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Legislative Update

Bush Proposes Changing Retirement Plan System

“Simplicity” Will Hurt Small Business Retirement Plans

On February 3rd, the Bush Administration released the fiscal year 2004 budget. Among the more controversial items proposed is a dramatic overhaul of the savings and retirement plan systems. We feel that it is critical for you, as a plan sponsor, to understand these changes and voice your opinions to your representatives in Congress if you disagree with these proposals.

Summary

The proposed changes, if enacted into law, would include...

- To provide consistency across plans with employee contributions, 403(b), 401(k) and governmental 457 plans would be consolidated into Employer Retirement Savings Accounts (ERSAs).
- Cross-testing and permitted disparity would be eliminated in stand-alone defined contribution plans. If an employer sponsors both a defined contribution and defined benefit plan, cross-testing or permitted disparity may still be used.
- The definition of Highly Compensated Employee (HCE) would change. Under the proposed rules, the compensation used to determine HCE will match the social security wage base. For 2003, this represents a reduction of \$3,000 (\$87,000 vs. \$90,000). The rule that limited the number of HCEs to 20% of the total employees would also be eliminated. These changes could make it more difficult for plans to pass non-discrimination tests.
- Top-heavy rules would be repealed in defined contribution plans. This would be a positive change, particularly for small businesses.
- Non-discrimination tests would be simplified, but not necessarily easier to pass.
- The safe harbor ERSA matching contribution would be lowered to 50% of each employee's deferrals (up to 6% of compensation).
- Retirement Savings Accounts (RSAs) would replace IRAs (Roth & traditional). The RSA contribution limit would be \$7,500 per year with no limits based upon compensation. They would operate in same manner as Roth IRAs (contributions not deductible, but earnings grow tax-deferred). Distributions are non-taxable if withdrawn after age 58.



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- Lifetime Savings Accounts (LSAs) would be introduced. Section 539 plans, Medical Savings Accounts and qualified state tuition programs would be converted into LSAs. Like RSAs, these plans also permit individuals to contribute \$7,500 per year. Distributions from LSAs are non-taxable at any time for any reason. Because of their distribution flexibility, LSAs may appeal to individuals who may need to access their savings prior to retirement.

Observations

IRA Changes Have Limited Appeal

The President's proposed overhaul of IRAs would, in effect, offer few advantages to the average American worker. Significant increases in IRA/RSA/LSA limits would benefit only high-income households. According to the Employee Benefits Research Institute, in 1998 only 4.3% of taxpayers with incomes between \$40,000 and \$50,000 contributed to an IRA. Only a small segment of the US population has sufficient income to make non-deductible contributions to IRAs; yet this is the cornerstone of the President's proposal, and—as noted later—has a profoundly negative impact on the appeal of small business retirement plans.

Short-Term Gain and Long-Term Pain

From a fiscal perspective, the proposed changes create a badly needed short-term revenue surge for the government. As traditional IRAs are converted to RSAs and LSAs, individuals will be required to pay taxes on the converted account balances over a four-year period. These taxes will create the windfall noted above. Conversely, these changes also eliminate an important long-term revenue source that the government cannot easily replace (the forgone income taxes on distributions from traditional IRAs).

According to the budget, the transition from traditional IRAs to RSAs and LSAs will create revenue of \$18.7 billion from 2003 through 2006. However, beginning in 2007, revenue becomes negative (-\$650 million). This deficit nearly triples in 2008, reaching -\$1.8 billion and is expected to continue growing at a staggering rate.

The Dividend Connection

These changes were also necessary to support President Bush's dividend tax repeal. One of the unanticipated outcomes of the tax repeal was the diminished tax advantages enjoyed by qualified retirement plans. This raised the possibility that participants in qualified retirement plans might begin contributing less to the plans in favor of other forms of savings. Realizing the likely outcome of this change in mindset would be a larger group of retirees with insufficient savings, the Administration felt they needed to make qualified retirement plans more appealing to sponsors and participants. Perversely, the more likely result of these changes is the elimination of most small business retirement plans, leaving millions of workers without meaningful savings opportunities.

What Happened to My Deduction?

RSAs and LSAs lack one important component of existing IRAs: Contributions are not deductible. This is particularly problematic for baby boomers who, in most cases, need current deductions more than tax-free retirement distributions.

Most Troubling: The Repeal of Cross-Testing

The proposed repeal of cross-testing in stand-alone defined contribution plans is confusing for two reasons: First, the IRS spent several years drafting new regulations relating to cross-testing. The goal of these regulations was to ensure adequate benefits were provided to rank-and-file participants in cross-tested plans. This was accomplished by creating so-called “Gateways” through which plans must pass in order to take advantage of cross-testing. Now the Bush Administration proposes eliminating this approach in the interest of “simplicity” (cross-testing, while very effective, is not a particularly simple methodology). Yet it is this approach that makes retirement plans cost-effective for many small businesses, which leads to the second point...

An employer’s ability to use cross-testing is probably the most critical driver of small-business retirement plans. It permits business owners, who are generally older than most other employees and have deferred their retirement savings in order to build their businesses, to accumulate retirement savings at a rapid rate, while providing “guaranteed” benefits to non-highly compensated participants. Under the new gateway regulations, everyone wins in a cross-tested plan.

Without cross-testing, business owners will lose the ability to accumulate retirement savings quickly. Profit sharing contributions would only be permitted on a pro-rata basis; if the business owner receives a 25% contribution, all other eligible employees would also receive a 25% contribution. As a result, business owners will likely channel all of their savings into RSAs and LSAs, which don’t require employer contributions. In the end, the employer needs to settle for non-deductible contributions that are lower than the current 401(k)/profit sharing plan limit, and employees are left without any employer-funded retirement benefits. Everyone loses.

Next Steps

There will be considerable debate over these issues in the coming months. Prominent republicans, including Speaker of the House Dennis Hastert and Rep. Rob Portman, chairman of the GOP leadership team, have already voiced their concern to Administration officials. It appears that, at the very least, compromise is the likely outcome. However, to further blunt the possibility of passage, it is vital that plan sponsors make their feelings known to their representatives in Congress, so that those elements of the President’s proposal that are misguided are eliminated. To identify your Representative in the House of Representatives, go to <http://www.house.gov/writerep/>. This link also provides contact information. For the names of your Senators and related contact information, go to <http://www.senate.gov/>.

ACI urges you to write, call or e-mail your Senators and Representative to express your opinion. If enacted as proposed, these changes would prove devastating to small business retirement plans, leaving millions of American workers without adequate retirement savings.