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WRITTEN TESTIMONY FOR THE RECORD

OF PATRICIA THOMPSON, CPA

ON BEHALF OF THE

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

SPECIAL COMMITTEE ON AGING

U.S. SENATE

HEARING ON

OPPORTUNITIES FOR SAVINGS: REMOVING OBSTACLES FOR SMALL BUSINESSES

MARCH 7, 2012 AT 2:00 P.M.

AMERICAN INSITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
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The American Institute of Certified Public Accountants ("AICPA") would like to thank Chairman Kohl, Ranking Member Corker and Members of the Committee for the opportunity to submit this statement for the record of the hearing on Opportunities for Savings: Removing Obstacles for Small Businesses, held on March 7, 2012. I am Patricia Thompson, Chair of the AICPA's Tax Executive Committee; and a partner with Piccerelli, Gilstein & Company, LLP, located in Providence, Rhode Island.

The AICPA is the national professional association of certified public accountants comprised of approximately 377,000 members. 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) top-heavy provisions; and (3) vesting upon partial plan terminations.

Retirement Plan Options

Current Law: The Internal Revenue 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.

Reasons for the change: 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 employees, whereas other plans require mandatory contributions or create significant administrative burdens. Such administrative burdens include annual return filings,

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[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).

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.

Proposal: 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.

Top-Heavy Provisions

Current Law: 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."[2] Section 416[3] imposes a minimum vesting period of either 6-year graded or 3-year cliff and requires a minimum contribution of generally 3% 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% of the aggregate value of all of the employees' accounts under the plan.[4]

Reasons for the change: 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 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.

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[2] 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).
[3] 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.
[4] IRC section 416(g)(1)(A)(ii).

Some small businesses can satisfy the top-heavy requirements. The 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., 4% for a 401(k) plan) or they provide for a non-elective contribution of at least a statutory rate (i.e., 3% 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 situation 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 3% 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 3-year cliff or 6-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 (IRA), 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 $17,000 for 2012 (or $22,500 for individuals age 50 or older) for pre-tax contributions compared to the contribution limit for IRAs of $5,000 (or $6,000 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-

[5] IR-2011-103, Oct. 20, 2011; Notice 2011-90.

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.

Proposal: 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

Current Law: 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 sponsor's business.

Reasons for the change: 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.

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[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).

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.

Proposal: 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.

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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.