American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

WRITTEN TESTIMONY FOR THE RECORD

OF JEFFREY A. PORTER, CPA

ON BEHALF OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
1455 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-1081

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

PUBLIC HEARING ON

THE CHALLENGE OF RETIREMENT SAVINGS FOR SMALL EMPLOYERS

OCTOBER 2, 2013

The American Institute of Certified Public Accountants ("AICPA") would like to thank Members of the Committee for the opportunity to submit this statement for the record of the hearing on The Challenge of Retirement Savings for Small Employers, held on October 2, 2013. I am Jeffrey A. Porter, Chair of the AICPA Tax Executive Committee. I am a sole practitioner at Porter & Associates, CPAs, a local firm in Huntington, West Virginia, which concentrates on providing tax planning and business advisory services for local businesses and high net worth individuals.

The AICPA is the world's largest member association representing the accounting profession comprised of over 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate the Committee's efforts to promote retirement savings and provide small businesses an opportunity to set up and maintain retirement plans for their owners and employees. Our remarks, which are supportive of this objective, focus on tax and simplification issues impacting many small businesses, specifically: (1) the various types of retirement plan options; (2) consolidation and simplification of the multiple types of tax-favored retirement plans and the rules governing them; (3) top-heavy provisions; and (4) repeal of the requirement that benefits become fully vested upon a partial termination of a qualified retirement plan.

Retirement Plan Options

The Internal Revenue Code (IRC or "Code") provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles,[1] each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. Although some consolidation of the rules governing these options has been introduced in recent years, further simplification of the confusing array of retirement savings options should be undertaken.

When a small business grows and begins to explore options for establishing a retirement plan, the alternatives, and the various rules, can become overwhelming. There are too many options that businesses need to consider before deciding which plan is appropriate for them. Some plans are only available to employers with a certain number of

[1] Currently the following plans are representative of the variety that may be sponsored by an employer: simplified employee pension (SEP), salary reduction SEP, savings incentive match plan for employees of small employers (SIMPLE), SIMPLE-401(k), profit sharing, money purchase pension, 401(k), 403(b), 457, target benefit, defined benefit, cash balance and the new defined benefit / 401(k) combination created in the Pension Protection Act of 2006 (Pub. L. 109-280).

employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings, discrimination testing, and an extensive list of notice requirements with associated penalties for failures and delays in distributing such notices to employees.

To determine which plan is right for their business, owners must consider their cash flow, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners. The choices are overwhelming, and many are too complex or expensive for small business owners.

Consolidation and Simplification of Retirement Plan Options

We recommend that the multiple types of tax-favored retirement plans currently available and the many rules governing such plans be consolidated and simplified to minimize the cost and administrative burden for employers.

Possible measures for simplifying the number and complexity of the various types of retirement plan vehicles include:

1. Create a uniform employee contributory deferral type plan. Currently there are four employee contributory deferral type plans: 401(k), 457, 403(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers. While we would like to see a more streamlined approach with regards to these types of plans, we also acknowledge that keeping a simple plan as well would benefit small businesses.

2. Eliminate the nondiscrimination tests based on employee pre-tax and Roth deferrals for 401(k) plans. These tests artificially restrict the amount higher-paid employees are entitled to save for retirement by creating limits based on the amount deferred or contributed by lower-paid employees in the same plan. They result in placing greater restrictions on the ability of higher-paid employees to save for retirement than those placed on lower-paid employees. Although the 403(b) plan is of a similar design, there is no comparable test on deferrals for this type plan.

There are currently two tests:

a) The actual deferral percentage ("ADP") test which limits the amount highly compensated employees can defer pre-tax or by Roth after-tax contributions by reference to the amount deferred by non-highly compensated employees. This test applies only to a 401(k) plan.

b) The actual contribution percentage ("ACP") test similarly limits the amount of employer matching contributions (which are based on employee contributions) and other employee after-tax contributions that highly compensated employees may receive. This test is applicable for both 401(k) and 403(b) plans.

An example of complexity in the rules is as follows: In the case of the traditional 401(k) plan, both the ADP and ACP tests would apply, while the same deferral and match formula in a 403(b) plan would result in only the ACP test being applicable.

3. Create a uniform rule regarding the determination of basis in distributions. Depending on the plan type, there are currently different methodologies to be used to determine basis in a distribution. For example, in a Roth individual retirement account (IRA), basis is considered returned first while in a traditional IRA or 401(k), including Roth 401(k)s, basis is distributed on a pro-rata basis, and distributed based on an algebraic formula if there are a series of payments. In addition, there are complicated rules concerning the aggregation of accounts. For example, traditional IRA accounts with pre-tax and after-tax (not Roth) contributions are aggregated separately from Roth IRA accounts. There are also special basis recovery rules in defined contribution plans that contain pre-tax, after-tax and Roth contributions.

4. Create a uniform rule of attribution. Currently, the rules of attribution are governed by different Code sections which each have subtleties and are used for different purposes:

a) Section 267(c)[2] referenced and modified in determining a disqualified person under prohibited transaction rules.

b) Section 318 for determination of highly compensated and key employee status.

5. Create a uniform definition for terms to define owners. Currently, there are different definitions for the terms "highly compensated employee" and "key employee." A defining factor of a "highly compensated employee" is a five-percent owner which is further defined as an individual with a direct or indirect ownership interest of more than five-percent. The ownership rules governing a "key employee" consider the five-percent ownership rule but also consider persons owning one-percent with compensation of $150,000 or more annually.

6. Eliminate the required minimum distribution rules. Participants must begin taking distributions beginning at age 70 ½ or be subject to penalties. In the case of qualified plans, a less than five-percent owner who continues employment may defer taking distributions until his or her subsequent separation from service. Additionally, in the case of a traditional IRA, the participant is entitled to consolidate multiple accounts,

[2] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the treasury regulations (the "Regulations" or "Reg.") promulgated pursuant to the Code.

subsequently taking a required minimum distribution from a single IRA; however, in a qualified plan the required minimum distribution must be taken from each plan individually and consolidation is not permitted.

If full elimination of required minimum distribution rules is not possible, the age requirement of 70 ½ should be addressed. The rules would be better served if the distributions were required to begin on a specific birthday as opposed to the computation of the "half-year birthday" for purposes of these regulations.

7. Create uniform rules for early withdrawal penalties. There are currently different rules governing penalties depending on whether the account is an IRA or a qualified plan. An example of this complexity is a distribution for higher education expenses; for an IRA the distribution avoids the ten-percent excise tax, while a hardship distribution from a qualified plan is still subject to the excise tax. The same is true for qualified first-time homebuyer distributions and medical insurance premiums.

Top-Heavy Provisions

The top-heavy rules were enacted under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), and subsequently amended, to protect employees when an employer offers a retirement plan which primarily benefits its "key employees."[3] Section 416 imposes a minimum vesting period of either six-year graded or three-year cliff and requires a minimum contribution of generally three percent for "top-heavy" plans. Retirement plans are considered top-heavy for a year, and therefore subject to the above rules, if the aggregate value of the key employees' accounts exceeds 60 percent of the aggregate value of all of the employees' accounts under the plan.[4]

Based on our members' experiences, the imposition of the top-heavy rules for retirement plans is causing some employers to (1) cease employer contributions to their plan, (2) terminate existing plans, or (3) not adopt a plan at all to cover their employees. This is primarily an issue with small and family-owned businesses sponsoring a 401(k) plan which consists of employee deferrals only, or employee deferrals and employer matching contributions.

Many small business retirement plans inevitably become subject to the top-heavy provisions for two reasons. First, most small businesses are owned by family members or a close group of individuals. Due to this type of ownership, it is common that the owners remain relatively static over the life of the business. As such, there is

---

[3] Generally, a key employee is defined as an officer with compensation in excess of $130,000 (indexed annually), a 5%-or-more owner, or a 1%-or-more owner with compensation in excess of $150,000. IRC section 416(i)(1)(A).
[4] IRC section 416(g)(1)(A)(ii).

frequently very low or no turnover of its key employees. Second, in today's work environment, employee turnover is commonplace. It is not unreasonable for employees to change jobs multiple times over their working careers as personal goals change, their skills improve, or they move geographically. Due to the static ownership of small businesses and the increasingly transitory employee base, it is becoming a certainty that most retirement plans sponsored by small businesses will become top-heavy at some point during the life of the plan.

Some small businesses can satisfy the top-heavy requirements. These businesses adopt provisions for their retirement plans to meet safe-harbor designs, such that they either provide for a matching contribution that rises to a statutory level (i.e., four percent for a 401(k) plan) or they provide for a non-elective contribution of at least a statutory rate (i.e., three percent for a 401(k) plan).

Unfortunately, many small businesses cannot afford to meet the strict contribution requirements imposed by the top-heavy rules. Their profitability margins and financial situations are such that these contribution levels cannot be attained. During the recent economic downturn, retirement plan contributions – specifically matching contributions – were an issue for many employers. Many employers which were able to satisfy the safe harbor requirements in the past were no longer able to continue making the same contributions. In too many cases, top-heavy rules become a financial burden by imposing an employer contribution for deferral only plans – where there was never intent for an employer contribution, or by requiring an additional contribution of three percent on top of the matching contribution the employer previously determined as being affordable to their budgetary and cash-flow constraints. As a result, the employers terminate the plan, which significantly diminishes the ability of their employees to save for retirement.

Prior to the top-heavy provisions, some employers terminated employees prior to vesting in order to use the forfeited dollars to reduce their contributions to the plan for current and future years. However, at the time these rules were passed, vesting schedules were 10-year cliff and 15-year graded. Employer plans are now subject to minimum vesting periods of either three-year cliff or six-year graded. The Pension Protection Act of 2006 changed the non-top-heavy defined contribution vesting schedule to generally coincide with the top-heavy schedule for contributions made after December 31, 2006. As a result, many defined contribution plans are unaffected by the top-heavy vesting requirements.

We recognize that the top-heavy rules were enacted to address the concern that employers will "churn" their employee base prior to the participants becoming fully vested. However, based on our members' experiences, smaller employers suffering from these top-heavy rules employ moderate matching formulas – less than those offered in safe-harbor 401(k) designs. Their actual cost of hiring and training employees is much greater than any benefit they might gain from this practice.

Although employees who find themselves not covered under an employer-sponsored 401(k) plan could contribute to an individual retirement account, the AICPA thinks that an employer-provided retirement plan is a better option for employees. First, the employees can contribute a higher amount to a 401(k) plan – up to $17,500 for 2013 (or $23,000 for individuals age 50 or older) for pre-tax contributions compared to the contribution limit for IRAs of $5,500 (or $6,500 for individuals age 50 or older).[5] Next, 401(k) plans generally offer access to more competitive investment alternatives than are accessible to an IRA investor. Finally, in an employer-sponsored plan the employer often pays at least a portion of the fees and the employee is part of a larger group that is likely to be charged a lower fee.

The AICPA supports the protection of employees and their ability to save for retirement. However, the top-heavy rules have become unnecessary due to the enactment of other provisions which protect the interests of employees. For example, section 401(k) plans are generally subject to special discrimination rules (the average deferral percentage test and average contribution percentage test, commonly referred to as the ADP/ACP testing) designed to prevent highly compensated employees[6] from receiving too much in contributions as compared to other employees.[7] These plans are also subject to general nondiscrimination rules designed to prevent qualified plans from covering too many highly compensated employees as compared to non-highly compensated employees.[8] As a result, the non-key employees are protected from employer discrimination regardless of whether the minimum contribution requirements for top-heavy plans are in effect.

The AICPA recommends an exception from the top-heavy rules for certain defined contribution plans. We think that retirement plans which provide for employee deferrals only and plans which provide for employee deferrals and matching contributions should not be subject to the strict minimum contribution requirements as other top-heavy plans.

Vesting Upon Partial Plan Termination

Section 411(d)(3) requires qualified retirement plans to provide for immediate 100% vesting upon a partial plan termination. In general, a partial plan termination may be deemed to have occurred when significant reductions in the workforce occur in a plan

[5] IR 2012-77, Oct. 18, 2012.
[6] A highly compensated participant is, in general, a more-than-5% owner in the current or preceding plan year or any employee who in the prior plan year earned in excess of $110,000 (indexed annually). IRC sections 401(k)(5) and 414(q).
[7] IRC section 401(k)(3) and m(2).
[8] IRC section 410(b).

sponsor's business.

This section was added to the Code as part of the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"). At that time, most qualified retirement plans were primarily or entirely employer-funded, and permitted vesting schedules were much longer than schedules that exist today. In the 1970s work environment, the vesting rule was necessary to protect the workers' retirement balances. However, the funding of retirement plans has changed significantly over the last forty years. In the present 401(k) environment, most, and sometimes all, retirement benefits are funded by employees' own contributions which are by law immediately 100% vested and not affected by the vesting rules. In addition, the maximum permitted vesting schedules have been greatly shortened. As a result, to the extent there are employer contributions in a retirement plan most workers are partially or even fully vested by the time an issue of partial termination arises.

The immediate vesting rule unfairly punishes small businesses. It is not uncommon for all employers to face a certain amount of turnover in their employee population. Employees can change jobs multiple times over their working careers as personal goals change, their skills improve, or they move geographically. For some employers, their employee base is sufficiently large that their experience closely follows the statistical performance of the labor pool as a whole. However, for small businesses, normal turnover can inadvertently create problems with the partial termination rules.

Furthermore, employers have not been given a clear and specific definition of what constitutes a partial plan termination. Employers must instead attempt to apply a series of narrow IRS rulings to their own situation, often by retaining outside counsel. The resulting uncertainty and expense creates an additional administrative burden when small businesses may lack the time and resources to resolve such a legally ambiguous situation.

We recommend an amendment to section 411(d)(3) to provide for an exception for "small plans" – under 25 participants – such that the partial termination rules do not apply.

* * * * *

We appreciate the Committee's efforts to promote retirement savings and are available to provide additional input on ways Congress can make further improvements in this area in general and with respect to small businesses.