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Comments Presented to the Committee on Small Business United States House of Representatives

Drop in Retirement Savings: The Challenges Small Businesses Face Funding and Maintaining Retirement Plans in a Struggling Economy

February 25, 2009

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to testify before the House Small Business Committee on the important issue of the challenges small businesses face in funding and maintaining their retirement plans in a struggling economy.

I am Stephen L. Dobrow, the current President of ASPPA and President of Primark Benefits, a growing San Francisco based employee benefits firm that provides consulting, recordkeeping, administration and actuarial services for retirement and flexible benefit plans. Primark Benefits was founded in 1971 and has 26 employees and a payroll of $2.4 million. As an employer, we sponsor both a defined benefit pension plan as well as a safe harbor 401(k) plan.

ASPPA is a national organization of more than 6,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. ASPPA's large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

Need for Relief for Small Business Retirement Plans

The current economic and financial markets crisis is weighing heavily on the heart of the American economy – our small businesses. Many of these companies are struggling to stay in business as sales drop off and businesses find it harder to come by loans. The

National Federation of Independent Business recently reported that their Index of Small Business Optimism fell 1.1 points to 84.1 in January. This is the second-lowest reading in the 35-year history of the survey.[1]

In 2007, about 11.7 million employees worked for a small employer (fewer than 100 employees) that sponsored a retirement plan.[2] These small business plan sponsors are concerned about the retirement security of their employees and want to continue to provide retirement benefits. However, plan sponsors are facing unprecedented pressures on their employee benefit programs due to the current economic conditions – and this is making it difficult for these employers to continue their plans. I would like to focus today on two important areas where relief is critically needed: defined benefit pension plan funding relief and 401(k) safe harbor plan relief. If relief in these two areas is not provided, many small businesses will be forced to freeze or terminate their retirement plans.

Defined Benefit Pension Plan Funding Relief

There are two basic varieties of retirement plans – defined benefit and defined contribution. Most workers who have an employer-sponsored plan now have only a defined contribution plan, typically a 401(k) plan. One key difference between defined benefit and defined contribution plans is who assumes the risk of market downturns. In a 401(k) plan, it is the plan participants who see the value of their benefit plummet when the market plummets. For a defined benefit plan, the employer takes on the investment risk. A worker covered by a defined benefit plan has not lost a penny of his or her accrued benefit even though plan assets have declined dramatically. That is because the employer has agreed to contribute whatever it takes to pay for promised benefits. Fewer and fewer employees have a pension promise because fewer and fewer employers are willing to take on investment risk. Employers that have been willing to take on risk in order to promise a secure retirement to workers are now being slammed by this market downturn. Help is desperately needed.

The market downturn is the root of the problem, but there are two aspects of the Pension Protection Act of 2006 (PPA) funding rules that are key to understanding both the problem and proposed solutions:

- The Worker, Retiree and Employer Recovery Act of 2008 (WRERA) amended PPA to permit plans to use "smoothed" asset values, averaged over a two-year period. In theory, the smoothing helps to reduce volatility. However, PPA also has a requirement that the resulting smoothed value cannot be greater than 110% of the fair market value of assets. Most plans cannot take advantage of smoothing because this corridor is too restrictive for current market conditions. Historically, most smaller plans use fair market value without any smoothing, so this has not been a concern. However, in this environment, more small plans might take advantage of smoothing if it were meaningful.

[1] National Federation of Independent Business, "February SBET: Small Business Optimism Index Dips Closer to All-Time Low," February 10, 2009, available at http://www.nfib.com/object/IO_39979.html.
[2] Purcell, Patrick, Congressional Research Service, "Pension Sponsorship and Participation: Summary of Recent Trends," September 8, 2008.

- PPA requires that any unfunded target liability (liability for benefits already earned under the plan) be amortized over seven years. This means a plan's minimum required contribution increases $19 or $20 for every $100 of investment loss. This adds up to serious dollars pretty quickly. Plans that were well funded before the market decline had no amortization payment due at all, and suddenly being saddled with substantial payments on substantial losses will be devastating.

There are many, many small employers in this situation. I want to tell you about one of my clients who is a real life example of an employer that has done the right thing – provided a defined benefit pension plan for employees – and now finds himself in serious trouble. The employer is an importer and distributor of fruit in the San Francisco area. They have 15 employees and payroll totals $1.4 million. They have a generous retirement program which includes a profit sharing plan and a defined benefit plan. Their defined benefit contribution in 2007 was $302,000 and in 2008 it was $177,000. Because of how the PPA rules work as well as a change in the market value of the plan's assets, the minimum 2009 contribution is $474,000.

There is no way that the employer can afford the nearly $300,000 increase. Profits are down because of the economy. The sponsor cannot go to a bank to borrow the money in this financial environment. They may be forced to pay an excise tax[3] this year because of the inability to contribute the increased amount, and plan termination will be the likely result unless adequate relief is offered.

There are a variety of proposals for providing funding relief. Because plans and employers that sponsor them vary widely, the ideal solution would provide options, and allow the employer to choose the one that best fits the situation. Options that would provide relief would include:

- Cap the increase in contributions that a company has to recognize due to the 2008 investment losses by allowing the company to "look-back" to the previous year's contribution requirement. The required contributions for the year the loss is recognized would be limited to 105% of the previous year's required minimum contribution, then 110% in the following year. In the third year, regular rules would apply.

- Temporarily widen the 10% corridor around market value to help companies that smooth asset values to manage the extreme unexpected losses experienced during the market downturn.

- Allow employers to pay interest only on their plans' 2008 losses for two years, then begin seven-year amortization of those losses in the third year. Under this proposal, the loss is recognized and contained – that is, interest on the loss is paid so that the loss does not grow. However, employers have two years to recover and plan before having to pay dramatically increased contributions. The extra time

[3] Plan sponsors must pay an excise tax of 10% on required contributions not deposited within 8 ½ months after the end of the plan year. Contributions not paid by the end of the following year can be subject to a 100% excise tax.

might also allow the plan investments to rebound as we come out of the current bear market, making the problem less onerous.

The employer I described earlier would receive substantial funding relief from either the look-back or the interest-only approaches. However, neither approach to funding relief would address another problem that arises from PPA requirements. PPA imposes restrictions on lump sum payments if a plan is less than 80% funded. PPA also prohibited additional benefit accruals when a plan falls below 60% funding, but WRERA provided relief for this restriction on accruals by providing a look-back to the prior year strictly for purposes of this 60% test. Congress should consider coupling funding relief with the same look-back for the restriction on lump sum payments that kicks in when funding falls below 80% as WRERA provided for the restriction on benefit accruals.

401(k) Safe Harbor Plan Relief

In general, 401(k) plans must satisfy certain non-discrimination requirements. These rules were enacted to ensure that contributions and benefits under the plan do not favor highly compensated employees over low and moderate income employees. These non-discrimination requirements can be onerous. However, in 1996, Congress passed the Small Business Job Protection of Act which provided 401(k) plans with alternative safe harbor methods of meeting the non-discrimination requirements by providing certain minimum employer contributions. The safe harbor 401(k) plan design has become quite popular with small businesses.

Under the safe harbor, a 401(k) plan is deemed to satisfy the non-discrimination rules if the plan satisfies one of two contribution requirements and satisfies a notice requirement. Under the contribution requirement, a plan must either (1) make a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan or (2) satisfy a matching contribution requirement.[4]

Under current Treasury Regulations, plan sponsors that choose to use the three percent nonelective safe harbor contribution are generally required to decide whether to implement or continue the safe harbor contributions prior to the beginning of their next plan year (*e.g.,* December 1, 2008 for a 2009 calendar year plan). Many plan sponsors elected in good faith to implement or continue the safe harbor provision for the 2009 plan year without knowing the severity of the current economic crisis or the full impact on their individual businesses.

Treasury Regulation §1.401(k)-3(e) generally requires that a plan satisfy the safe harbor requirements for the entire plan year, and failure to do so could result in disqualification of the plan. The Regulations provide two key exceptions to the plan year requirement.

- A safe harbor plan may be terminated mid-year, subject to certain conditions such as providing participants with advance notice and making the safe harbor contribution up to 30 days after the notice is provided; and

[4] Internal Revenue Code §401(k)(12).

- A plan that satisfies the matching contribution safe harbor may reduce or suspend safe harbor matching contributions during a plan year with the same notice and contribution requirements that apply when a plan is terminated mid-year. There is no similar exception in the Regulations that would permit plans that satisfy the three percent nonelective safe harbor to suspend contributions during the year.

Therefore, the only recourse for an employer that cannot afford to continue the three percent nonelective contributions for the entire year is to terminate the plan.

A significant number of small businesses, including one of my clients, Cyclonix, have found themselves in the difficult position of considering terminating their 401(k) plans because they cannot afford this year's safe harbor nonelective contribution. Cyclonix is a Silicon Valley company with approximately 60 employees and annual payroll of approximately $2.4 million. Cyclonix does branding and trade show work for local companies.

Cyclonix has sponsored a safe harbor 401(k) plan since 2007. Last year they contributed approximately $69,000 to their plan. In November 2008, Cyclonix complied with the safe harbor notice requirement and notified their eligible employees that they would be making a three percent nonelective contribution to their 401(k) plan in 2009. Therefore, this year Cyclonix will be required to contribute approximately $72,000 to the plan.

However, Cyclonix contacted us last month to determine what their options were because their financial picture had changed and they no longer could afford the required contribution. And unfortunately, under the current rules, none of the options are good. Cyclonix is now considering terminating their 401(k) plan or possibly laying off some employees. Ideally they'd like to borrow the money to make the contribution but with the current banking situation, Cyclonix – like most small businesses – have lost the ability to expand their line of credit.

To help Cyclonix and other small businesses maintain their 401(k) plans, ASPPA has asked the IRS to promptly issue guidance permitting employers to suspend safe harbor nonelective contributions during a plan year. We suggested that certain notice requirements and other protections be incorporated into this guidance, including notification on when such a suspension would occur, a timely amendment made to the plan, notification provided to affected employees, and a provision that the three percent nonelective contribution be made for compensation earned prior to the effective date of the suspension. These requirements are consistent with Internal Revenue Code §401(k)(12) and the existing exception for plans that satisfy the matching contribution safe harbor, and would ensure that the suspension of nonelective contributions will not result in discriminatory deferrals for highly compensated employees.

We are hopeful that the IRS will respond and allow employers to suspend safe harbor contributions without terminating the 401(k) plan. However, we are concerned that having to suspend the contribution will make employers gun shy about adopting a safe harbor in the future. To address this concern, we recommend a statutory change to the 401(k) non-elective safe harbor that would allow employers to adopt the safe harbor later in the year, even after the end of the year, when the employer knows it is affordable. In exchange for permitting more time to elect the safe harbor, the required contribution would be increased from 3% to 4% of pay.

Summary

Small employers are the heart of the American economy. As a small business owner who provides services to other small business owners, I can tell you that we want to do the right thing by our employees. Small businesses that provide retirement plans for their workers want to continue to provide retirement benefits. We just need your help in navigating the challenges we all are facing now. We are not looking for a bailout – only for a life jacket to keep our heads above water during these troubled times. Regulatory relief for non-elective safe harbor 401(k) plans, and funding relief for defined benefit pension plans, are straightforward ways to help small businesses meet cash demands without terminating plans (and in some cases dumping liability on the PBGC) or laying off more workers.