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On behalf of the
Securities Industry & Financial Markets Association

Before the
House Small Business Subcommittee
for Finance and Tax

"Pension Parity: Addressing the Inequities Between Retirement Plan Options for Small and Large Businesses"

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Madame Chairwoman and members of the Subcommittee, thank you for holding this hearing on expanding retirement coverage for small businesses, and for offering the Securities Industry and Financial Markets Association ("SIFMA")[1] an opportunity to testify on this important issue. I am Jim McCarthy, Managing Director, Retirement Plan Services, for Morgan Stanley.

SIFMA's member firms are engaged in every aspect of the retirement plan industry, including retirement plan creation, investment management, recordkeeping, and advice and education. Morgan Stanley is a global financial services firm, providing brokerage, custodial and investment-related services to approximately 255,000 retirement plan accounts and approximately $29 billion in assets. Like many brokerage firms, Morgan Stanley's financial advisers are actively engaged in marketing retirement programs to the business community, in particular the small and medium-sized marketplace.

In my testimony today, I will focus on three areas: first, I will highlight the barriers that discourage small businesses from offering retirement programs to their employees, then discuss milestones that usually must be achieved before a small business offers retirement plan coverage, and finally, suggest legislative reforms that would lead to more small business pension coverage.

Retirement savings adequacy, expanding pension coverage – particularly for small business, and easing the burden of paying for health care in retirement – still need the attention of policy makers. Research by SIFMA makes clear that Americans are doing far too little to prepare financially for retirement. Thirty-five percent of early Boomers – those who are in the mid-50s to early 60s will not be able to maintain their standard of living in retirement.[2] The percentages worsen for those who are younger. And, one of the most effective ways to increase savings is to get workers actively saving through payroll deduction. Research shows that when retirement savings opportunities are available in the workplace, at least 77 percent of workers participate when the opportunity is available.[3]

Small businesses are crucial to our economy and provide important job opportunities to workers. According to the Small Business Administration, 60 to 80 percent of net new jobs annually have been created by small business.[4] On average,

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] SIA Research Report, Vol. VII, No. 7, (June 27, 2006), Retirement Savings By the Numbers...

[3] Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007.

[4] Small Business Administration, Office of Advocacy.

private sector workers stay in a job for about 4 years.[5] With this type of mobility, it is likely that workers will be employed by a small business at some point in their career. If you are in the job market, it is more than likely that your next job will be with a small business. But it is not at all likely that the business will offer access to a retirement plan. This raises a significant threat to retirement security when there is no ability to save through an employer plan with payroll deduction and no employer contribution to leverage the employee's own contribution.

Leading Barriers to Plan Sponsorship

Survey data consistently reports that cost and complexity are the leading barriers to plan sponsorship. The owner of a newly formed business is first and foremost concerned with the capital requirements of the business. Nearly every penny earned is reinvested directly in to the business. Offering retirement plan coverage at the inception of a business is simply a luxury that cannot be afforded. I am sure the members of this Subcommittee are aware that fewer than half of start-ups survive more than the first four years.[6] Adequate capital is key to early survival.

Once the business is more stable, the business owner and the employees are typically more interested in getting access to health care insurance as the first step in the employee benefits ladder. As we know, health insurance is not universally offered. The National Compensation Survey, which looks at full-time workers, age 25- 64 indicates that 59 percent of businesses who employ less than 100 employees offer health care benefits. Only about 45 percent of those businesses sponsor some type of retirement plan.[7]

Once health care benefits are established, a small business may be on more solid footing and more open to sponsoring a retirement plan. Even at this point, the business owner may believe that the start up costs of offering a plan coupled with the need to make contributions on behalf of the employees is not a good value proposition.

Milestones

Experience has demonstrated that saving for retirement is much more effective if done through an employer plan that facilitates the convenience of making contributions through an employer payroll system. The key is getting the business owner to offer a plan.

In general, a small business owner does not embark on the search for a retirement plan without the assistance of a professional. Advice and consultation with a business or personal advisor such as the owner's personal financial adviser, an accountant, or other trusted professional is a common starting point for discussions about the potential benefits of starting a retirement plan. When this conversation occurs, the business is

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[5] EBRI Notes, April 2007, Vol. 28, No. 4
[6] Kiplinger Letter, January 20, 2006, Volume 83, No. 3
[7] Bureau of Labor Statistics, National Compensation Survey, page 9 – page 12.

probably entering years where profitability has been reached and revenue is more certain. At the point of profitability, the tax incentives available are an important factor that encourages the business to start a plan.

Health care is also an important milestone. A small business that can provide health care is probably a prospective retirement plan client. However, we shouldn't limit ourselves and look only at firms that are offering health care. As the BLS study indicates, 40 percent of small businesses are not offering any health care benefit to their workers.

Finally, a business that has sustained growth has also achieved an important milestone. Once the business begins to grow, it needs to attract good, stable employees. For those small businesses that do offer a plan, retention and recruitment is cited as a very significant factor. Retirement plan benefits are easily understood by potential employees who are weighing the pros and cons of various employers.

Policy Recommendations

We encourage policy makers to consider ways to help small businesses offer retirement plans. Small business owners are competing to attract and retain the same workers as a larger business. The costs of providing these benefits can be overwhelming because there will always be a certain level of fixed cost and the small business has fewer employees over which to spread these costs.

Congress has been a strong advocate of initiatives to expand participation in retirement savings programs for small business. In 1996, Congress created the SIMPLE IRA. The SIMPLE IRA responds to the needs of many small business employers who would like to offer a retirement savings plan to their employees but are concerned about the administrative and legal obligations that come with a 401(k) plan.

The SIMPLE IRA has lower contribution limits than a 401(k), and requires an employer to either match employee contributions or to make non-elective contributions. In addition, the program provides for immediate vesting of participants. These plans have lower administrative costs than the traditional 401(k) plan, less liability, and permit the owner to reduce the employer contribution in the event of a downturn in the business (but not below 1 percent in any 2 out of 5 years.).

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) also targeted the low rate of plan sponsorship at businesses with less than 100 employees. To encourage additional plan sponsorship, EGTRRA raised the limit for SIMPLE IRAs, simplified the top heavy rules, and provided a tax credit to encourage small businesses to offer retirement savings programs.

The SIMPLE IRA has proven itself in the marketplace. IRS statistics from 2001 indicate that there were nearly 2 million taxpayers with SIMPLE IRAs, just 4 years after the SIMPLE became available.[8] Industry studies indicate that the number of SIMPLE IRA accounts continues to increase each year.[9]

As you consider ways to encourage employers to sponsor retirement plans, SIFMA believes that the SIMPLE IRA offers the most potential for growth. The SIMPLE IRA is a worthy retirement savings program that – with some adjustments – holds real promise for millions of workers who are now without coverage. The SIMPLE IRA is unique among retirement savings programs in that any employee who participates in a SIMPLE IRA will always receive a benefit from the employer. The employer must match employee contributions up to 3 percent of compensation or make non-elective contributions for all eligible employees of 2 percent of compensation. And, there is immediate ownership of that contribution. Employees will not forfeit a benefit if they terminate employment.

To make SIMPLEs even more attractive, SIFMA believes the following enhancements should be enacted. First, we would urge Congress to increase the maximum contribution amount to put it on par with the contribution limit for 401(k) plans. Since SIMPLE requires that the employer either match employee contributions or make a non-elective contribution with immediate vesting, the small business owner who offers a SIMPLE is providing employees with substantial retirement benefits that potentially exceed the benefits offered by a business with a traditional 401(k) plan. We see no reason to continue a policy that discriminates against the small business owner when the expectation that benefits being provided to the employee are the same or better than what is found in traditional 401(k) plans.

We also support several changes that will provide more flexibility for SIMPLE plan sponsors.

- **Allow Additional Non-Elective Employer Contributions to SIMPLE Plans:** Currently, small businesses are not permitted to make any additional contributions to their employees' SIMPLE accounts. Allowing an employer to make additional non-elective contributions to the SIMPLE plan (up to 10 percent) for either non-elective or matching plans would allow small businesses to take advantage of a good year or as an ongoing benefit for employees.

- **Eliminate Higher Penalty on SIMPLE Distributions:** Distributions made before age 59 1/2 from a SIMPLE IRA are subject to a 25 percent excise tax (unless otherwise exempt) during an employee's first two years participating in a SIMPLE IRA and 10 percent each year after. The 25 percent excise tax should be repealed, because we believe that it is both confusing and counter-productive to single out this particular type of retirement vehicle as requiring additional penalties to prevent premature distributions. Premature distributions from SIMPLE IRAs should be subject only to the 10 percent excise tax applicable to other retirement plans, including SIMPLE 401(k)s and IRAs.

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[8] Internal Revenue Service, Statistics of Income, 2001.
[9] Investment Company Institute, *Perspective*, Vol. 11., No.1, February 2005

- **SIMPLE Plan Portability:** Eligible rollover distributions from qualified plans and traditional IRAs cannot be rolled over to a SIMPLE IRA. Distributions from SIMPLE IRAs can be rolled over to other retirement accounts only after two years of participation. Again, creating an artificial distinction between SIMPLE IRA plans and other qualified vehicles breeds confusion at the participant level and needless complexity at the recordkeeper. SIMPLE IRA participants should be eligible to rollover their retirement assets like other plan participants.

- **Allow a Mid-Year Change from a SIMPLE IRA or SIMPLE 401(k) to Another Plan:** A business owner should be allowed to move from a SIMPLE plan to another retirement plan during the year. Currently, a business owner must decide by November 1 if a plan is going to be offered for the next year. This rule does not recognize that businesses operate on a variety of cycles – often the last quarter of year is a pivotal period for the business making it a difficult time to decide about whether or not to offer a plan.

- **Simplify Some Operational/Compliance Issues for SIMPLE IRA and SIMPLE 401(k):** We would also suggest that Congress revisit some of the practical eligibility and operational issues that SIMPLE plan sponsors face, in an attempt to simplify the rules without undermining the integrity of the small plan program. Currently "related" employers are required to be treated as a single employer to satisfy the SIMPLE requirements, as they are for standard retirement plans for discrimination testing and benefits purposes. Such requirements make sense in the context of deterring inappropriate or excessive deferrals or contributions under a standard qualified plan, and may be relatively straightforward for SIMPLE plan sponsors in applying to a controlled group of corporations or brother/sister entities. However, in trying to interpret some of the more difficult affiliation rules under the Code that also apply, especially the definition of "affiliated service groups", SIMPLE plan sponsor eligibility becomes a much more difficult question to answer. We would encourage Congress to investigate whether all of these tests are truly needed to determine eligibility in the SIMPLE context.

We would also encourage Congress to review the tax credits available for small businesses that start retirement plans. SIFMA members have seen very little use of the tax credit by employers because many small businesses have no tax liability at all. You may want to give consideration to offering a refundable tax credit to businesses that is refundable against payroll taxes or offering a refundable tax credit for every employee that participates in the plan. We would also encourage Congress to expand the small business pension plan start-up credit to those businesses that offer a payroll deduction IRA.

The revenue cost associated with these proposals is likely to be relatively modest. Increasing our pool of savings must continue to be a priority both for the country and for individual financial security. Larger pools of savings will have positive benefits for economic growth. By encouraging savings, the amount of capital available for investment will increase. This investment capital is a primary source of job creation and worker productivity – the primary components needed to raise living standards and generate sustainable economic growth

We look forward to working with you to narrow the gap in retirement coverage for small businesses and would be happy to provide assistance in any way that would be helpful.