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Protecting the Small Business Retirement Plan System

- **The Qualified Retirement System is the Primary Way that Most Americans Save for Retirement**

A 2015 study,[1] which used actual data from employees' W-2 forms, found that 80% of all employees who work in companies with 10 or more employees are offered a retirement plan and that of these employees, 65% made 401(k) contributions.[2] Because of the large number of employees who are actually covered by the qualified retirement plan system any changes that would motivate employers to freeze or eliminate the plans could have significant and detrimental long term repercussions.

The predecessor study to the 2015 study which was conducted in 2011,[3] revealed that, when asked, only 49% of employees who worked for companies with 10 or more employees thought they were participating in a retirement plan, whereas the W-2 data indicated that 62% of employees were actually participating in a plan. This means that 13% of all employees making 401(k) contributions through payroll deduction did not even realize that they were making 401(k) contributions.

Only 28% of small businesses with fewer than 10 employees offer a retirement plan. The data, however does not take into account that in the first 4 years of a company's existence, approximately 40% of all new startups fail. One would assume that most startups have fewer than 10 employees. It is not surprising, then, that there is a lower level of sponsorship of retirement plans for this group when taking into account the precarious nature of most "new" small businesses.

These numbers reflect that the small business retirement plan system is successful in delivering benefits for small business employees. Further, most small business plans are adopted by the small business to provide a tax-advantaged way for the owners to save for their and the other key employees' retirement. The rules of retirement plans force the owners to make significant contributions for the non-highly compensated employees. Thus, in the small business qualified retirement plan world, it is not

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[1] Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol. 75 No.2 2, 2015, Retirement Plan Coverage by Firm Size: An Update.

[2] The size of the company makes a significant difference. W-2 data, which is accurate only to 401(k) plans and 401(k) contributions, reflects that 51% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that 63% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 73% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 87% 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 large businesses.

[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.

unusual for the company (in addition to contributions made by the employee) to make contributions for its employees in the 3 – 8.5% of compensation range.

In addition to Dushi, Iams and Lichtenstein utilizing verifiable data, they accounted for the fact that there is a difference between employees who do not participate in the retirement plan system and employees who are not eligible to participate in the retirement plan system. Most data used to measure the success of the retirement plan system (unlike the Dushi, Iams and Lichtenstein data), ignores the fact that not all employees meet the retirement plan eligibility requirements. Part-time employees, employees under age 21 and transient employees are generally ineligible to participate in a retirement plan. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the entire workforce and that percentage of the workforce that is actually eligible to participate in a retirement plan. When these ineligible employees are excluded, the coverage numbers improve significantly.

- **Tax Incentives in the Retirement Plan System are the Primary Motivation for Small Business Owners to Sponsor Retirement Plans**

Reducing the tax advantage of sponsoring a retirement plan will incentivize small business owners to freeze or terminate their plans. Most small business owners view 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. When a small business closes down its retirement plan, the owners are not likely to increase the pay of the non-key employees to take into account the loss of the plan contribution. Rather the owners will take the amount that would have been contributed to the non-key employees as additional compensation for themselves, or reinvest it in the company.[4] In the early 1980s, a series of laws decreased benefits for the key employees and increased contributions for non-key employees while increasing administrative burdens. As a result, many small business owners determined that the costs of sponsoring a retirement plan outweighed the benefits to be derived for the key employees. Accordingly, existing plans were frozen or terminated in droves and new plans were not established. The same thing will happen today if the tax incentives are limited or removed from the underpinning of the small business qualified retirement plan system.

- **Taxing 401(k) Contributions for Higher Income Contributor Will Motivate Business Owners to Freeze or Terminate Their 401(k) Plans**

Small business plans are adopted by the small business to provide a tax advantaged way for the owners to save for their and the other key employees' retirement. The rules with respect to retirement plans force the owners to make significant contributions for the non-highly compensated employees. If the 401(k) contributions of small business owners and their key employees are taxed at the time the

[4] Some economists have claimed that if a small business did not sponsor a retirement plan, the small business owners would pay the employees their regular compensation plus the amount that would have gone into the retirement plan for them. These claims do not account for the financial decisions faced by small business owners nor the fact that many employees themselves do not consider retirement contributions when assessing their compensation. When a small business closes its retirement plans, owners are not likely to increase the pay of non-key employees to take into account the loss of the plan contributions.

contributions are made, small business owners will be likely to cut back or freeze the 401(k) feature in a profit sharing plan since this is the most burdensome part of the plan. The data clearly demonstrates that the most effective way for people to save is through payroll deduction. Employees are far more likely to save in a 401(k) plan than in any other vehicle, including an IRA. It is therefore counterproductive for the retirement security of small business employees to impose a tax on the business owners and other key employees at a possible cost of eliminating the most effective method for all of the employees to save.

- **Forcing Assets Out of IRAs Shortly After Death Will Deter Employees from Fully Utilizing IRAs as a Means of Saving**

Over the last few years, both the administration and the Senate Finance Committee have presented proposals (such as the Retirement Enhancement and Savings Act, "RESA") which would require some or all retirement plan assets to be forced out of an IRA shortly after the passing of the employee (and the employee's spouse, if married). While IRAs are not always the optimal vehicle for many employees to save for retirement because they allow for easy withdrawals and do not provide ERISA safeguards, they play a critical role in the retirement plan system. This role is as the final receptacle for account balances of employees.[5]

The SBCA is gravely concerned that the partial or total elimination of the "stretch IRA" (which allows the amount remaining in an IRA at an employee's death to be distributed over the life expectancy of the beneficiary who inherits it), will cause people to be wary of accumulating "too much" retirement money because of its ultimate undesirable tax treatment. This may cause employees to under save for their retirement and could further give rise to owners freezing contributions or closing down the whole plan. It is important to many individuals who have accumulated funds that they can name their children as beneficiaries. An employee who rolls his/her funds to an IRA can ensure that any remaining funds in the IRA at death will pass to his/her designated beneficiaries.[6] With the "stretch IRA," employees can invest in an IRA not only to secure their own retirement future but knowing that if there are any remaining funds left upon death, these funds can provide their children with a safety net if the children so choose. This is because the children are allowed to take the funds out of the IRA over their lifetimes rather than being forced to take the funds out in a lump sum. Many children prefer to draw the money out quickly, but those who view savings as an important goal, will often draw out the money over their lifetimes. Of course, forcing out the funds in a lump sum immediately subjects them to income tax, removes them from the tax free compounding environment and will likely cause them to be spent rather coming out in a stream of revenue throughout the beneficiary's lifetime. With every generation of employees seeming to live longer than the one before it, the law should be structured to encourage employees to plan towards their futures as much as possible without having to fear that over-saving will result in a loss of their hard earned money. Proposing to partially or eliminate the "stretch IRA" is directly counter to these goals.

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[5] This is done by employees directly transferring or rolling over their account balances from retirement plans to an IRA.

[6] There are many taxpayers who would have chosen not to have saved as much as they did in the retirement plan system if they had anticipated the elimination of the stretch IRA. This is especially true of individuals who converted retirement plan assets to Roth IRAs relying upon the law remaining constant.

The SBCA is concerned that the proposal to eliminate the "stretch IRAs" will cause the same response by accountants as the "excess retirement plan accumulations" law did. That is, accountants will let their clients know that they should not save "too much" retirement money because of its undesirable tax treatment. This may cause employees to under-save for their retirement and could further give rise to owners freezing contributions or closing down the plan prematurely to the detriment of themselves and their employees. *This is exactly what happened during the time that the 15% excise tax on "excess retirement plan accumulations" was in place.*

Many workers have made irrevocable financial decisions relying on the existence of the stretch IRA. If a total or partial elimination of the stretch IRA is planned, the proposal should either a**) grandfather current funds in plans and IRAs to receive existing tax treatment, b) not apply to those over a certain age, for instance, any individual who is age 50 or older as of the effective date of the bill, c) set the threshold at which the stretch IRA option would be eliminated at an amount that well exceeds what the majority of Americans would safely need to save for retirement (at least $1 million), indexed for inflation *and set the thresholds per beneficiary rather than for the entire amount of all IRAs*, d) allow payments to be made over the lifetimes of the children or e) allow payments to be made over a set period of time - say twenty-five years instead of a shorter period such as five years.** The first two alternatives would allow the funds in the current retirement plan system to remain in the system and provide the long-term financial security for those who saved in reliance upon the existing law. Younger employees could choose to save only the amount they were certain to spend during their lifetimes and to save the remainder in other more tax-advantaged vehicles.[7] The third option is perhaps the least desirable inasmuch as it still penalizes the older individuals who chose to save during their lifetimes and are now too old to use up the funds and thus, are leaving their children with a terrible asset from a tax viewpoint. **The last two alternatives are the best since they would very likely alleviate any negative impact that the partial elimination of the stretch IRA would have on individuals saving in retirement plans**.

- **Detrimental Proposals to the Small Business Defined Contribution Retirement Plan System Must be Rejected.**

Despite common misperceptions, as a whole, the tax treatment of retirement plans is not particularly attractive since all retirement plan funds are eventually subject to ordinary income. Further, retirement plan assets do not receive a step up in basis upon the death of the owner. Because of this, it is important that all existing tax incentives for retirement plans be preserved. This includes maintaining existing contribution levels, not subjecting 401(k) contributions to additional personal income taxes for individuals in higher tax brackets and retaining the ability of individuals to have any money remaining in an IRA be paid in installments over their beneficiaries' lifetimes, especially for their children.

Proposals that curtail or eliminate the existing tax treatment for retirement plans must be rejected because the small business retirement plan system is largely dependent upon its tax advantages for its

[7] The data is clear that most people only save in retirement plans. Thus, it is possible that people would choose to save less in a retirement plan because they would not want their beneficiaries to face such draconian taxes. Ultimately, they would simply save less because they would spend the funds outside of the retirement plan, rather than investing them in more tax-advantaged vehicles. The end result is less retirement security due to the loss of the stretch IRA.

survival. Any significant tax change to the treatment of retirement plan savings could cause employees to decide against participating in a retirement plan. More significantly still, they could also cause small business owners to take out the funds that would have gone into the retirement plan (including all of the employer contributions for the non-owner employees and the costs of running the plan) as compensation and invest the assets in a more tax advantaged method – e.g., life insurance or assets subject to capital gains treatment. Ultimately, the real losers will be the small business employees who often enjoy generous employer contributions. We know this is likely to occur because this is what happened when "excess" retirement plan accumulations were taxed with an excise tax. Accountants advised small business owners that retirement plan money was "tainted" and that they should not accumulate "too much." The "excess" accumulation tax caused retirement plan contributions to be significantly reduced and significant numbers of small and mid-sized plans to be prematurely frozen or terminated. Congress should insure that this type of chilling effect on retirement savings never happens again.

The Small Business Council of America (SBCA) is a national nonprofit organization which has represented the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters since 1979. 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.

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