

## Small Business and Employee Retirement Savings Plans

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### Introduction

Over several decades, employer-provided pension plans have played a diminishing role in employees' retirement incomes. "Defined benefit" plans provide a post-retirement income based on a worker's earnings history and tenure. But defined benefit pensions now cover only 20 percent of private-sector employees — just half the rate of three decades ago.<sup>1</sup> In 2007, 34 percent of firms with more than 100 employees offered defined benefit pensions, compared to only 9 percent for firms with fewer than 100 employees.<sup>2</sup>

Today, many of these plans are underfunded and some have been terminated, with employees receiving only a fraction of the benefits promised, even when covered by the federal government's Pension Benefit Guaranty Corporation.<sup>3</sup>

Instead of pensions, many firms now offer defined contribution plans like 401(k) plans. Defined contribution plans — primarily 401(k) plans for for-profit firms and 403(b) plans for nonprofits — have grown in popularity. Essentially created by accident from a loophole in the Revenue Act of 1978, these plans are better than pension plans for workers who change jobs frequently or experience gaps in employment. Employers usually match employees' contributions, and the funds that accumulate in the account are the employees' property. Defined contribution plans make workers responsible for choosing among investment options. The average 401(k) plan offers employees nine actively managed investment choices, according to the Employee Benefit Research Institute (EBRI), although some offer unlimited choices.<sup>4</sup>

But not all employers offer defined contribution plans, particularly small businesses. This paper will examine the challenges small businesses face in providing retirement plans for their employees, and potential public and private solutions to ease the burden on small business.

### Why Small Businesses Don't Provide Retirement Plans

Now more than ever, employees are faced with the challenge of taking ownership of a significant chunk of their retirement income, something they had to worry little about in the past. But workers with smaller firms are less likely to have access to an employer-sponsored 401(k) or other defined contribution retirement plan.

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<sup>1</sup> "Employers Abandoning Pensions," *Cellular South*, January 27, 2008. Available at [www.cellularsouth.com](http://www.cellularsouth.com).

<sup>2</sup> Emily Brandon, "Jobs that Offer Traditional Pensions," *U.S. News*, June 2009.

<sup>3</sup> The Pension Benefit Guaranty Corporation (PBGC), created in 1974, is a federal corporation that insures the pensions of private corporations. The PBGC does not receive tax dollars, but is funded by insurance premiums paid by these corporations, investment income and assets from companies that have defaulted on pensions. See "Pension Benefit Guaranty Corporation: Protecting America's Pensions." Available at <http://www.pbtc.gov/>.

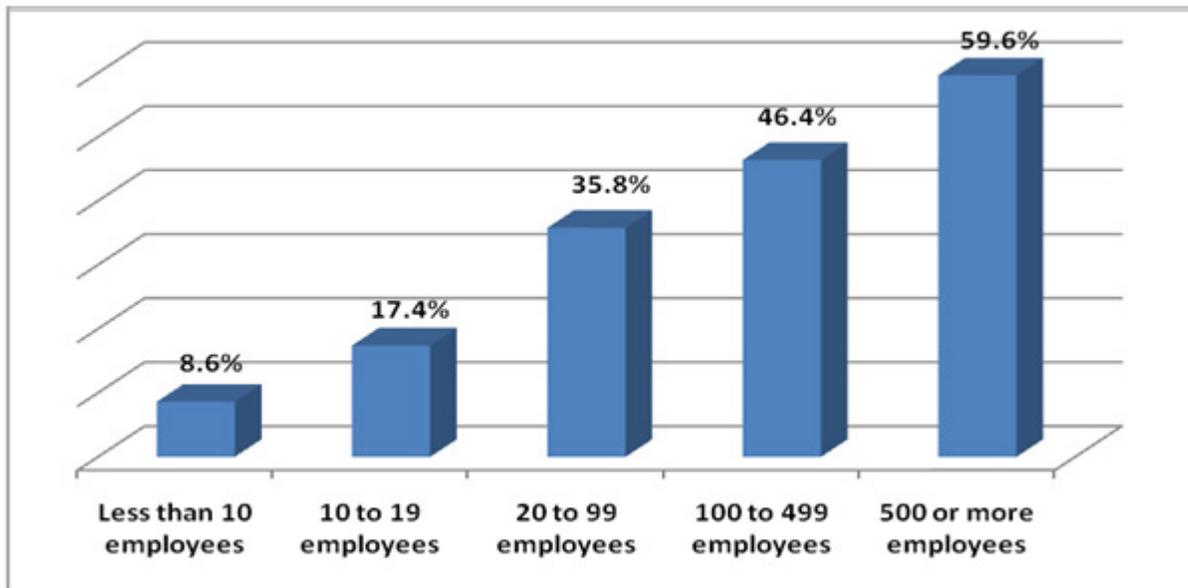
<sup>4</sup> Matt Moore, "401(k) Reform: Doing it the Right Way," National Center for Policy Analysis, Brief Analysis No. 393, April 2002.

According to the AARP Public Policy Institute [See Figure I]:

- In the smallest firms (less than 10 employees) less than 9 percent of workers are covered by a 401(k)-type plan.
- In firms with 20 to 99 employees, 401(k) coverage increases to 36 percent of employees.
- Compare this to firms with 500 or more employees, where nearly 60 percent of workers are covered by a 401(k)-type plan.

Being that firms with less than 100 workers comprise 98 percent of U.S. businesses,<sup>5</sup> this means a substantial number of workers in the United States may not have access to employer-sponsored plans.

**Figure I: Workers with 401(k)-type Coverage at Current Job by Firm Size**



Source: Mackenzie and Wu, "Employer-Provided Pensions: Less to Count on," AARP Public Policy Institute, October 2009, Table A.4.

The growing number of employers who offer 401(k) or 403(b) plans must comply with IRS rules and regulations set by the Department of Labor. These policies are designed to make the fiduciary responsibilities of the employer clear and protect them from any liability for bad investments, yet they impose costs, particularly for small businesses.

Employer retirement plans, specifically 401(k) plans and 403(b) plans (for nonprofits), are an appealing benefit to an employee when an employer matches part of the employee's contribution. Traditional 401(k) plans allow individuals with wage income to set aside pretax dollars in savings and investments which are withdrawn and taxed during retirement. Roth 401(k) plans, on the other hand, allow individuals to set aside and invest after-tax dollars that are withdrawn tax-free during retirement. Since the Pension Protection Act of 2006, employers are allowed to automatically enroll their employees in these plans while providing them with an "opt out"

<sup>5</sup> Author's calculations based on "Number of Firms, Number of Establishments, Employment, Annual Payroll, and Estimated Receipts by Enterprise," 2007 Statistics of U.S. Businesses, U.S. Census Bureau, [www.census.gov](http://www.census.gov).

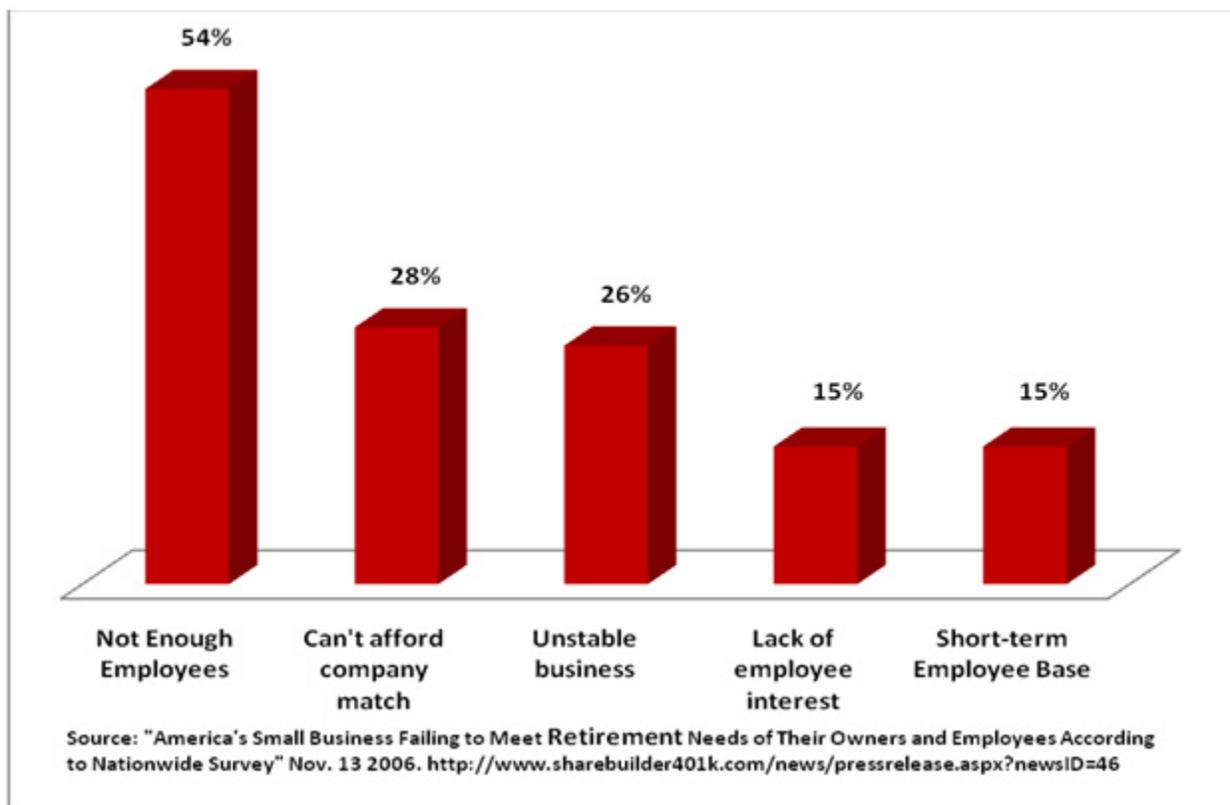
option. Furthermore, since auto-enrollment plans require an employer matching contribution, these plans provide an attractive incentive to workers.

But only one-third of firms with fewer than 25 employees sponsor retirement plans, compared to about 80 percent of firms with 100 or more employees.<sup>6</sup> While providing such a benefit may be relatively easy for large firms, it can be an obstacle for small firms for various reasons.

A 2003 survey by Sharebuilder401(k) asked small businesses why they do not offer retirement plans. Survey respondents cited the following reasons:<sup>7</sup>

- Not having enough employees to make it worthwhile (54 percent);
- The inability to afford a company match (28 percent);
- Unstable business circumstances (26 percent);
- Lack of employee interest (15 percent);
- Short-term employee base (15 percent).

**Figure II: Why Small Businesses Plan Not to Offer Retirement Benefits**



Finally, while cost appears to be a hindrance for some, 63 percent of respondents said they had no idea what a 401(k) plan would cost to administer.

<sup>6</sup> "Table 10.9. Retirement Plan Sponsorship, Participation and Vesting," *EBRI Databook on Employee Benefits*, Employee Benefits Research Institute.

<sup>7</sup> Stuart Robertson, "America's Small Business Failing to Meet Retirement Needs of Their Owners and Employees According to Nationwide Survey," [www.sharebuilder401k.com](http://www.sharebuilder401k.com), November 13, 2006.

**Problem: Economies of Scale.** It is understandable why small firms feel they do not have enough employees to provide a retirement plan. Large fund companies do not typically deal directly with small businesses unless they have a minimum amount of assets to invest or will pay a hefty fee.<sup>8</sup> Thus, many employers who provide a 401(k) or 403(b) plan use a financial services provider (referred to as the “third party administrator”) to carry out the investment of contributed funds. Once the employer (also referred to as the “plan sponsor”) transfers its workers’ contributions to the third party administrator, they invest the funds based on the investment elections of the firm’s employees.

The use of a third party administrator provides many benefits for a small firm, such as ensuring compliance with ERISA rules, but they typically charge a flat start-up fee, plus a per-employee participant fee.<sup>9</sup> The per-employee fee declines as more employees participate, thus reducing the average cost for large firms, but not small ones.

**Problem: Affording a Matching Contribution.** Normally, 401(k) and 403(b) plans are subject to nondiscrimination testing. This requires that higher- and lower-compensated employees contribute roughly the same percentage of their income to 401(k) accounts. If highly-compensated employees contribute far more than is allowed compared to their lower-compensated counterparts, the plan must distribute excess contributions to large contributors, which are then subject to federal income tax.<sup>10</sup>

Under the 2006 Pension Protection Act, employers who provide a company match contribution that meets specific criteria (whether or not the employee contributes to his/her account) fall under the “Safe Harbor” provisions and are exempt from nondiscrimination testing. The employer match requirements are as follows:<sup>11</sup>

- Employers must match, dollar for dollar, up to 3 percent of each employee’s pay, and 50 cents per dollar of contribution beyond 3 percent and up to 5 percent, or;
- A non-elective 3 percent match for each employee.

The challenge for small business is setting aside funds for the company match in order to qualify for the “Safe Harbor” provision. During profitable years this may not be an issue, but during recession years, firms, both large and small, temporarily suspend the employer match as a cost-cutting measure. Indeed, a survey from Boston College Center for Retirement Research found that nearly 5 percent of 401(k) participants were affected by a suspended employer match from 2008 to 2009 due to the downturn in the economy.<sup>12</sup>

## Options for Small Business

Excluding partnerships and sole proprietorships, businesses with up to 100 employees may implement 401(k) plans (either tax-deferred plans or Roth plans), or they may establish a Savings Incentive Match Plan for Employees, known as a SIMPLE IRA. SIMPLE IRAs and 401(k) plans are similar, except that the SIMPLE IRA generally poses fewer administrative burdens and is more cost-effective for small businesses for several reasons.<sup>13</sup> For example:

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<sup>8</sup> “401(k) Fund Selection,” Retirement Plans, March 2008 archives. Available at [www.personalbizfinance.com](http://www.personalbizfinance.com).

<sup>9</sup> In order to protect employers from fiduciary liability due to poor performance of investment funds, the U.S. Department of Labor has issued requirements that make retirement plans ERISA-compliant as specified in Section 404(d) in the Department of Labor regulations.

<sup>10</sup> For further details, see, “The Pension Protection Act of 2006,” Hay Acquisition Company, 2006. Available at [http://www.haygroup.com/downloads/us/Hay\\_Group\\_PPA\\_2006\\_-\\_New\\_Rules\\_for\\_Retirement\\_Plans.pdf](http://www.haygroup.com/downloads/us/Hay_Group_PPA_2006_-_New_Rules_for_Retirement_Plans.pdf).

<sup>11</sup> U.S. Department of Labor, “401(k) Plans for Small Businesses.” Available at <http://www.dol.gov/ebsa/publications/401kplans.html>.

<sup>12</sup> Alicia H. Munnell and Luran Quinby, “Why Did Some Employers Suspend their 401(k) Match?” Center for Retirement Research at Boston College, February 2010. No. 10-2.

<sup>13</sup> Strouss Hui Roomberg Ellis, P.C., “Simple Retirement Solutions for Small Business.”

- SIMPLE IRAs do not require the IRS paperwork (specifically form 5500) required of employers for 401(k) plans.
- Reporting requirements to employees are annual, not quarterly, as for 401(k) plans.
- SIMPLE IRAs are exempt from nondiscrimination testing.

An significant difference between SIMPLE IRAs and 401(k) plans is that SIMPLE IRAs can be set up at any bank or financial institution of the worker's choice, and the institution handles the majority of the paperwork. In essence, the employee is the sole owner of his or her account. However, the maximum annual contribution allowed by an employee (\$10,500) is less than the \$16,500 maximum contribution allowed for a 401(k).

Employer match requirements for the SIMPLE IRA are less stringent than the 401(k): Employers must match up to 3 percent of each contributing employees' salary, or a 2 percent contribution for all eligible employees (whether they contribute to the plan or not). However, employers may also reduce the 3 percent match to 1 percent for two out of five years, or change the match to a 2 percent non-elective contribution.<sup>14</sup> This provides flexibility for businesses that experience financial hardship.

## Improving Retirement Plans for Small Businesses

Encouraging more small businesses to participate in providing defined contribution retirement plans requires a multipronged approach.

**The Role of Public Policy. Auto-enrollment IRAs.** Auto-enrollment in 401(k) plans has shown to be very successful in increasing and maintaining employee participation.<sup>15</sup> In the past, bills have been discussed and introduced in Congress that would allow businesses to enroll their employees in regular IRA accounts. However, unlike auto-enrollment 401(k) plans, employers would have no fiduciary liability, and would not have to make matching contributions, making the plans simple and more cost-effective for small businesses. Like SIMPLE IRAs and 401(k) plans, a tax credit would be given to help offset the cost of initial set-up. Finally, since the IRA account would belong strictly to the employee (no vesting of matching contributions), it would be portable and not subject to rollover procedures if employment is terminated.

**The Role of Tax Policy: Create better incentives.** There are a couple of tax breaks that small businesses can use when establishing employee retirement plans. First, small businesses that begin to offer retirement plans are eligible to receive a tax credit in order to defray startup costs:

- Half of the expenses of setting-up, administering and educating employees about a SIMPLE IRA or 401(k) plan are eligible for a tax credit of up to \$500 per year for the first three years.<sup>16</sup>
- Businesses must have 100 or fewer employees whose annual pay is at least \$5,000 and at least one participant must be a non-highly compensated employee.
- The credit is recorded as a general business credit and may be moved back or forward to another tax year if it cannot be used in the current year.<sup>17</sup>

Second, any expenses associated with instituting and maintaining a retirement plan, including employer contributions made to employee plans and contributions made by the business owner to his or her own account, are tax deductible.<sup>18</sup>

<sup>14</sup> "Simple IRAs: Contributions," Investopedia. Available at <http://www.investopedia.com/university/retirementplans/simpleira/simpleira2.asp>.

<sup>15</sup> <http://www.gpo.gov/fdsys/pkg/BILLS-111s3760is/pdf/BILLS-111s3760is.pdf>

<sup>16</sup> "Retirement Plans for Small Businesses," Publication 560, Internal Revenue Service. Available at <http://www.irs.gov/pub/irs-pdf/p560.pdf>.

<sup>17</sup> The General Business Credit is IRS form 3800, OMB No. 1545-0895.

However, when using the \$500 tax credit, the employer must reduce other deductible business expenses by the amount of the credit.<sup>19</sup>

*Tax Policy Improvement.* The tax credit already in place for small business retirement plan contributions could provide a greater incentive with some modifications:

- Make the \$500 start-up/administrative credit permanent as opposed to just three years; and
- Allow a choice between the flat \$500 credit currently offered or a “per participant” credit; the per participant credit would provide an incentive for employers to encourage their employees to participate, and would also be a more significant and meaningful credit as a business expands.<sup>20</sup>
- Employers could then choose between the two types of credit depending on which is most beneficial to them.

**The Role of Public and Private Small Business Organizations: Provide more information.** The perception by small businesses that offering retirement plans is expensive and cumbersome may be more a result of lack of information and education than cold, hard truth. Many public and private organization websites offer a wealth of information on starting and maintaining a small business, but information about employee retirement plans is often buried several links down. Easy to obtain information is crucial; thus, organizations such as the Small Business Administration and the National Federation of Independent Business could feature retirement plan information more prominently. For example, in its own section as opposed to listing it as just as a subheading under employee compensation and benefits.

Finally, just as there are numerous “clearinghouse” websites that allow small businesses to obtain quotes on health insurance plans (ehealthinsurance.com, HealthInsuranceBuyer.Zone.com), retirement plan administrators, together with small business organizations, could take a more active role in developing similar informational sites pertaining to the costs of third-party retirement plan administrators.

**The Labor Force: “If You Auto-Enroll, They Will Come.”** Numerous surveys have found that auto-enrollment of employees into employer-sponsored retirement plans is a more effective way to secure participation than simply providing information about plans. For example, a 2006 survey from T. Rowe Price found:<sup>21</sup>

- Ninety-five percent of employees will participate in a plan when they are automatically enrolled compared to just 83 percent in an “opt in” plan.
- Furthermore, opt out rates change very little over time once employees are enrolled.
- Over time (5 to 10 years), 70 percent of retirement account participants tended to increase their contributions beyond the default rate, partly due to automatic increases by their employer as their salaries increased.

Although some small businesses cite that their employees are not interested in such plans, it would be difficult to ascertain unless firms implemented an auto-enrollment program and then experienced a high-rate of “opt outs.”

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<sup>18</sup> “Pension Plans,” Business Expenses; Publication 334; Available at [http://www.irs.gov/publications/p334/ch08.html#en\\_US\\_publink100025362](http://www.irs.gov/publications/p334/ch08.html#en_US_publink100025362).

<sup>19</sup> “Credit for Small Employer Pension Plan Startup Costs,” IRS Form 8881.

<sup>20</sup> The “per participant” employer credit would be based on the number of employees who actually contribute to accounts, not just non-elective contributions. As with the \$500 credit, the per participant credit would count against other deductible expenses.

<sup>21</sup> Mark Robinson, “Success of Auto Enrollment and Auto Increase: Using Behavioral Finance to Improve Retirement Planning,” EBRI Policy Forum and T. Rowe Price, May 13, 2010.

## **Conclusion**

Small businesses should be encouraged, although not mandated, to offer retirement plans for their employees. The current \$500 tax credit to help with administrative and start-up costs should be made permanent, and a choice between the flat \$500 credit currently offered or a “per participant” credit should be offered. In addition, small business groups should make information on how to set up retirement plans more readily available for small business owners. Finally, as focus continues to grow on the importance of post-Baby Boomers preparing for retirement, the job market will respond accordingly: more employees will look for retirement plan offerings as part of their compensation and more employers will have to provide them in order to remain competitive for workers.