



Testimony of the American Society of Pension Actuaries At a Hearing on Retirement Security and Pension Reform Before the United States House of Representatives Subcommittee on Oversight, Committee on Ways and Means

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Introduction

Mr. Chairman, members of the Subcommittee, thank you for inviting me today to testify on this important subject. My name is Carol Sears. I am an enrolled actuary, certified pension consultant, and Vice President of Small, Parker and Blossom, a pension administration and consulting firm located in Peoria, Illinois. Small, Parker, and Blossom provides retirement plan services to over one thousand small businesses located in the Midwest. All together, these plans provide retirement plan coverage to over one hundred thousand small business employees.

I also presently serve as President of the American Society of Pension Actuaries (ASPPA) on behalf of whom I am testifying today. ASPPA is an organization of over 4,000 professionals who provide actuarial, consulting, and administrative services to approximately one-third of the qualified retirement plans in the United States. The vast majority of these retirement plans are plans maintained by small businesses, and today I would like to focus on the myriad of rules and regulations which continue to make it exceedingly difficult for small businesses to offer meaningful retirement plan coverage to their employees.

The Small Business Retirement Crisis

Everyone agrees on the problem. Americans, as a whole, are getting older and their retirement needs are growing. The number of Americans age 65 or older will double by 2030 (from 34.3 to 69.4 million) so that one in five Americans will be retired. As reflected in the current debate, the stress and strain on the current Social Security system will be significant.

However, even if the Social Security system remains strong through the 21st century, it will not be enough. Income from Social Security represents less than half of what the average American needs to retire comfortably. Meanwhile, according to recent surveys conducted by the Employee Benefits Research Institute one-third of the American workforce has not begun to save for retirement, and 75% of Americans believe they do not have enough retirement savings. Americans with low to moderate incomes are hardest hit since they are most likely to have no savings.

This highlights the need to expand and reform the private pension system. However, this need is especially acute with respect to small businesses. Since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the Congress has enacted layer upon layer of complex laws, and the Internal Revenue Service (IRS) has issued layer upon layer of complicated regulations seriously retarding the ability of small businesses to maintain retirement plans for their employees. In most cases these rules were enacted not in the interest of promoting retirement savings, but to raise revenue and to fund unrelated initiatives.

The effect of these costly rules and regulations on small business pension coverage is both dramatic and rather disturbing. The facts speak for themselves. According to a 1996 General Accounting Office study⁽¹⁾, a whopping 87 percent of workers employed by small businesses with fewer than 20 employees have absolutely no retirement plan coverage. It's only slightly better for workers at small businesses with between 20 and 100 employees, where 62 percent of the workers have no retirement coverage. By contrast, 72 percent of workers at larger firms (over 500 employees) have some form of retirement plan coverage.

This significant disparity is made even more troubling by the fact that small business is creating the majority of new jobs in today's economy. As big firms go through corporate downsizing, many of the displaced workers find themselves working for small businesses. In fact, according to the Small Business Administration, 75 percent of

the new jobs in 1995 were created by small business. Small business now employs over half of the nation's workforce. However, because of the many impediments to small business retirement plan coverage, small business employees will often find themselves without a meaningful opportunity to save for retirement.

The Comprehensive Retirement Security and Pension Reform Act (H.R. 1102), introduced by Congressmen Portman (R-OH) and Cardin (D-MD), and co-sponsored by you, Mr. Chairman, Congressmen Lewis (D-GA) and Weller (R-IL), and several other members, contains numerous provisions which, if enacted, would have a substantial and immediate impact on small business retirement plan coverage. Throughout my testimony I will highlight some of the more significant of these provisions.

Roadblocks and Solutions to Small Business Retirement Plan Coverage

1. Top Heavy Rules

Surprisingly, there are a number of present-law rules which work to discourage small business from establishing retirement plans on behalf of workers. Many of these rules grew from a bias that small business plans were only established by wealthy professionals (e.g., doctors and lawyers) and that only the professional received any benefits under these plans. This is simply not the case in today's workforce. According to the Small Business Administration, less than 10% of small firms today are in the legal and health services fields. Small business includes high technology, light industrial, and retail firms which have stepped into the void created by the downsizing of big business. The same rules targeted at the doctors and lawyers also negatively affect these burgeoning small businesses. This is unfair and impedes the ability of small business to compete with larger firms when trying to attract employees. One of the most prominent examples of this problem is the top-heavy rules.

The top-heavy rules are not relevant for large firm (over 500 participant) plans. They only affect plans maintained by small business. The top-heavy rules look at the total pool of assets in the plan to determine if too high a percentage (more than 60%) of those assets represent benefits for key employees, namely the owners of the small business. How much the small business owner makes is not relevant. Even if the small business owner is making only \$30,000, the plan can still be considered "top-heavy." Because it is a small business, the likelihood of a small business plan being top-heavy is greater because you are spreading the pool of plan assets over a smaller number of workers. This problem is made worse when a family member of the owner works in the small business because the top-heavy rules discriminate against family-owned small businesses by treating all family members as key employees no matter what their salary.

If a plan is top-heavy, the small business must make special required contributions which substantially increase the cost of the small business plan. According to a survey of small businesses conducted by the Employee Benefit Research Institute, these required contributions were the number one regulatory reason why small businesses did not maintain a retirement plan for their employees. For example, in the case of a 401(k) plan that is considered top-heavy, the small business owner is generally required to make a 3% of compensation contribution on behalf of every employee. This is not a matching contribution; the 3% of compensation contribution has to be made regardless of whether the employee saves into the plan. In fact, even if the small business owner chooses to offer matching contributions to employees, under IRS regulations the matching contributions will not count toward satisfying the top-heavy minimum contribution requirement. As a result of the top-heavy rules, the cost per participant to the small business owner maintaining a 401(k) plan can be more than double the cost per participant to the large firm.

Simply put, the excessive fascination with doctors and lawyers has left the majority of small business employees out in the cold with respect to retirement plan coverage. The Comprehensive Retirement Security and Pension Reform Act contains several provisions which will bring some sense to the overly burdensome top-heavy rules. In particular, these changes will allow small businesses, even if they employ some family members, to offer a basic 401(k) plan to their employees. It's time to give small businesses who want to provide retirement benefits for their employees an extra break not an extra burden.

2. Retirement Plan Limits

Since ERISA was enacted, Congress has placed significant limits and caps on retirement plan contributions and benefits. Although these provisions were enacted under the false premise of reducing the benefits of high-paid individuals, they have actually served to reduce the benefits of rank-and-file employees.

Let me tell you a story. An agricultural trucking and shipping company established a defined benefit plan shortly after ERISA for which I was the actuary. The owner had invested a lot of years in the late 60's and early 70's investing and reinvesting income into developing such a capital hungry company. As he had spent many years as a trucker and had started this company later in his career, the defined benefit program was a super tool to accumulate retirement benefits that fit his and his devoted and older employees' life style maintenance needs in the time remaining before their retirement. He established the plan in the late 70's. He once had as many as 50 employees benefiting in the plan. In 1992, Congress reduced the amount of annual compensation that can be taken into account for purposes of accruing retirement benefits from \$235,000 to \$120,000. Combined with reductions in the amount of benefits employees can earn, which were enacted by Congress in the 80s, the benefits for the owner and a few devoted employees were cut by more than half.

So what did they do? They terminated their generous defined benefit plan, like so many other similar businesses in the early 90s, and replaced it with a 401(k) plan. Since the employer paid completely for the defined benefit plan, whereas 401(k) plans are funded with employee contributions, the result was a significant reduction in retirement benefits for rank-and-file workers. So what about the owner and few devoted employees? They made up for the loss of defined benefits by adopting a special retirement plan, called a "nonqualified top-hat plan." Unlike a traditional qualified defined benefit plan, a nonqualified top-hat plan does not have to provide any benefits to rank-and-file workers and is not subject to any of the limits on contributions and benefits. Even though the business does not get to currently deduct the value of these benefits, from the perspective of the executives, these benefits receive essentially the same tax preference as benefits under a traditional qualified plan (i.e., they are taxable when distributed).

Is this sensible retirement policy? ASPPA and numerous other groups certainly do not think so. That is why organizations representing unions, employer groups, retirement professionals, and the Pension Benefit Guaranty Corporation support the increases of these limits in the Comprehensive Retirement Security and Pension Reform Act. Increasing these limits will bring employers back to qualified retirement plans, which will provide meaningful retirement benefits for all workers. The tax benefits granted to qualified plans, as opposed to nonqualified plans, help subsidize the benefits of rank-and-file workers. Increasing the limits on retirement plan contributions and benefits is a win-win for both employers and workers.

3. Impediments to Defined Benefit Plan Coverage

A. Full Funding Limit

The present-law funding limits, for defined benefit plans, are a prime example of how overbroad legislation can have a disastrous effect on small business retirement plan coverage. In 1987, the full funding limit – the limit on the amount an employer is allowed to contribute to a defined benefit plan – was substantially reduced. The changes were made solely to raise revenue and had nothing to do with retirement policy. As an actuary, I can tell you that the current law full funding limit seriously impairs the funded status of defined benefit plans and threatens retirement security because it does not allow an employer to more evenly and accurately fund for projected plan liabilities. One way to conceptualize the problem is to compare a balloon mortgage to a more traditional mortgage which is amortized over the term of the loan. The full funding limit causes plan funding to work more like a balloon mortgage by pushing back necessary funding to later years. This is particularly harsh on small business because a small business does not have the cash reserves and resources that a large firm has, and so would be better off if it could more evenly fund the plan. Even worse for small business, a special rule in the Internal Revenue Code relaxes the full funding limit somewhat, but only for larger plans (plans with at least 100 participants). Once again this appears to be a vestige of the view that small business plans are just for doctors and lawyers.

Small business owners are aware of the present-law funding limits on defined benefit plans, and that is why small businesses with defined benefit plans are trying to get rid of them and new small businesses are not establishing them. From 1987, when the full funding limit was changed, to 1993 – a period which saw a significant increase in the number of small businesses established – the number of small businesses with defined benefit plans dropped from 139,644 to 64,937(2). That is over a 50 percent decline in just seven years.

To reverse this trend, ASPPA strongly believes that the full funding limit should be repealed to allow for more secure funding. Repeal of the full funding limit is supported by wide variety of organizations

representing the entire spectrum of views pertaining to retirement policy. Repeal is supported by organizations representing unions, participants, employers, financial institutions and retirement professionals. It is also supported by the Pension Benefit Guaranty Corporation, which as you know is responsible for guaranteeing workers retirement benefits(3). The repeal of the full funding limit is included in the Comprehensive Retirement Security and Pension Reform Act, as well as the Retirement Accessibility, Security, and Portability Act of 1998 (H.R. 4152), introduced last year by Congressmen Gejdenson (D-CT), Neal (D-MA), Gephardt (D-MO), and numerous others.

B. Reduced PBGC Premiums for New Small Business Plans

Imagine if you had to pay premiums on a life insurance policy based on a \$100,000 benefit, but that the policy only paid a \$50,000 benefit. No sensible consumer would purchase such a policy. However, that is in fact what often occurs when a small business adopts a new defined benefit plan.

Let me explain. If a newly created defined benefit plan gives credit to employees for years of service prior to adoption of the plan, the tax code funding rules limit, in the early years of the plan, how much can be contributed to the plan to fund the benefits associated with this past service credit. Consequently, the new plan is treated as "underfunded" for PBGC premium purposes and the plan is subject to a special additional premium charged to underfunded plans. This premium is assessed even though the premium is based on benefits which exceed the amount the PBGC would pay out if they had to take over the plan. In other words, the small business is forced to pay premiums to insure benefits that exceed what the PBGC will guarantee.

This additional premium can amount to thousands of dollars and is a tremendous impediment to the formation of small business defined benefit plans. Fortunately, both Congress and the Clinton Administration have recognized this problem. The President's pension proposals, introduced by Congressman Neal (D-MA), and the Comprehensive Retirement Security and Pension Reform Act include a provision that would reduce PBGC premiums for new small business defined benefit plans to \$5 per participant for the first five years of the plan. Given the pressing need to expand pension coverage for small business employees, particularly defined benefit plan coverage, ASPPA hopes this legislation can be enacted as soon as possible.

4. Other Proposals Expanding Small Business Retirement Plan Coverage

I would like to highlight some other provisions in the Comprehensive Retirement Security and Pension Reform Act, as well as other legislation that, if enacted, would lead to expanded small business retirement plan coverage.

A. Allowing Catch-up Contributions for Spouses Returning to the Workforce

Under present law, contributions to defined contribution plans, like 401(k) plans, are limited to the lesser of 25% of compensation or \$30,000. Furthermore, under present deduction rules an employer may have to reduce contributions, like matching contributions, it makes on behalf of an employee because the employee saves too much of his or her own wages. In many cases a spouse returning to the workforce after helping to raise a family, who is working part-time or is lower paid, cannot save sufficiently for retirement because of the 25% of compensation limitation and the deduction rules. For example, a spouse making \$20,000 on a part-time basis can presently only save \$5,000 a year, including both employee and employer contributions. Because of other resources, he or she may want to save a greater percentage of this income to ensure a more secure retirement. Part-time and lower-paid workers should be able to save a greater percentage of their compensation if they choose to do so. Provisions in the Comprehensive Retirement Security and Pension Reform Act would correct this problem. Also, a provision in Congresswoman Dunn and Congressman Weller's "Lifetime Tax Relief Act of 1999," H.R. 1084, to allow special homemaker 401(k) contributions would assist with this problem.

B. Tax Credit for Start-up Costs

According to surveys of small businesses, high administrative costs are one of the chief reasons small businesses do not adopt a retirement plan. A provision in the Clinton Administration's budget

and the Comprehensive Retirement Security and Pension Reform Act would greatly alleviate this problem. A 50% tax credit would be given for administrative expenses incurred in connection with a new small business plan. The credit would be for expenses up to \$2,000 for the first year and \$1,000 for the second and third years.

C. Simplified Defined Benefit Plan for Small Business

As noted earlier, the costs associated with interpreting and applying the regulations governing retirement plans are enormous, particularly for small business because there are fewer workers among which to spread the cost. For example, the average cost of administrative expenses for defined benefit plans is approximately \$157 per participant⁽⁴⁾. However, the cost per participant for a small business defined benefit plan can often be twice that amount.

In 1996, Congress enacted a simplified defined contribution plan for small business called the SIMPLE plan. However, many small businesses would like to offer a defined benefit to their employees, but are impeded by high administrative costs. The Secure Assets for Employees (SAFE) Plan proposal, introduced by Nancy Johnson (R-CT) and Earl Pomeroy (D-ND), would offer small businesses such a defined benefit option. ASPPA believes that small business needs a simplified defined benefit plan, like the SAFE plan, to complement the SIMPLE plan.

D. Plan Loans for Small Business Owners

For no apparent policy reason, many small business owners are currently not permitted to obtain plan loans from their retirement plan like their employees can. Plan loans to the small business owner are only permitted if the small business is incorporated under Subchapter C of the Internal Revenue Code. As you know, for business reasons many small businesses choose to operate as a Subchapter S corporation, partnership, or limited liability company. Retirement plan rules should not be dependent on the form of entity. The Comprehensive Retirement Security and Pension Reform Act contains a provision which allows plan loans to owners regardless of their form of ownership.

E. Roth 401(k) and 403(b) Plans

The Comprehensive Retirement Security and Pension Reform Act includes an innovative provision which allows 401(k) and 403(b) plan participants to choose their tax treatment. Under the proposal participants could choose to treat their contributions like contributions to a Roth IRA (i.e., as after-tax contributions not included in income when distributed if held for five years). ASPPA believes this exciting new proposal will encourage many small businesses to offer these plans to their employees, and we support its enactment.

Conclusion

As early as President Carter's Commission on Pension Policy in 1981, there has been recognition of the need for a cohesive and coherent retirement income policy. ASPPA believes there is a looming retirement income crisis with the convergence of the Social Security trust fund's potential exhaustion and the World War II baby boomers reaching retirement age. Without a thriving pension system, there will be insufficient resources to provide adequate retirement income for future generations. In particular, four elements have converged to create this crisis:

- The baby boomer population bubble is moving inexorably toward retirement age.
- Private savings in the United States has declined dramatically.
- Many employees, particularly small business employees, continue not to be covered by qualified retirement plans.
- In the absence of major changes, our Social Security system is headed for bankruptcy.

During the years 2011 through 2030, the largest ever group of Americans will reach retirement age. Without a change in policy or practice, many in this group will find themselves without the resources to be financially secure in retirement. Most pension practitioners will tell you that the constantly changing regulatory environment has

created more complexity than most employers are willing to bear; consequently, coverage under qualified retirement plans has dropped. The problem has affected small businesses most severely – they have fewer resources to pay the compliance costs and must spread those costs over fewer employees. During the early decades of the next century, the ratio of workers to retirees will be significantly lower than it is today. The shrinking ratio of workers who pay Social Security to those drawing benefits makes it likely that future retirees will have to rely more on individual savings and private pension plans and less on Social Security.

We believe there is need for constructive pension reform, particularly with respect to small business retirement plan coverage. We believe the time has come to enact legislation like the Comprehensive Retirement Security and Pension Reform Act, which will provide an opportunity for all working Americans, including small business employees, the opportunity to obtain financial security at retirement. We look forward to working with you Mr. Chairman, and the other members of the subcommittee, to move this bill and other positive initiatives through the legislative process.

Endnotes:

1. General Accounting Office, 401(k) Pension Plans – Many Take Advantage of Opportunity to Ensure Adequate Retirement Income Table II.3 (August 1996).
2. U.S. Department of Labor, Private Pension Plan Bulletin – Abstract of 1993 Form 5500 Annual Reports Table F2 (Winter 1997).
3. The Advisory Council on Social Security also urged in its report that the full funding limit be modified to allow better funding of private pension plans. Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations 23 (January 1997).
4. General Accounting Office, Private Pensions – Most Employers That Offer Pensions Use Defined Contribution Plans Table II.7 (October 1996).