

## Defined Contribution Plans: What Does "Reform" Mean to Employers?

May 2009

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*With some unemployment rates the highest they have been in generations and the economy in a fragile state, many Americans are facing serious challenges to their retirement security. Policymakers, as well as average Americans and employers, are starting to question the overall design of the U.S. private retirement plan system and whether the saving arrangements currently in place give a typical worker a real opportunity to reach his or her retirement income goals.*

The optimal retirement income security comes from a combination of defined benefit (DB) plans (both private sector and Social Security) and defined contribution (DC) plans, with both employer and employee contributions. We focus here on DC plan *design* reforms rather than on distribution or investment option reform. Specifically, this *InsightOut*:

- Reviews the growth of DC plans.
- Describes four proposals for DC plan design reform.
- Poses questions to consider in assessing whether these proposals would provide a more secure and reliable retirement system.

### DEFINED CONTRIBUTION PLANS: PAST, PRESENT, AND FUTURE

DC plans were not always the predominant form of employer-sponsored retirement plans. In fact, when Congress passed the Employee Retirement Income Security Act (ERISA) in 1974, only 29 percent of all private qualified retirement plan assets were held in DC plans. The addition of Section 401(k) to the Internal Revenue Code in 1978 provided a catalyst for DC plan growth.

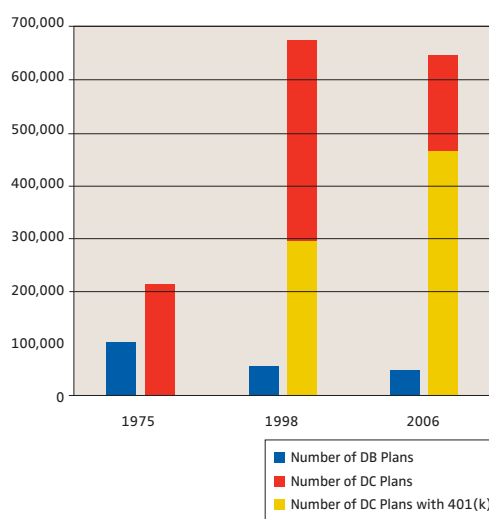
As Chart One illustrates, in the 20 years following the enactment of Section 401(k) in 1978, DC plans grew rapidly – in absolute numbers, in proportion to all retirement plans, and in the number of participants. In comparison, the number of private DB plans declined as shown although the total number of participants in private DB plans remained steady at slightly more than 41 million. In 1984, there were slightly more than 17,000 DC plans with a 401(k) feature and 7.5 million

participants. By 1998 however, there were almost 300,000, such plans with more than 37 million participants. By 2006, the number of 401(k) plans had increased to about 466,000 with estimated active participants of 58.4 million.

### FOUR DC PLAN PROPOSALS

Although the head counts and asset pools of DC plans have significantly increased, some policymakers believe these plans are inadequate tools for retirement savings. They believe the system is in need of reform. Following is an overview of four reform proposals; with a table on page three indicating which of a dozen plan features are or are not included in each proposal.

Chart One



## 1. Automatic Individual Retirement Accounts (IRA)

The automatic IRA generally is associated with the Retirement Security Project supported by The Pew Charitable Trust, in partnership with Georgetown University's Public Policy Institute and The Brookings Institution. The Obama Administration also supports the concept of the automatic IRA (most recently in the Administration's 2010 revenue proposals), and legislation was proposed in the last Congress to establish such accounts as well. The Retirement Security Project proposed automatic IRAs as a supplement to the current private employer-sponsored system. The expectation is that employers will graduate from these to qualified employer-sponsored plans after they grow accustomed to having a retirement plan. The thinking is that employers would want to upgrade to a qualified plan where the contribution level is higher and employer contributions are permitted.

Under this proposal, employers of a certain size (such as ten or more employees) who do not sponsor a retirement plan and have been in business at least two years would be required to deposit a certain amount of each employee's pay directly into an IRA unless the employee opts out of the arrangement. Small employers that process payroll by hand would most likely be exempt, and those who are not exempt could make the contributions along with their federal payroll taxes.

Deposits would be made to private IRAs, elected by either the employer or the employee. However, if employers or employees cannot find a cost-effective private IRA, deposits could be made

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to a low-cost IRA provided by an entity similar to the Thrift Savings Plan (or an equivalent financial services industry consortium or nonprofit organization). Private financial institutions would maintain and operate these "fallback" IRAs under contract with the federal government. They would provide the investment funds as well as investment management, record keeping, and related administrative services. Federal standards would be imposed to lower costs, by limiting the number of investment options and the number of times investments may be changed, for example, and by prohibiting loans and other withdrawals, and encouraging online transactions and disclosures. The proposal also suggests that the statute could specify whether the default IRA would be a pre-tax salary reduction or an after-tax Roth IRA.

With either private or fallback IRAs, initial contributions would be invested in diversified investment options, such as "target asset allocation" or "life-cycle" funds, unless the employee elects a different investment option. A national Web site would provide employee education regarding savings and investment.

In addition to depositing the money directly into an IRA, the employer would be required to provide employees notice of the arrangement and the ability to opt out (a model notice would be provided by the government). The employer would be required to keep records showing which employees actually opted out. Employers would also be required to certify annually to the IRS that they were in compliance. Failure to offer the automatic IRA would result in an excise tax on the employer for each employee affected by the violation.

Many employers do not sponsor DC plans because of the potential for fiduciary liability. Under this proposal, employers would be insulated from liability concerning the manner in which employees invest the deposits in IRAs the employees select. However, the employer would have fiduciary liability if the employer selects the IRA. This liability could be avoided if funds are deposited in a government-contracted default IRA or in an IRA the employee selects.

The proposal attempts to limit employer costs by not allowing matching contributions, not classifying this arrangement as a qualified plan, and not subjecting the arrangement to ERISA's requirements. In addition, employers would be eligible for a temporary tax credit based on the number of employees who participate.

Table One: Comparing Provisions and Features Found in Each Proposal

Provision/Feature	Automatic IRA	America's IRA	Individual Career Accounts	Guaranteed Retirement Accounts
Replaces current system				
Supplements current system	X	X	X	X
Mandatory	X			X
Employer required to make payroll deposits as contributions	X		X	X
Allows an employer match			X	
Requires an employer contribution				X
Provides for a match from the federal government		X	X	
Expands employer notice and record keeping requirements	X		X	
Builds on Social Security				X
Builds on the current IRA structure		X		
Establishes a new government clearinghouse to receive contributions	X		X	
Limits investment options		X		

**Automatic IRA Questions**

- Would it be more cost effective for the government to encourage and educate employers and employees on the current law, which already allows direct deposit IRAs, rather than create a new mandate?
- Without employer contributions, will automatic IRAs provide sufficient retirement income security?
- Will employers actually graduate to 401(k) plans or remain in the automatic IRA? If the latter, will that, in effect, limit any potential for increased contributions, including employer matches?
- Are there hidden costs and burdens on the employer in administering an automatic IRA, such as the cost of additional disclosures?

- Would the cost increase if employers were required to cover part-time employees?

**2. America's IRA**

The Aspen Institute has proposed a holistic savings approach entitled "Savings for Life," which includes a DC plan element known as the "America's IRA." This proposal supplements the current employer-sponsored retirement system as a way of increasing the retirement savings of low- and moderate-income individuals.

The America's IRA would be offered through the existing IRA structure, without employer involvement. Under this proposal, the individual would be *required* to open his or her own account. The federal government would offer an annual dollar-for-dollar match to individuals who contributed at least three

percent of their income. The match would be capped at \$2,000 annually for individuals earning less than \$40,000 per year, with a partial match for individuals earning up to \$50,000. The match would be deposited directly in the IRA when the individual claims it on his or her federal income tax return. The America's IRA would also offer a one-time seed payment of \$1,000 for individuals earning less than \$12,500 a year, with partial payments of that \$1,000 to individuals with incomes between \$12,500 and \$30,000.

Proponents claim that, because the America's IRA would only offer two investment options (an age-based mutual fund and a risk-free principal preservation fund), saving would be simpler for individuals.

#### **America's IRA Questions**

- Would employers stop sponsoring their current retirement plans if the America's IRA were available?
- If employers no longer sponsor current retirement plans because of the availability of the America's IRA, would this proposal provide sufficient retirement security for middle- and high-income employees?
- Would the financing of the America's IRA possibly limit the tax-favored status of elective deferrals by higher income employees?

### **3. A Universal 401(k) Plan: Individual Career Accounts**

Michael Calabrese of the New America Foundation has proposed a universal 401(k) plan that would establish Individual Career Accounts (ICAs). An ICA would act as a supplement to the current employer-provided retirement system. ICAs have three basic elements: (i) incentives, (ii) infrastructure, and (iii) inertia.

**Incentives:** The incentive would be a government match in the form of a refundable tax credit deposited directly to each ICA (similar to the Administration's proposal to have the Saver's Credit deposited directly to either a qualified plan or an IRA). The match would be provided on a sliding scale based on income and would be available for both employee and employer contributions whether they were made to an

employer-sponsored plan or to a government clearinghouse (described below). However, if an employer elected to contribute to an employee's account, the employer would be required to contribute either a flat dollar amount or percentage of pay for all employees.

**Infrastructure:** The infrastructure of the ICA would build upon the current payroll system. When an employee completes the required IRS Form W-4 (the form used to calculate income tax withholding), the employee would also indicate the amount of pay to be directed to the ICA. The employer would then direct the deduction to either the employer's own retirement plan (assuming the employee is eligible to participate) or a government clearinghouse. As with the automatic IRA, this proposal assumes that administrative costs for employers would be negligible because most already use automated payroll processing services. For those who do not, the proposal indicates that the additional administrative burden would be minor.

ICAs would use a government clearinghouse similar to the Thrift Savings Plan (the 401(k)-style retirement plan for federal employees). This entity would be the default administrator and would maintain ICA-related records. Investment management would be outsourced to private firms. Individuals would be allowed to transfer funds from the clearinghouse to an employer-sponsored plan or an individual retirement account.

**Inertia:** To encourage retirement savings, it was suggested that employees be automatically enrolled, rather than be allowed to elect to participate on the Form W-4. An opt-out option could be made available to employees when they fill out the Form W-4. The initial contribution by employees and employers would be between three or four percent of pay, with an escalation of one percent per year up to a percentage that would accomplish adequate retirement savings. The contributions would be to a default investment, such as a life-cycle fund, unless the employee elects another investment option.

At retirement age, the default form of benefits would be monthly payments rather than a single lump-sum payment. The annuities could be provided by either private insurers or the Pension Benefit Guarantee Corporation.

### **ICA Questions**

- Would there be a limit on the tax-favored amount that could be deferred to the government clearinghouse?
- If the amount that can be deferred to the government clearinghouse is the same as current limits for elective deferrals, will employers stop sponsoring their current plans?
- If the deferral limit is the same as for current 401(k) plans, in what way would the ICA improve upon the current system?
- What fiduciary liability will the employer have?
- Will the administrator of the government clearinghouse have the same fiduciary responsibility that employer sponsors have? Who would enforce any such fiduciary responsibility?
- If employees are allowed to elect to have funds contributed either to an employer-sponsored plan or to the government clearinghouse, what impact will this election have on the employer-sponsored plan's ability to meet applicable nondiscrimination rules?

### **4. Guaranteed Retirement Accounts**

Although most of the DC reform proposals are designed to supplement the current private employer-sponsored system, New School Professor Teresa Ghilarducci's comprehensive proposal for guaranteed retirement accounts (GRAs) would almost completely replace the current system. GRAs would be similar to the universal 401(k) plan concept, except that the federal government would invest and manage the assets.

Participation in a GRA would be mandatory for all employees except those who participate in an employer-sponsored DB plan to which the employer contributes at least five percent of pay and distributes benefits as a life annuity only. Minimum contributions to the GRA would be five percent of earnings, equally split between the employer and employee. The employer would be required to deposit this amount directly into an employee's account, which would be administered by the Social Security Administration. The wage base for GRA contributions would be equal to the Social Security wage base, but employees would have the option to make additional contributions.

The current tax-favored status of elective deferrals would be replaced by a \$600 refundable tax credit, indexed to wage inflation. If an individual's annual contributions were less than \$600, the remaining tax credit would be deposited in the individual's account. Employees would not direct the investment of their contributions. Instead, employees would earn a fixed three percent return on their accounts, subject to adjustment for inflation. This amount would be guaranteed by the federal government.

Individuals could not access funds before retirement, except in case of the participant's death or disability. Individuals could begin collecting benefits from the GRA when they become eligible for Social Security benefits. Distributions would be made as inflation-indexed annuities, with a partial lump-sum option, equal to the greater of ten percent of the account or \$10,000. If an individual died before retirement, half of the account could be left to a beneficiary. If an individual died after retirement, his or her beneficiary would receive one-half of the account balance, less any benefits already received.

### **GRA Questions**

- Although employees who are covered by DB plans to which employers contribute at least five percent of pay would be exempt from making GRA contributions, given the decline in DB plans, does this proposal effectively eliminate the employer's role in providing retirement benefits?
- In what ways would eliminating the current private sector system create unintended consequences by attempting to force all private sector employees into a "one-size-fits-all" approach to retirement income planning?
- What guarantees would there be that the federal government would not use GRA assets to fund general government expenditures, as it currently does with Social Security remittances?
- Given the similarity between the manner of accrual and payment of proposed GRA benefits and current Social Security benefits, why not just increase the payroll tax by the amount necessary to fund GRAs, and provide a GRA-equivalent increase in the level of future Social Security benefits?

## CONCLUSION

As the federal government struggles to respond effectively to the current economic crisis, it must also consider the long-term economic security of all Americans. In doing so, policymakers need to compare the current private sector retirement system with the various reform proposals and assess which will deliver the best retirement security. This comparison raises a critical question about the role of the employer versus the government in providing retirement security, especially now as the government has taken on a number of other funding obligations. Although the solution to retirement security may not be clear, it is clear that now is the time to find one.

### ***About the Authors:***

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