transfers or rollovers of plan balances to IRAs. Congress subsequently created additional employer-sponsored IRAs (SEP-IRA in 1978, SAR-SEP IRA in 1986, and SIMPLE IRA in 1996) to allow small employers to offer their employees retirement savings plans. In 1997, Roth IRAs were created, and made available to all but those in higher-income groups. Roth IRA contributions are made on an after-tax basis, but the investment earnings accumulate tax free, and all withdrawals are also tax exempt. While Roth IRAs are popular, traditional IRAs account for approximately 90% of total IRA assets.

[23] Defined Contribution Institutional Investment Association (DCIIA), "Raising the Bar: Pumping Up Retirement Savings."
[24] Employee Benefit Research Institute (EBRI), "The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income, Sept. 2007.
[25] J.P. Morgan Asset Management 2013 Plan Participant Survey Findings, "Searching for direction on the journey to retirement."

Assets in IRAs, including direct contributions and rollovers, increased from $38 billion in 1981 to more than $5.4 trillion in 2012 (Figure 5). Approximately 55% of IRA-owning households (27 million households) are between 35 and 64 years old, with the median of 52 years old. About 73% of IRA-owning households are married or living with a partner, and 67% of IRA-owners are employed. Over 72% of IRA-owning households have income above the U.S. median household income. The median IRA-owning household had $75,000 income and $200,000 of financial assets in 2012.

**Figure 5. IRA Assets (in $ billions), 1981-2012**[26]




By the end of 2012, approximately 40.4% of U.S. households (49 million households) held some type of IRA and 32.5% (39.4 million) held traditional IRAs. About 51% of traditional IRA account holders (20.1 million households) had rollovers from their previous employer-sponsored defined contribution plans and the other half (19.3 million households) did not have rollovers into their IRA accounts. About 16.8% of households (20.3 million) held Roth IRAs and 7.6% of households (9.2 million) held employer-sponsored IRAs. Over 80% of IRA participants also own another type of employer-sponsored retirement plan; 73% also hold DC retirement accounts, while 46% also own DB plans. Less than 8% of U.S. households (9.7 million) only hold IRAs without any other retirement account (Table 7).

[26] Board of Governors of the Federal Reserve System. 2013. Flow of Funds.

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Table 7. Households Owned IRAs, as of End-2012[27]

| | # of Households | % of Total U.S. Households |
|---|---|---|
| Traditional IRA | 39.4 million | 32.5% |
| Includes rollover | 20.1 million | 16.6% |
| Have made contribution at some point after rollover | 11.3 million | 9.3% |
| Have never made contribution since rollover | 8.8 million | 7.3% |
| Does not include rollover | 19.3 million | 16.0% |
| Roth IRA | 20.3 million | 16.8% |
| Employer-sponsored IRA (SEP, SAR-SEP, and SIMPLE) | 9.2 million | 7.6% |
| Any IRA | 48.9 million | 40.4% |

During the 2011 tax year, approximately 16% of U.S. households (48.9 million) made a contribution to their IRA, with a median contribution of $5,000 per household. About 9.1% of total U.S. households (39.4 million) made contributions to a traditional IRA, with a median contribution per household of $4,000. For the more restrictive Roth IRA accounts, 6.2% of U.S. households (20.3 million) contributed in 2011, with a median of $3,000 per household. Lastly, 4.2% of households (9.2 million) contributed to other employer-sponsored IRA accounts (SEP, SAR-SEP, and SIMPLE), with a median of $4,300 per household (Table 8).

Table 8. Contribution Activity to IRAs in Tax Year 2011, by Type[28]

| | Median contribution per household ($) | Households Made IRA Contribution | | |
|---|---|---|---|---|
| | | # of households (million) | % of households owning each type | % of Total U.S. Households |
| Traditional IRA | $4,000 | 39.4 | 28.0% | 9.1% |
| Roth IRA | $3,000 | 20.3 | 37.0% | 6.2% |
| Employer-sponsored IRA (SEP, SAR-SEP, and SIMPLE) | $4,300 | 9.2 | 55.0% | 4.2% |
| All IRA | $5,000 | 48.9 | 39.0% | 15.7% |

## Role of Financial Advisors

Given the lack of sound financial knowledge among a broad subset of the U.S. population, the role of financial advisors in promoting and guiding retirement savings for IRAs is critical. Financial advisors assist in setting up IRAs, recommending a retirement strategy including contribution amounts and asset allocation, and providing guidance on the size and timing of withdrawals.

According to ICI's recent IRA Owners Survey, more than half of traditional IRA-owning households used a professional financial advisor to select the asset allocation of rollover assets; 61% of these households consulted with an advisor to create an investment strategy and allocate assets in their IRAs; and 58% of

[27] Investment Company Institute. 2012. "The Role of IRAs in U.S. Households' Saving for Retirement, 2012." ICI Research Perspective; and authors' estimates.
[28] Ibid.

households that made withdrawals in the 2011 tax year consulted with an advisor, compared to 16% that did not consult with any source.[29]

There is increasing evidence that IRA holders who use financial advisors save more, have better diversification strategies, and are less likely to experience income shortfalls during retirement. In a 2013 Putman study, survey data show that those who use an advisor exhibited a much higher Lifetime Income Score (24 points higher, 80% vs 56%), a measure of replacement of income during retirement, than those not using an advisor.[30] Of those who were likely to produce 100% of their current income in retirement, 39% reported using an advisor. Those respondents who have an advisor also have higher confidence levels with respect to their asset allocation choice, a decision that many individuals find challenging to determine on their own.

Strategic Business Insight's CFD group conducted an analysis of households with at least $100,000 in investable assets, and found that over a 12-year period, investors who always obtained investment advice before making major financial decisions ended up with a much larger increase in assets ($84,000) as compared to those who sometimes ($23,000) or never (-$57,000) obtained advice.[31] A study from Charles Schwab based on a client survey finds that 401(k) account holders who work with an advisor increase their average monthly deferral percentage, and that savings rates for these individuals double from 5% to 10% as a result of implementing the advice they received.[32] Also, these account holders were better diversified across asset classes (eight asset classes on average, as compared to fewer than four classes for those choosing their own investments). Furthermore, during the turbulent July 2008 to February 2009 period, a very high proportion of those working with advisors stayed the course in their 401(k) portfolios, which likely provided significantly higher returns over the longer run than those who did not.

An ING study of over 14,000 investors also found that those individuals spending one-on-one time with a financial advisor have saved, on average, more than twice the amount for retirement than those who did not consult with an advisor, and that their investment knowledge and confidence for retirement readiness have also increased.[33] A study of 401(k) participants across different age groups conducted by Financial Engines and AON Hewitt find that the median portfolio returns over a five year period (2006-2010) were consistently higher for those receiving help from a financial advisor across all age groups, varying from 2.53% to 3.40% higher (net of fees) depending on the group.[34] In addition, those seeking help had a significantly lower median portfolio risk than those investing without the benefit of any advice, and this makes the higher returns of those being advised even more impressive. The study also finds that those

[29] Investment Company Institute. 2012. "The Role of IRAs in U.S. Households' Saving for Retirement, 2012." ICI Research Perspective.
[30] Putnam Investments. 2013. "Lifetime Income Scores III: Our latest assessment of retirement preparedness in the United States." April.
[31] Strategic Business Insights. 2009. "The Financial-Advisor Advantage." MacroMonitor Marketing Report, May.
[32] Charles Schwab. 2010. "The New Rules of Engagement for 401(k) Plans." November.
[33] ING Retirement Research Institute. 2011. "Help Wanted." December.
[34] Financial Engines and AON Hewitt. 2011. "Help in Defined Contribution Plans: 2006 Through 2010." September.

seeking help have more appropriate "glide paths" that help savers reduce their level of portfolio risk as they approach retirement age.

**Distribution of Assets in Defined Contribution Plans and IRAs**

As shown earlier in Figure 1, 32.0% of U.S. households have no retirement savings plan (outside of Social Security). Table 9 below shows that almost half of U.S. households do not hold a defined contribution or IRA plan. Regrettably, even for those households who do hold a DC or IRA account, slightly more than half of those have less than $50,000 in those accounts. Only 4% of households have at least $500,000 in their DC and IRA accounts. Given that many individuals in these households are already retired, or may be close to retirement age, this suggests that a large majority of individuals will struggle to adequately replace their income during retirement. Table 9 also shows only slightly better results for those households with the head or spouse in the labor force.

**Table 9. Distribution of Retirement Assets among Households in 2010[35]**

| | All Households (100%) | | Households in which the Head or Spouse is in the Labor Force | |
|---|---|---|---|---|
| | # of households | % of all households | # of working households | % of working households |
| $0 | 58,363,198 | 49.6 | 39,849,170 | 43.8 |
| $1 ~ $50,000 | 31,527,732 | 26.8 | 27,810,222 | 30.6 |
| $50,001 ~ $100.000 | 8,325,406 | 7.1 | 7,023,745 | 7.7 |
| $100,001 ~ $500,000 | 14,690,016 | 12.5 | 12,322,614 | 13.5 |
| $500,001 ~ $1,000,000 | 2,919,566 | 2.5 | 2,516,501 | 2.8 |
| $1,000,001 ~ $2,000,000 | 1,273,997 | 1.1 | 1,047,414 | 1.2 |
| $2,000,001 ~ $3,000,000 | 335,415 | 0.3 | 283,192 | 0.3 |
| >$3,000,000 | 173,886 | 0.1 | 129,983 | 0.1 |
| Total | 117,609,216 | 100.0 | 90,982,841 | 100.0 |

**Saving for Retirement – International Comparisons**

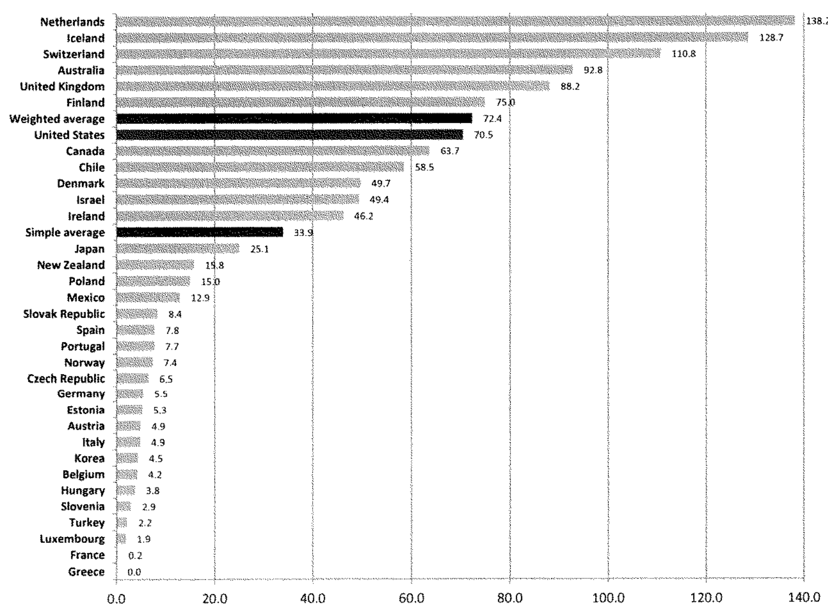
Many policy makers have expressed concern that the U.S. savings rate is too low to ensure that future retirees will have a sufficient replacement rate of income during their retirement years. The National Retirement Risk Index (NRRI), as calculated by Boston College's Center for Retirement Research in 2010 (based on the Survey of Consumer Finances data from the U.S. Board of Governors of the Federal Reserve System), indicates that over half (53%) of U.S. households may be unable to maintain their standard of living in retirement.[36] Between 2007 and 2010, the NRRI increased by 9 percentage points due to the severe drop in housing prices, rapidly falling interest rates, the rise in Social Security's Full

[35] Topoleski, John J. 2013. "U.S. Household Savings for Retirement in 2010." CRS Report for Congress.
[36] Munnell, A. H., A. Webb and F.N. Golub-Sass, "The National Retirement Risk Index: An Update," Center for Retirement Research at Boston College, Report # 12-20, October 2012.

Retirement Age, and the stagnant stock prices during that period. Unfortunately, the households that were most impacted were those nearing retirement. The NRRI for low-income households was 61% in 2010, a full 8 percentage points higher than for all households, indicating the large risk of this income group suffering a low replacement rate during retirement years.

With regards to savings through just the private retirement system discussed above, the U.S. does lag behind several OECD countries. The assets of private retirement savings as a percentage of GDP in the U.S. are approximately 70.5% in 2011, which is below that of countries such as Australia (92.8%) and the United Kingdom (88.2%), and slightly below a *weighted* average of 34 OECD countries (72.4%). Nevertheless, total assets of private retirement as a percentage of GDP of the U.S. is more than double the *simple* average of 34 OECD countries (33.9%), reflecting low private retirement saving rates in many OECD countries such as France (0.2%), Italy (4.9%), Germany (5.5%), and Japan (25.1%) (Figure 6).[37]

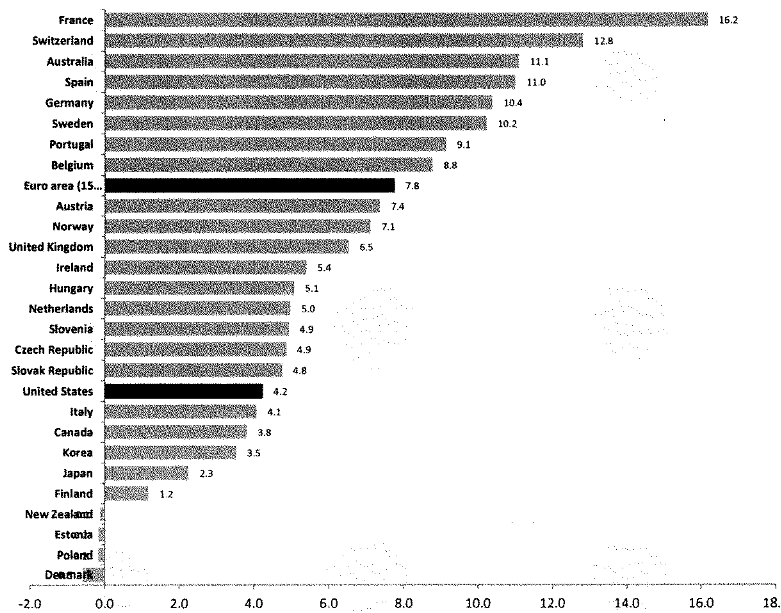
**Figure 6. Private Retirement Savings in Selected OECD Countries, 2011(as percentage of GDP)[38]**




[37] There are differences between the calculations of private retirement savings as a percentage of GDP determined by the OECD and the Federal Reserve System; however, the discrepancies are negligible and therefore we include both sources in this report.
[38] OECD Global Pension Statistics.

The household savings rate (defined as household disposable income less consumption plus the change in net equity of households in pension funds) in the U.S. was 4.2% in 2011, compared to 7.8% average in the Euro area and above 10% in several European countries (Figure 7).

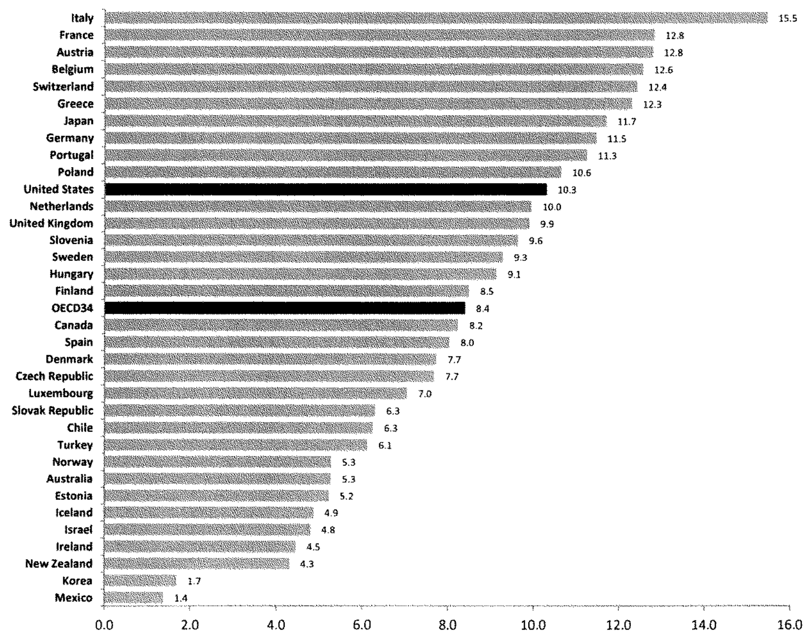
**Figure 7. Household Savings Rates in Selected OECD Countries, 2011 (percentage of disposable household income)[39]**




It is also useful to compare the pension systems in different countries from the perspective of the size of benefit payments made from both public and private pension funds. The average benefit expenditure across OECD countries was 8.4% of GDP in 2007. Approximately one-third of the countries (that have data available) spent more than 10% of GDP on public and private pension benefits. In 2007, the OECD reported that the U.S. spent 10.3% of GDP on public and private pension benefits, compared to 15.5% in Italy (the highest), 12.8% in France, 11.5% in Germany, and 11.7% in Japan (Figure 8). The U.S. thus lags behind many of the largest OECD countries in terms of pension benefit expenditures.

[39] OECD Economic Outlook No. 93, June 2013. Web.

**Figure 8. Public and Private Pension Benefit Expenditures in Selected OECD Countries, 2007 (as percentage of GDP)** [40]

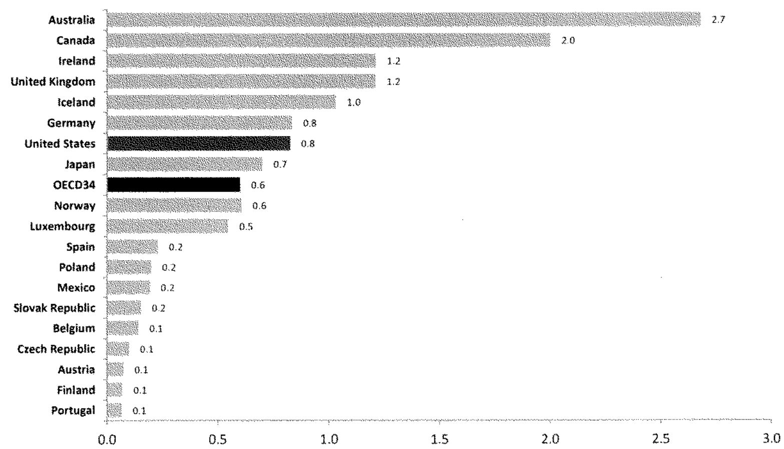



The tax-deferred defined contribution and IRA plans provided in the U.S. appear to be effective in promoting retirement savings, based on the strong growth in assets in these plans over the past three decades. Most OECD countries encourage private retirement savings by using tax incentives for tax deferral fully or partially their private contributions and investment gains from income that is subject to taxation. Among 21 OECD countries that have available data for tax incentives for private retirement savings, 11 countries have less than or equal to 0.2% of GDP, 5 countries have more than 0.2% but lower than 1.0% of GDP, and 5 countries have more than 1.0% of GDP. The tax incentives for private retirement savings in the U.S. accounted for 0.8% of GDP, compared to the 0.6% OECD average (Figure 9).

[40] OECD. 2011. *Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries.*

It is important to note that tax incentives through tax *deferrals* are not the same as tax deductions or tax exemptions. As the term indicates, tax deferrals just allow individuals to defer tax payments to later dates. Depending on many factors (including income tax rates at the times of contribution and distribution the return on assets, and the length of the deferral period), it is quite typical that total taxes paid after the deferral period are higher than the amount of tax that would be paid at the time of the retirement plan contribution, and possibly substantially higher.[41]

**Figure 9. Tax Incentives for Private Retirement Plans in Selected OECD Countries, 2007[42]**
(as percentage of GDP)




### Impact of Retirement Savings on Capital Markets

Assets accumulated in the private retirement system support investments in equity and debt markets, as well as other market sectors such as real estate, which in turn lead to economic growth and job creation. Numerous empirical studies have shown the positive impacts of retirement savings and pension reform on the development of capital markets, economic growth, and poverty reduction in both developed and developing countries.[43]

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[41] Yoo, Kwang-Yeal and Alain de Serres. 2004. "Tax Treatment of Private Pension Savings in OECD Countries." OECD Economic Studies No. 39; Brady, Peter. 2012. *The Tax Benefits and Revenue Costs of Tax Deferral*. Investment Company Institute.

[42] OECD. 2011. *Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries*.

[43] For example, Cihak, Martin, Asli Demirguc-Kunt, Erik Feyen, and Ross Levine. 2012. "Benchmarking Financial Systems around the World." Policy Research Working Paper 6175, World Bank; Niggemann, Taro and Jorg Rocholl. 2010. "Pension

Retirement savings in defined contribution and IRA plans in the U.S. rose from 11% of GDP in 1985 to 64.7% of GDP in 2012. Including assets invested in defined benefit plans, total retirement savings in the U.S. grew from 37.5% of GDP in 1985 to 118.1% of GDP in 2012 (Table 10).

**Table 10. Retirement Assets as Percentage of GDP, Selected Years, 1985-2012[44]**

| | 1985 | 1990 | 1995 | 2000 | 2005 | 2010 | 2012 |
|---|---|---|---|---|---|---|---|
| DB, DC, IRA | 37.5 | 62.3 | 91.1 | 113.1 | 110.8 | 117.5 | 118.1 |
| DC, IRA | 11.0 | 22.8 | 40.2 | 55.8 | 55.7 | 63.8 | 64.7 |

Holders of traditional IRAs (which account for over 90% of total IRA assets) who are in their twenties invested more than 51.5% of their assets directly in equities and equity funds, and 6.9% of their assets directly in bonds and bond funds. In addition, more than 23.4% of the assets in these IRAs were in target date funds and non-target date hybrid funds that invest in both equities and fixed-income securities. Altogether, these IRA investors held 81.8% of their assets in equities and fixed-income securities. The remaining 18.2% of their assets were held in money funds and other assets. Similarly, 401(k) accounts, the largest class of defined contribution plans, held 39.2% of their assets directly in equities and equity funds, and 42.5% in target-date funds and non-target-date balanced funds in 2011. Overall, 401(k) accounts were 89.1% invested in equities and fixed-income securities. The remaining 11% of assets were held in money market funds and other assets.[45]

### Conclusions

The private retirement savings system in the U.S. continues to evolve in many positive directions. The size of retirement savings has increased substantially in the past several decades. Innovative product features such as auto-enrollment and auto-escalation have helped to encourage greater savings for many individuals. Employees' needs for portability and flexibility have been addressed by financial institutions and supported by legislation. Increased financial education available to DC plan participants, and greater access to financial advisors assisting IRA holders, have helped individuals gain greater confidence in their plans for saving for retirement.

Funding and Capital Market Development." Working Paper; Bekaert, Geert, Campbell R. Harvey, and Christian Lundblad. 2005. "Does Financial Liberalization Spur Growth?" Journal of Financial Economics; Roldos, Jorge. 2004. "Pension Reform, Investment Restrictions, and Capital Markets." IMF Policy Discussion Paper; Catalan, Mario, Gregorio Impavido, and Alberto R. Musalem. 2000. "Contractual Savings or Stock Markets Development: Which Leads?" The World Bank.

[44] Board of Governors of the Federal Reserve System. 2013. Flow of Funds; Investment Company Institute. 2013. *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*. 53rd edition; authors' estimates.

[45] Investment Company Institute. 2013. *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*. 53rd edition; asset allocation of IRAs and 401(k) accounts are based on participants in their twenties.

However, there is still much to be achieved in terms of increasing both participation rates and contribution amounts to ensure that individuals can achieve their retirement goals, including reducing the risk of retiring without sufficient funds to replace their income at a reasonable rate. The U.S. is lagging in retirement savings when compared against many other OECD countries. Saving more for retirement improves the lives of future retirees in the country. It also puts fewer burdens on other citizens. Beyond the direct impact on individuals, retirement savings promote economic growth through a larger domestic asset base that is invested in productive activities in the economy. With an already low household savings rate in the U.S., a reduction in private retirement savings would only further exacerbate this situation. All of these critical goals underscore the importance of continuing to reinforce all the improvements that have been made to the private retirement system.

Assets in retirement savings accounts can be further enhanced by increasing limits on tax-deferred contributions. Since the ability of individuals to save may not be smooth over time, the ability to contribute more at some points in time provides valuable flexibility. In general, higher limits also support greater levels of retirement savings, thus reducing the number of individuals who may be at risk of having too low replacement rates during retirement. Proposals to tighten limits on tax-deferred contributions seek to increase tax revenue in the short run while ignoring the decreased tax revenue in the longer run that would come from taxable withdrawals from defined contribution and traditional IRA accounts. The tax incentives associated with retirement savings are merely tax deferrals, not tax deductions or exemptions. Myopic proposals that focus on increasing tax revenue in the short run ignore the general economic benefits of encouraging a secure retirement for a large number of citizens, and improving the growth of the overall economy.

Retirement savings should also be encouraged by expanding the scope of auto-enrollment and auto-escalation features. These features help to counteract a natural behavioral tendency for individuals to delay saving for retirement, even when it is clearly in their best interest to do so. Starting auto-enrollment at a significantly higher percentage level of income, and auto-escalating at a faster pace and to a higher cap will all help to achieve appropriate income replacement levels in retirement. While financial literacy programs can help to inform employees to plan their retirement savings more carefully, default enrollments clearly serve a more direct role in encouraging savings, while providing flexibility to individuals with opt-out features. Increasing guidance to savers in the form of financial literacy and advisory services is also very valuable. Imposing additional restrictions on the ability of investment advisors to assist individuals merely limits the benefits that are frequently ascribed to these advisory services.

Public policies related to retirement savings must continue to focus on increasing access to tax-advantaged retirement vehicles, encouraging employees to participate in these plans, and educating, incentivizing and nudging them to meaningfully contribute to those plans. Particular focus should be on segments of the populations that don't have access or have low participation rates in retirement plans, including part-time workers, those working for smaller companies, and lower-income earners. Protecting and expanding the retirement security of all individuals is paramount from both societal and economic perspectives.

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**About ndp|analytics.** ndp|analytics is a strategic research firm that specializes in economic analysis of public policy and legal issues. Our services include economic impact studies, business impact analyses, cost-benefit analyses, statistics, and data construction. Our analytical frameworks are data-driven and are supported by economic fundamentals, robust, transparent, and defensible. We present facts and findings to tell a complete story in a simple yet effective language for the broad public audiences. We excel in supporting organizations for advocacy, government and industry relations, public affairs campaigns, and strategic initiatives. Clients of ndp|analytics include trade associations, coalitions, financial institutions, law firms, U.S. and foreign corporations, and multinational organizations. Our work has been prominently cited in the 2011 Economic of Report of the President to the Congress, the media, reports from government agencies, Congressional testimonies, and by Congressional leaders.

**House Select Committee on Small Business Retirement Plan Formation and Sponsorship Among Small Businesses**

As the House Select Committee on Small Business considers retirement plan formation and sponsorship among small businesses, the Principal Financial Group® is pleased to offer our insight based on our work with thousands of small business retirement plan clients.

As a leading provider of retirement plans and a global investment management leader, the Principal Financial Group provides comments based on more than 70 years in the retirement industry and our experience with small to medium-sized employers and their employees. We currently provide retirement services to more than 43,000 retirement plans and 4.2 million employee participants, including more than 38,000 retirement plans of small businesses[1] and their 1.6 million participants.

We agree that more small businesses need to establish qualified retirement plans for their employees, and we offer some suggestions to encourage greater adoption of plans.

However, we believe it is instructive to understand not only what is preventing small businesses from offering plans now but why many others ***are*** offering plans and how and why they are doing so successfully.

For 12 years we have studied and recognized small to medium-sized employers (those with between 5 and 1000 employees) for their commitment to employee financial security. *The Principal 10 Best Companies for Employee Financial Security* consistently rely on robust retirement programs as part of their overall business strategy to attract, retain and motivate employees. We have published case studies of these winning companies over the years to educate other small organizations that retirement programs and other benefits are more than a cost, they are an investment in employees which is an investment in the future of the business.

Another common thread among the best practices of this group of employers is an emphasis on providing significant financial education to employees. We will profile the efforts of one of these small business employers, The Spiratex Company, from Romulus, Michigan.

**401(k) Plan Offerings Are Up Among Small Employers**

Every small business builds, sells or services something different but all deal with the daily challenges of managing and growing their business, including competing for talent with not only small business peers but large corporations. In this competitive environment, small businesses are often challenged to compete purely on salary with larger firms and must also seek to offer strong employee benefits plans, including qualified retirement plans.

[1] Retirement plans of small business defined as those with less than 500 participants.

In 2011, research conducted by Harris Interactive on behalf of The Principal® found that more than half (52 percent) of small business owners agree that offering a good employee benefits plan is an essential component of their strategy to recruit and retain employees. The majority (84 percent) of plan sponsors say their defined contribution/401(k) plan is a key part of their company's benefit strategy. More than a third (36 percent) say their defined contribution/401(k) plan helps them compete for talent.

More than half (51 percent) of business owners said they offer some type of qualified retirement plan, **with a 401(k) plan being the most common type of plan offered (35 percent, up significantly from 23 percent in 2010)** followed by profit sharing (11 percent), SIMPLE (6 percent) and SEP (6 percent).

And, of the business owners who don't currently offer a qualified retirement plan to their employees, approximately two in ten (22 percent) plan to implement a retirement plan in the next 12 months.

What keeps more small employers from offering plans? Those responding to the survey cited a belief that employees would prefer wages (31 percent) and that it costs too much to set up and administer a plan (27 percent). Over half of employers not offering a plan are not aware of the start-up tax credit. However, more than a third (35 percent) said the credit would be a strong incentive to consider offering a 401(k) plan.

**Small Businesses Can and Do Establish Outstanding Retirement Plans: A Case Study**

Outstanding employee benefit programs are not solely reserved for large firms. Countless small businesses across the country share the belief that strong benefits build a strong workforce, which helps support a strong bottom line. *The Principal 10 Best Companies for Employee Financial Security* is a prestigious, nationwide program that recognizes growing companies in everything from retirement plans to benefit education. Every year, an independent panel of judges selects companies based on their continuing commitment to employee financial security.

One such company is The Spiratex Company, a manufacturer founded in 1955 in Dearborn, Michigan and now based in Romulus, Michigan, that currently employs 140 employees. Named one of The Principal 10 Best Companies in 2008, Spiratex is very focused on the welfare of their employees and seeks to retain skilled staff for the long-term to create an environment where new hires have an opportunity to learn from those with 20, 30 and even 40 years of experience.

Even though the company offers a fantastic 401(k) plan with an almost unheard-of match – 50 percent on every dollar employees contribute, up to 100 percent of pay – plus a profit sharing contribution, there was a time when well over one-third of employees didn't take full advantage of the plan.

Thirty-three percent of employees simply didn't get around to enrolling. Some employees enrolled but didn't defer enough to get the full employer match. Others were too timid with their investment selection, lacking diversification appropriate for their risk tolerance and time horizon.

Following the market downturn, the company took action. Over the course of two years, it:

- **Implemented automatic enrollment and automatic deferral increases**
- **Added lifecycle** investment options
- **Boosted overall education** through mailings, payroll stuffers, newsletter articles and quarterly meetings on company time
- **Engaged both its retirement plan provider and financial advisor to educate employees** on investing in volatile markets
- **Added mandatory, one-on-one meetings on company time** including with a human resources representative at enrollment in the plan and with a salaried benefit specialist from the plan service provider to educate all employees about the value of the plan and develop a financial action plan for ongoing follow-up

The change in The Spiratex Company 401(k) plan was dramatic. Participation went from 67 percent to 89 percent. More than 20 percent of employees opted for automatic deferral increases of one percent per year for an average of eight years. Nearly 40% of participants transferred their retirement funds to the professionally managed lifecycle or balanced investment options. Today, the average participant is on track to replace 74% of their retirement income when combined with social security, with younger workers age 18-34 on track to replace 88% of their retirement income.

**Expanding Coverage of Employees in Employer-Sponsored Retirement Plans**

It's clear that, in the case of The Spiratex Company, a combination of effective plan design, employer commitment and a strong focus on financial education is paying dividends in helping employees' retirement readiness.

But not all small businesses are in a position to support such a robust employer commitment. To make progress in expanding coverage of employees in employer-sponsored plans while increasing retirement savings to adequate levels, we urge Congress to consider the following positions:

**Preserve existing tax incentives and contributions limits** – These incentives have helped millions of Americans save trillions of dollars. Reducing or removing current tax incentives would have a detrimental impact on retirement security. According to The Principal Retirement Readiness Survey[2]:

- Ninety-two percent of employers who offer a plan say retirement *tax incentives for employees* are important to their decision to offer a 401(k) or other defined contribution plan.
- Approximately four out of five plan sponsors (79 percent) say *the tax incentive given to employers* is important in their decision to offer a 401(k)/defined contribution plan.

[2] The Principal Retirement Readiness Survey 2011, commissioned by the Principal Financial Group and conducted by Harris Interactive online. Data was gathered May 17 through June 17, 2011 from 1,305 employers. Employers who currently do not offer a DC retirement plan, and employers who do offer DC plans, serviced by The Principal, were included in the survey.

According to a recent non-partisan Employee Benefit Research Institute survey[3], American workers validate that they would save less if they could not do so on a pre-tax basis.

- Forty-five percent of workers say they would stop or reduce contributions to worksite retirement plans if they could no longer do so on a pre-tax basis.
- Lower income workers ($35,000 or less) would be much more likely to stop contributing if the tax incentive were removed. Twenty-four percent with incomes less than $35,000 said they would stop contributing compared to 11 percent for incomes of $35,000 to $74,000 and 17 percent of incomes over $75,000.

**Retirement plan tax deferrals are not tax forgiveness** - These tax incentives have been mischaracterized as expenditures when they are actually revenue-producers. The federal government eventually collects significant tax revenue on distributions from tax deferred retirement savings. When workers withdraw money from their retirement accounts, they generally pay ordinary income taxes not only on the original savings but also on the potential accumulated, compounded earnings.

**Our analysis of a typical middle income worker shows that over the course of a 40-year career, for every $1 of taxes deferred, the federal government collects at least $4 in tax revenue when the contributions and earnings are withdrawn[4].** (See Appendix I)

With $10.5 trillion[5] currently saved in worksite retirement defined contribution plans and IRAs, the government will be collecting significant tax revenue for many years to come.

**Move beyond preserving the system to enhancing the system** – Congress can help expand financial security for Americans by building on the current employer-sponsored system. By removing barriers to new retirement plan formation and encouraging plan designs that increase participation and savings, Congress can help more Americans have access to retirement plans and encourage them to save more effectively.

The Principal recommends the following steps:

- Give small businesses reasons to offer plans and remove barriers from plan formation.
  - Increase tax incentives for starting a plan.
  - Make it easier to set up and administer plans.
  - Lower the cost to administer plans by streamlining reporting requirements and promoting policies that encourage modern communication modes such as electronic document delivery to cut down excessive cost of paper.

[3] Employee Benefit Research Institute 2013 Retirement Confidence Survey
[4] Analysis by the Principal Financial Group. See Appendix I for assumptions used.
[5] Source Investment Company Institute, "Retirement Assets Total $19.5 Trillion in Fourth Quarter 2012," News Release, March 27, 2013.

- Encourage retirement plan designs that increase savings and participation.
    - Encourage automatic enrollment at higher deferral rates, automatic annual increases and employer matches structured to incent higher deferrals.
    - Update the automatic contribution arrangement safe harbors to:
        - Include single-tier match formulas that meet certain minimum criteria.
        - Remove the 10 percent cap on default deferral and auto escalation.
    - Provide additional incentives to employers who use auto escalation.
    - Expand savers credit and deposit it back into the participant's retirement account.
- Address the challenge of retirement income.
    - Encourage broader use of retirement income illustrations on benefit statements to drive home how long savings will last in retirement.
    - Clarify ERISA regulations to alleviate fiduciary concerns related to the selection of an annuity provider and encourage plan sponsors to voluntarily provide education about and access to income annuities in the workplace.
- Preserve retirement plan education for participants.
    - Ensure any proposed regulation focused on conflicts of interest will not result in the loss of investment education to small business plan sponsors and American workers.

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**About the Principal Financial Group**

The Principal Financial Group® (The Principal®)[6] is a global investment manager leader offering retirement services, insurance solutions and asset management. The Principal offers businesses, individuals and institutional clients a wide range of financial products and services, including retirement, asset management and insurance through its diverse family of financial services companies. Founded in 1879 and a member of the FORTUNE 500®, the Principal Financial Group has $451 billion in assets under management[7] and service some 19.8 million customers worldwide from offices in Asia, Australia, Europe, Latin America and the United States. Principal Financial Group, Inc. is traded on the New York Stock Exchange under the ticker symbol PFG. For more information, visit www.principal.com.

[6] "The Principal Financial Group" and "The Principal" are registered service marks of Principal Financial Services, Inc., a member of the Principal Financial Group.
[7] As of June 30, 2013

## Appendix I
## Worker Savings and Tax Implication Analysis
From the Principal Financial Group[8]

The following estimation is based on an average worker with access to a 401(k) plan and employer match throughout an entire working career.

| | |
|---|---|
| $74,348 | Amount of taxes the government would have received if the employee had not been allowed to defer 7% annually with 3% match ($265,529 x 28%). |
| $328,495 | Tax collected on distributions on a 4.5% draw down rate of the total account balance over a 30 year period ($2,189,970 x **15% tax rate**). |
| $4.40 to $1 | For every $1 of tax deferred, the government could get roughly $4.4 in the future ($328,495/$74,348= 4.418). |
| | |
| $437,994 | Tax collected on distributions on a 4.5% draw down rate of total account balance over a 30 year period ($2,189,970 x **20% tax rate**). |
| $5.9 to $1 | For every $1 of tax deferred, the government will get roughly $5.9 in the future ($437,994/$74,348= 5.891). |

This analysis is a conservative estimate of the implications of tax deferred savings. Factors that would increase the ratio include:

- ***A lower marginal tax rate for the worker than the 28% assumption***. The marginal rate could be lower over the worker's career on average which would decrease the estimates of the current tax amount.
- ***A higher effective tax rate in retirement***. The assumed 15% and 20% tax rate could be low considering the likelihood of higher rates in the future.
- ***A higher draw down rate in retirement***. The assumed 4.5% draw down rate in retirement would leave a substantial remaining account balance for heirs. This remaining amount would eventually be taxed as well.

**Assumptions[9]:**

- Individual contributes to a 401(k) beginning at age 25 through age 65.
- Beginning salary of $30,000 with annual increase of 3.5 percent.
- Seven percent deferral rate and 3 percent match.
- Pre-retirement marginal tax rate of 28 percent, post-retirement effective of rates of 15 and 20 percent.
- Annual rate of return 7 percent.
- *This example is for illustrative purposes only. The assumed rate of return used is hypothetical and does not guarantee any* future *returns nor represent the return of any particular investment option.*

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[8] Calculation by Principal Life Insurance Company, a member company of the Principal Financial Group

[9] Calculation performed by Principal Life Insurance Company