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The Challenge of Retirement Savings for Small Employers

Testimony of:

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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 todayφs 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 ñmatchingò 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 donφt 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 HCEõs 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 HCEõs. For example, if the non-HCEõs defer on average 4% of their compensation into the plan, the HCEõs 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 ñmatchingò 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 doesnõt 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 óset it up and forget itô convenience.

Matching

Employers who offer matching contributions provide more incentive to employees to contribute to their own retirement accounts. ñFree moneyò 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 employeesô 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. Letøs 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, itøs 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 doesnøt have any assets in the plan yet.

Investment Management Cost

Once again, the economies of scale are huge in this business. A Fortune 500 companyøs 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 canøt 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 itôs 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 havenôt gotten around to it. Most likely, itôs 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 ñcappedò 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 ï 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 ñbail outò 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