



**Comments to the U.S. Senate Committee on Finance
Savings and Investment Working Group
On Simplifying and Promoting the Small Business Retirement System**

Senator Crapo, Senator Brown and Members of the Senate Committee on Finance Savings and Investment Working Group, the Small Business Council of America (SBCA) appreciates this opportunity to share its insight on the relationship between current tax laws and the small business retirement system and comment on the potential impacts of various tax reforms on the small business retirement system.

Proposals for Simplifying the Law Governing Retirement Plans

The goal of simplifying the rules governing retirement plans should be to reduce or eliminate complexities that are unnecessary or that result in burdens that outweigh the desired policy objectives. This is often best achieved by providing plan administrators with the opportunity to take advantage of *optional* simplification such as the 401(k) safe harbor provisions. This allows companies to weigh the advantage of reducing complexity with the costs of possible plan amendments, required contributions, redoing employee communications and software and educating plan participants, if necessary. While the focus of this paper is on plans that cover fewer than 350 participants, most of these proposals would assist larger plans as well.

The following proposals would encourage small and mid-size employers to establish qualified plans by simplifying the rules and reducing unnecessary administrative burdens:

Eliminate Top-Heavy Rules for Defined Contribution Plans

Rationale: When first enacted, the top-heavy rules imposed additional minimum contributions and accelerated vesting on small and mid-size retirement plans, which were virtually 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 This outdated view has resulted in inertia on the Hill when it comes to repealing these unnecessary and complicated rules.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 ameliorate the negative aspects of the top-heavy rules. However,



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these ideas would not accomplish the goal nearly as effectively as outright repeal of these obsolete rules for defined contribution plans.

Policy Objective: Significantly simplify the law by eliminating obsolete provisions.

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

Rationale: 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 perspective we would want to encourage new hires to start saving for their retirement as soon as possible, the top-heavy rules impede this. 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.

Policy Objective: Allow more small business employees to start participating in the 401(k) portion of the plan sooner.

Allow Small and Mid-Size Companies to Sponsor Employee Pay All 401(k) Plans Without the 401(k) Contributions Made by Key Employees Triggering the Top Heavy Rules

Rationale: 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 perspective, employees who might have made 401(k) contributions are not given the opportunity because the significant barriers that stand before small to mid-size companies offering this type of plan. It seems that some members of Congress do not understand that most small business owners are not interested in incurring additional expense and administrative burdens without any perceived benefits for themselves. Employees of small or mid-sized employers would certainly be better off with an employee pay-all plan, in which both key and non-key employees could contribute without creating a required contribution for the company, than with 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.



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Policy Objective: Allow more small business employees access to a 401(k) plan. Level the playing field between larger and smaller business entities.

Simplify the 401(k) Discrimination Testing Referred to as the “ADP” Tests

Rationale: 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 – see below) 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.

Policy Objective: Simplify the law governing 401(k) plans by providing a new optional test in order to increase new plan formation.

Eliminate Yearly Safe Harbor Notices for 401(k) Safe Harbor Match and Eliminate the 3% Non-Elective Safe Harbor Notice Entirely

Rationale: 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. In fact, one could argue that it might cause plan participants to reduce their 401(k) contributions since they are being notified that the company will be making a 3% contribution for them.

Policy Objective: Eliminate unnecessary notice requirements that result in burdensome paperwork for small businesses.

Have an Optional Definition for Compensation that HR Can Understand

Rationale: Companies should be given a new optional safe harbor definition of “compensation” that is easy to understand and calculate. Many mistakes occur in the determination of participants’ compensation because the definition of compensation is now too complicated for a



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layperson to understand. In fact, it is now too complicated for most ERISA experts to understand. As with many other areas of the retirement plan law, we now have definitions of “compensation” that are “perfect” in that almost every conceivable situation is now covered by regulations and required plan amendments. However this perfection has come at a real cost - a loss of accuracy due to a lack of comprehension.

Policy Objective: Provide an optional simplified definition of compensation in order to make operation of the plan easier, thereby increasing accuracy.

Reduce Extensive, Burdensome and Unnecessary Reporting to Participants and Employers

- Amend ERISA to eliminate summary annual reports.
- Eliminate the requirement for quarterly investment statements (and make an annual notice) if participants have Internet access to their investment account information.
- There are too many notices – they must be consolidated and simplified.

Policy Objective: Rid the system of unnecessary notices that are not conveying timely or worthwhile information.

Eliminate Required Minimum Distributions (RMDs)

Rationale: 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 70 ½ beginning date should be pushed back to 75. Concern has been raised that this change would reduce revenue from taxes but the policy objective here is far more important than a short term deferral in revenue.



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Policy Objective: Ensure to the greatest extent possible that individuals will have enough savings for their retirement, taking into account increasing longevity, so that they will not have to rely upon the government for their welfare.

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

Rationale: 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.

Policy Objective: Rid the law of absurd provisions that serve no valid purpose.

Limit Interim Amendments

Rationale: Small plans (like all plans) had been getting hit with almost yearly amendments that were costly, and, by and large, unnecessary. These interim amendments placed an enormous 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.

Policy Objective: Make plans less expensive and burdensome to maintain while imposing no hardship on the plan participants.

Proposals to Increase Retirement Plan Formation

Allow Companies to Exceed Funding Levels to a Defined Benefit Plan When Times Are Good and Ease Up on Funding Rules When There are Significant Losses in the Market

Rationale: Congress has historically been concerned that companies might be sheltering excess money in their defined benefit plans. As a result, laws have been structured over time to the current point where companies are more or less forced to fund to a specific target each year rather than be allowed to prefund their retirement plan obligations when times are good. These strict parameters make little sense. Under the law, companies are already prohibited from benefitting from excess funding of defined benefit plans. Companies are still required to make up the difference if there is an underfunding but are prohibited from benefitting from a plan being overfunded. Thus, the only policy justification behind prohibiting companies from



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prefunding their retirement obligations is already fully addressed by other laws. On the other hand, companies will be more motivated to offer defined benefit plans if they are able to prefund and not have to worry that the defined benefit plan contributions will become a burden for them in down years.

Policy Objective: Ensure to the greatest extent possible that defined benefit plans are properly funded and easier to sponsor for small businesses.

Change the Law so that All or a Portion of a Retirement Plan Distribution is Subject to Capital Gains Tax

Rationale: In order to induce employers to provide qualified retirement plans that are inherently costly to administer and administratively burdensome, the final tax consequences should be as advantageous as possible. Today, some owners balk at putting in a plan because they believe that it is easier and just as cost-effective to take an after-tax bonus and invest it in the market where it will ultimately receive favorable capital gains treatment. Retirement plans are not tax shelters; rather, they are trusts that simply defer taxation for a time.

Policy Objective: Dramatically increase retirement plan formation in the small to mid-size business sector.

Change the Law so that a Portion of a Retirement Plan Distribution is Not Subject to Estate Tax

Rationale: In order to induce employers to provide qualified retirement plans that are inherently costly to administer and administratively burdensome, the final tax consequences should be as advantageous as possible. Retirement plan money is subject to both federal estate tax and income tax when a plan participant dies with money still in a retirement plan or IRA. Thus, some advisors suggest to owners that they should not accumulate “too much” in their retirement plan or IRA because of this double taxation. Years ago the tax code provided first a complete and then a partial exemption from estate taxes for retirement plan assets. This law should be reinstated.

Policy Objective: Increase retirement plan formation in the small to mid-size business sector.

Extend Charitable Distributions from Qualified Plans at age 65 (age 65 for IRAs also) of up to \$100,000 Per Year Per Individual

Rationale: Help charitable organizations.

Policy Objective: Increase contributions to charitable organizations.



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The SBCA thanks this Committee for its consideration of these issues and would welcome the opportunity to discuss these comments further.

The Small Business Council of America (SBCA) is a national nonprofit organization that 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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