ERIC Defined Contribution Plan Position Paper
August 2005

Overview

The voluntary employer-sponsored retirement plan system has been a cornerstone of individual retirement security for over fifty years. In 2003 alone, private-sector employers spent more than $194 billion to provide future retirement benefits to 53.1 million current workers and 9.8 million retirees, disabled workers, and beneficiaries[1]. Upon the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), most employer- sponsored retirement benefits were delivered through defined benefit[2] pension plans; however, since then, participation in defined contribution[3] plans among private-sector employees has increased steadily. In 1975, 44% of the American workforce participated in defined benefit plans, while only 18% participated in defined contribution plans; by 2004 only 21% of employees participated in defined benefit plans, and 42% participated in defined contribution plans.[4]

Based on this data, it is clear that defined contribution plans are a significant part of the modern worker's retirement security strategy. ERIC members, all major employers, have a strong interest in strengthening the voluntary employer-sponsored retirement system and supporting defined contribution savings vehicles that are cost-efficient, encourage maximum employee participation, and provide substantive, valuable benefits to America's workforce. With

[1]Employment Policy Foundation, News Release, October 14, 2004.
[2] A defined benefit pension plan provides for a specific monthly benefit upon retirement, death, or disability based on facts such as an employee's salary and years of service with the employer. Employees are generally not required to make contributions to these plans.
[3] A defined contribution plan provides for individual accounts for each worker. Benefits are based on the amount contributed to the plan by the employer (and, in some plans, the employer) and gains and losses experienced in investing the plan contributions.
[4]EBRI Notes, *The Decline of Private-Sector Defined Benefit Promises and Annuity Payments: What will it Mean?* Volume 45, No. 7 (July 2004); Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Private Industry, 2004* (November 9, 2004 Press Release).

this in mind, ERIC members have articulated certain action principles that will help strengthen and enhance the current defined contribution system. If implemented, ERIC members believe that these action principles will address the changing needs of workers, strengthen long-term retirement security, encourage plan sponsorship and participation, and reduce future stresses on overburdened government retirement security programs. ERIC members believe that advancement of these action principles also is necessary to encourage both employers and employees to contribute to defined contribution plans in a manner that will provide workers with greater economic security upon retirement.

This white paper advances ERIC's action principles by discussing them in the natural order in which they would occur during the life of a qualified plan:

- First, we review the best methods for "getting money into" defined contribution plans, including policy initiatives that would increase both participation in and contributions to defined contribution plans.
- Second, we discuss policy objectives that would help workers make the most of their investments while they are in the plan.
- Finally, we discuss policy objectives with regard to distributions from plans, with a special focus on increasing the likelihood that the money is distributed in ways that maximize the workers' long-term retirement goals.

The paper approaches each individual action principle by first giving a "state of play" on the general issue, then outlining the current law or regulatory guidance on the issue. We then examine the "hurdles" that currently prevent implementation of each principle, and conclude with a summary of ERIC "action strategies" for achieving the proposed changes to the defined contribution system.

I. Increasing participation in and contributions to defined contributions plans

Action Principle #1: Legislative and regulatory modifications should encourage automatic enrollment design features in defined contribution plans.

Employers are seeking ways to increase participation in their defined contribution plans. Tax-qualified defined contribution plans today are different from the savings plans of two decades ago—plans that were largely intended to accumulate supplementary savings and serve as bonus vehicles. The vast majority of defined contribution plans are now designed to be long-term retirement savings vehicles. Increased participation is essential to the future retirement security of the majority of American workers.

As previously discussed, defined benefit plans, where enrollment is usually automatic, are no longer the most prevalent employer-sponsored retirement savings vehicle. A March 2004 study by The Bureau of Labor Statistics found that while virtually all workers with access to a defined benefit plan participated in it, only 79% of workers with access to defined contribution plans participated in the plan. [5] This disparity in participation rates can be attributed largely to the fact that unlike defined benefit plans, most defined contribution plans today do not have an automatic enrollment feature.

According to the Profit Sharing/401(k) Council of America (PSCA), 8% of defined contribution plans used automatic enrollment in 2003[6]. Automatic enrollment was more common in large plans (with 24.2% of plans having an automatic enrollment features) than in small plans (1.1%)[7]. In a survey of mainly large firms, the benefits consulting firm Hewitt Associates found

[5] United States Department of Labor, Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004 (November 2004).
[6] Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004) (website summary: http://www.psca.org/DATA/47th.html
[7] Id.

that 14% used automatic enrollment in 2003, up from 7% in 1999, but the same percentage as in 2001 and 2002[8].

In the case of a cash or deferred arrangement, such as a 401(k)[9] plan, an automatic enrollment feature would require a employee to elect not to have a portion of his or her pay deferred into the employer's defined contribution plan in lieu of wages. Employees who fail to elect out of participation in the plan, or who elect to defer an amount other than the "default" amount, would have a stated percentage of their pay automatically deferred as a contribution to the plan.

While experience indicates that automatic enrollment increases participation in a defined contribution plan, it may not result in participation at savings levels sufficient to provide adequate funds in retirement. To increase savings rates, some advocate an approach that would allow workers to dedicate a portion of their future salary increases raises to their §401(k) plan deferral. As pay increases, contribution levels to the §401(k) progressively increase, without any reduction in take home pay, and without any additional action on the part of the employee.

Summary of Current Law

In 1998, the Internal Revenue Service (IRS) issued Revenue Ruling 98-30, clarifying that automatic enrollment in §401(k) plans is permissible for newly hired employees. The IRS subsequently issued Revenue Ruling 2000-8 stating that automatic enrollment also is permissible for newly enrolled current employees.

In order to clarify its interpretation of federal law with respect to contribution rates in automatic enrollment arrangements, the IRS issued a general information letter on March 17,

[8] Summary of Hewitt Study "2003 Trends and Experience in 401(k) Plans", http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=hew&script=410&layout=-6&item_id=445092

[9] A 401(k) plan one of several types of defined contribution plans. Because 401(k) plans are the preferred defined contribution plan for many employers, we make several specific references to these plans throughout the paper.

2004, stating that the automatic contribution level may be more (or less) than the 3% that the Service had used in previously published examples of acceptable automatic enrollment practices. The letter also stated that the automatic contribution percentage could be increased (or decreased) over time under a specified schedule. The employer must describe the details of the change in a required notice to employees. The Service also stated that increases in the automatic contribution percentage could be triggered by increases in an employee's pay or by bonuses. However, if this trigger is used, the required employee notice must describe exactly how this would affect participating employees.[10]

The Hurdles

- Employees who are automatically enrolled in plans at low levels fall victim to inertia and fail to voluntarily increase their employee contribution rates over time.

- Employers are concerned that choosing a default investment vehicle for a plan with an automatic enrollment feature may jeopardize the plan's ERISA §404(c) status and may subject the employer to liability for investment losses.

- Some employers resist implementing an automatic enrollment feature due to fear that employee inertia and failure to increase contribution rates will create ADP testing problems for the plan.

[10] In studying the effects of the automatic enrollment design with contribution levels that increase with salary, Economists Richard Thaler of the University of Chicago and Shlomo Benartzi of UCLA have found that 80% of workers who joined the plan continued with scheduled increases through at least the fourth pay raise. Participants raised their average contribution rate from 3.5% of pay to 13.6% of pay over approximately 3.5 years of employment.

- Some state laws bar employers from deducting contributions from employees' paychecks without their prior approval.

- Employers are hesitant to include automatic enrollment plan features that include a automatic contribution increase triggered by an event such as a pay raise for fear that the feature will bind them to future pay increases under the terms of the plan.

- Employers have no protection from fiduciary liability with regard to their choice of a default investment for enrollees in an automatic enrollment plan that fail to select investment options.

ERIC Action Strategies

Congress should make every effort to assist employers in encouraging more active participation in employer-sponsored defined contribution plans by making automatic enrollment a more attractive plan design feature. Employers need legislation that provides more relaxed testing safe harbors, 404(c) protections, and preemption of state withholding laws.

- Although the recently issued final 401(k) regulations confirm the permissibility of automatic enrollment features[11], the Internal Revenue Service should allow for more flexibility with regard to 402(g) limits for plans with automatic increase features that include automatic contribution increases.

[11] IRC Reg. §1.401(k)-1(a)(3)(ii)

- The Department of Labor should clarify that automatic enrollment plans with automatic contribution increases triggered by pay increases do not create a promise or expectation of future pay raises for any individual employee.

- The IRS should amend the nondiscrimination testing (ADP/ACP) rules to better accommodate plans that include automatic enrollment.

- Congress should clarify that automatic enrollment features in defined contribution plans are permissible, notwithstanding state laws that may present a conflict.

- Congress and/or the Department of Labor should clarify that, to the extent that a plan is otherwise designed to comply with IRC §404(c), employers that implement an auto-enrollment program with pre-selected investment choices are provided §404(c) protection if workers are allowed to re-invest funds in a broad array of investment choices provided in compliance with §404(c) and the plan otherwise meets the §404(c) requirements.

- Congress should encourage default account options that serve the principal object of providing long-term investment savings.

Conclusion

Simply stated, automatic enrollment in defined contribution plans increases employee participation. In 2001, PSCA surveyed 25 companies that had adopted automatic enrollment. Nine provided information on participation rates before and after the implementation of automatic enrollment. The average participation rate at these companies increased from 68% three months before automatic enrollment was implemented to 77% at the time of the survey. In

addition to encouraging higher participation rates in retirement plans, automatic enrollment programs also send a message that employers are committed to helping employees achieve adequate retirement savings levels[12]. Employers should therefore be encourage to take steps implement automatic enrollment plans that will allow employees to amass substantive retirement savings by providing for automatic contribution increases and default options that include a broad mix of asset classes.

ERIC Action Principle #2

Legislative and regulatory modifications are needed to promote proposals that encourage employees to increase their rate of savings and allow contributions to remain in retirement accounts.

Employers want to encourage employees participating in defined contribution plans to increase contribution levels. A 2001 EBRI study found that the average 401(k) participant contributes only 6.8 percent of salary to his or her retirement account before taxes, practically all on a pre-tax basis[13]. In contrast, the PSCA estimates that the average worker must contribute at least 8 percent of pay with an 8 percent return on investment over a period of 40 years in order to retire with a lump sum distribution that is adequate to provide for a secure retirement[14].

Several factors contribute to the low savings rate among employees, including limits on the amount that can be contributed to an employer-sponsored retirement account on a tax-favored basis and testing and discrimination rules that discourage employers from designing plans to allow workers to supplement pre-tax savings with after-tax savings. Furthermore, EBRI research shows that employee activities such as taking loans, taking pre-retirement withdrawals,

[12] PSCA mini-survey *Automatic Enrollment in 2001*. http://www.psca.org/data/autoenroll2001.asp
[13] EBRI Issue Brief, *Contribution Behavior of 401(k) Plan Participants*, Sarah Holden, Jack VanDeheri (October 2001).
[14] "Neglect that Spells Retirement Ruin", Albert B. Crenshaw, Washington Post, January 23, 2005

or cashing out account balances at job change reduce projected 401(k) accumulations and thus reduce the balance payable at retirement.[15] At the same time, employers recognize that giving employees the option of borrowing from their 401(k) accounts clearly increases contribution rates and encourages employees in middle and lower salary ranges to participate in the plan.[16] This is evidenced by the fact that of the 14.6 million 401(k) plan participants in the EBRI/ICI database, 80 percent were offered a plan loan by the plan sponsor.[17]

Summary of Current Law

Contribution Limits

The Internal Revenue Code places a number of limits on the annual contributions that can be made to an employee's tax-favored retirement plan. Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001[18] (EGTRRA) IRC[19] §415 placed two limits on the amount of contributions made to either a defined benefit or defined contribution plan: a dollar limit ($35,000) and a percentage of compensation limit (25%). EGTRRA raised those limits to the lesser of $40,000 or 100% of compensation. The amount of compensation that can be taken into account for purposes of the contribution and benefit limits, deduction limits, and certain discrimination testing was also increased under EGTRRA, from $170,000 in 2001 to $200,000, in 2002[20], indexed for inflation in subsequent years in $5000 increments. Finally, EGTRRA increased the IRC §402(g) limit on elective deferrals to a §401(k) plan from $10,500 in 2001 to $11,000 in 2002, and by an additional $1000 per year thereafter, until 2006, when the limit will be $15,000. The $15,000 limit will be adjusted for inflation in $500 increments

[15] EBRI November 2002 Issue Brief "Can 401(k) Accumulations Generate Significant Income for Future Retirees?"
[16] EBRI October 2001 Issue Brief "Contribution Behavior of 401(k) Plan Participants".
[17] Id.
[18] P.L. 107-16, 6/7/2001.
[19] All references herein to the "IRC" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
[20] EGTRRA §611(c).

beginning in 2007[21]. The increased limits were enacted as part of EGTRRA in an effort to eliminate the "obstacle to adequate private pension savings" created by years of lowered annual contribution limits[22]. However, in order to comply with the Congressional Budget Act of 1974 (the "Budget Act"), EGTRRA includes a "sunset" provision, pursuant to which its provisions will not apply to plan years beginning after December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the IRC and ERISA will be applied as though EGTRRA has never been enacted.

After-tax contributions and nondiscrimination testing

Employee after-tax employee contributions and employer matching contributions under a defined contribution plan are subject to the actual contribution percentage (ACP) test. The ACP test compares the actual contribution percentages of the highly compensated employee group and the non-highly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year. The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the non-highly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the non-highly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ACP of the non-highly compensated employee group for the

[21] IRC §402(g)(4). EGTRRA §611(d).
[22] Committee on Education and the Workforce Fact Sheet: "Background and Summary on Key Provisions of H.R. 10". May, 2001.

prior plan year.[23] If the plan fails the ACP test, the employer must either return excess employee contributions to highly paid participants or make additional contributions to lower-paid participants so that the test is passed.

Saver's Credit

EGTRRA also established a savers tax credit available to certain low-income earners who participate in a qualified retirement plan. The credit permits employees with household incomes of $30,000 or less (married filing jointly) to receive a credit of 50% of contributions made to a qualified retirement plan.

Loan, early withdrawal, and hardship rules

Pre-tax deferral contributions to a defined contribution plan generally cannot be distributed prior to the earliest of retirement, death, disability, and severance from employment, attainment of age 59 ½ or upon occurrence of a hardship.[24]

IRC Regulations permit an employee to take a distribution from a defined contribution plan in the event of an "immediate and heavy financial need"[25]. The requirement for an "immediate and heavy financial need" is a facts and circumstances test; however, the need must be one that cannot be satisfied from other resources reasonably available to the employee, including assets of the spouse and minor children. An employer may reasonably rely on the participant's certification that the need cannot be relieved through other accessible resources. Denials of requests for a hardship withdrawal are subject to ERISA's appeal procedure.[26] A hardship distribution permanently depletes plan assets, and cannot be repaid by the employee.

[23] IRC Reg. §1.401(m)-2
[24] IRC §401(k)(2)(B)
[25] Treas.Reg. §1.401(k)-1(d)(2)(i).
[26] ERISA §503

A defined contribution plan may also permit loans of plan assets to a participant. The amount of the loan may not exceed the lesser of (i) $50,000 or (ii) ½ of the present value of the participant's accrued benefit or account balance. If the participant's account balance is less than $20,000, however, $10,000 can always be borrowed, as long as the loan does not exceed 50% of the pledged account. The loanable amount is reduced by the participant's highest outstanding loan balance during the one-year period ending on the day before the date on which the new loan is made over the amount of any outstanding loan.[27]

Definition of Highly Compensated Employee

Prior to amendment by the Small Business Jobs Protection Act of 1996 [28] (SBJPA), section 414(q)(1) generally provided that an employee was a highly compensated employee (HCE) if, at any time during the year or the preceding year, the employee:

(A) was a 5-percent owner,

(B) received more than $100,000 (for 1996) in annual compensation from the employer,

(C) received more than $66,000 (for 1996) in annual compensation from the employer and was in the top-paid group of employees during the same year, or

(D) was an officer of the employer who received compensation in excess of $60,000 (for 1996).

Section 414(q)(1), as amended by SBJPA, provided for a more restrictive definition of HCE. Under SBJPA, a HCE is any employee who:

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the prior year had compensation from the employer in excess of $80,000 (indexed) and, if the employer so elects, was in the top-paid group for the preceding year.

[27] IRC §72(p)
[28] Pub. L. 104-188

The Hurdles

- Because EGTRRA's increases in contribution and deferral limits will sunset in 2010, employees will be able to contribute less to their employer-sponsored retirement plans. This will further exacerbate the current pension savings crisis.

- Pre-EGTRRA limits contributed to depressed pre-tax savings among employees; a return to these levels will cause a decline in employee savings rates, and erase many of the gains made as a result of the increased limits under EGTRRA.

- Mandatory discrimination testing for after-tax contributions discourages plan design that would permit employees to contribute additional funds beyond current limits to employee retirement vehicles.

- The current compensation limit for designated HCEs discourages savings at salary levels at or around the HCE limit.

- The current loan/early withdrawal/plan loan restrictions depress retirement savings, particularly among moderate and lower income employees.

ERIC Action Strategies

- Congress should make EGTRRA increases in compensation, contribution, and benefits limits permanent.

- The Internal Revenue Code and ERISA should provide for greater savings through employee after-tax contributions by modifying current testing requirements, and providing a safe harbor under which testing is not required for after tax contributions.

- The Internal Revenue Code should be amended to give employers incentives to match both pre-tax and after-tax contributions, such as waiving nondiscrimination testing on safe harbor plan designs if the employers matches before or after-tax contributions.

- Congress should support and expand the savers credit by simplifying the way in which the credit is obtained and communicating the credit more widely.

- Congress should work with employers to create a savings structure that allows workers to participate in various programs in addition to a 401(k), but allows them to commingle the savings for easier administration. Individual savings structures need to be incorporated into provider products so that employees can easily access these vehicles and maximize their savings potential.

Conclusion

At the current savings rate, the average American worker will not have enough money to ensure a secure retirement at age 65. Policy initiatives that encourage retirement savings must be enacted now in order to effect long-term change in current savings trends. Congress has taken a step in the right direction by increasing employee savings levels under EGTRRA; making these increases permanent would provide workers with tax-favored incentives to

continue building a more adequate retirement nest egg. In addition, changes to loan and hardship withdrawal rules and simplifying savings through the creation of a "common investment" account would encourage higher savings rates among workers who participate in defined contribution plans by reducing pre-retirement asset depletion and streamlining savings options.

II. Protecting defined contribution plan assets

ERIC Action Principle #1: Employees need better access to investment advice mechanisms in order to effectively invest, and manage, their retirement assets.

According to PSCA, 21% to 27% of workers who have access to defined contribution plans will have insufficient financial assets at retirement.[29] Employees' ability to save adequately for retirement depends largely on three factors: the availability of tax-favored retirement vehicles, the employee's level of contribution to those plans, and the investment return on plan assets. Even employees who are diligent about putting aside funds for retirement must investment those funds wisely and effectively in order to be able to spend at pre-retirement levels post-retirement. Despite the unmistakable importance of a proactive approach to the investment of plan assets, a recent study reported that over 53% of active employees look to their employer/ plan sponsor for investment advice rather than seek out professional investment advice services.[30] Given that many employers recognize the importance of sound investment advice with regard to retirement plan assets, most employers have responded to employees' needs for investment advice services. In a 2003 survey conducted by PSCA, 51.9 percent of

[29] The Profit Sharing Council: *Projected Retirement Adequacy of Workers Age 50 to 61:Changes Between 1998 and 2001*,Sherman Hanna, E. Thomas Garman and Rui Yao, June 19, 2003
[30] Stable Value Investment Association (SVIA), July 11, 2002.

employer/respondents provided investment advice.[31] The survey indicates that advice is most prevalent in small companies (59.7%) and least prevalent in large companies (34.5%). Of the employers who do not provide investment advice to their employees, the three most frequently cited reasons are fiduciary concern about liability for advice that results in a loss, even if the advisor is competent and there is no conflict of interest (cited by 93.1% of respondents), fiduciary concerns about ability to select competent advice provider under ERISA "prudent man" standard (cited by 91.1% of respondents), and fiduciary concern about ability to monitor advice provider under ERISA "prudent man" standard (cited by 90.2% of respondents).[32]

Current State of the Law

ERISA §404(c) provides employers with some level protection with regard to employees' investment decisions. However, the regulations implementing the protection are so difficult to maneuver that employers find it challenging to fully comply. In addition, in order to obtain §404 (c) protection, employees must exert "control" over their investment decisions. Plans with default investment provisions may not comply with this requirement, and employers may find themselves inadvertently exposed to possible fiduciary liability for investment losses.

The Hurdles

- Employers are unsure about their exposure to liability for investment losses that may result from employer-provided investment advice.[33] Thus, most major employers opt to provide no advice at all.

[31] Profit Sharing/401k Council of America's "46th Annual Survey of Profit Sharing and 401k Plans," September 2003.
[32] Profit Sharing/401k Council of America's "Investment Advice Survey 2001."
[33] However, an employer who prudently selects and monitors third party investment advice service providers may not be responsible for the specific investment recommendations or decisions of investment advisors. See, *e.g.* ERISA §405(c) and 405(d)(1).

- Section 404(c) does not provide employers with adequate protection from fiduciary liability for investment decisions made by employees.

- Recently publicized employer stocks "scandals" have resulted in employers seeking new, more innovative means for offering employees investment advice options while limiting their fiduciary liability exposure.

- A number of regulatory agencies are weighing in on employer fiduciary responsibility with regard to plan investments, further clouding the waters and discouraging employers from trending toward providing investment advice to employees.

- In choosing a default investment vehicle, employers may want to emphasize maximizing long-term return over preservation of capital. Employers with plans that are intended to comply with IRC §404(c) are concerned that choosing such a default investment vehicle for an automatic enrollment program may jeopardize the plan's §404(c) status.

ERIC Action Strategies

- ERISA fiduciary regulations should be clarified to provide employers who provide sound, disinterested investment advice with greater protection from fiduciary liability.

- Employers need additional formal written guidance from the Department of Labor that reaffirms that employers do not have fiduciary responsibility for the specific

recommendations and decisions made by an investment advisor or an investment manager that has been prudently selected and monitored by the employer.

- Financial service providers need to work with employers to create advice mechanisms that are appropriate for the types of investment options offered under the plan.

- Policymakers should encourage employers to offer investment options that are designed to provide long-term retirement savings for plan participants.

Conclusion

Employers should be encouraged to provide their workers with access to sound investment advice mechanisms. Employee access to effective and efficient investment advice mechanisms is a key factor in helping American workers save for retirement. Furthermore, employers need more adequate protection under 404(c) against the possibly of fiduciary lawsuits resulting from investment losses associated with advice provided through an investment advisor chosen by the employer. Absent such changes to the law, employees may be left without the currently available investment advice necessary to protect their retirement plan assets and secure their retirement savings.

III. Distribution of Retirement Savings

ERIC Action Principle #1: Employees need better incentives to transfer retirement assets into tax-favored retirement savings vehicles upon separation from service.

According to a recent study by Hewitt Associates, over 50% of workers who separate from service with their employer opt to cash-out their retirement funds rather than roll them over

into a tax-deferred savings vehicle. [34] Employees who choose to cash out tax-deferred retirement savings incur significant tax penalties and decrease the chance that their retirement savings will grow into an effective income replacement instrument through the combined positive effects of tax-favored savings and compound interest.

Employees need better incentives to encourage the transfer of retirement assets to tax-favored retirement savings vehicles upon separation from service. Despite the best efforts of plan sponsors to provide incentives for employees to save for retirement in a defined contribution environment, the tendency to cash out retirement savings undermines the goal of establishing and maintaining qualified defined contribution plans. While employers recognize that the portability of a defined contribution account is one of its more attractive features, maximizing portability must be balanced against the "leakage" of retirement savings as a result of employee cash outs.

Current State of the Law

While many employees cite reasons such as financial distress and unforeseen fiscal emergencies as reasons for cashing out retirements assets, many employees are simply unaware of the detrimental tax consequences associated with withdrawing tax-deferred retirement funds. Eligible rollover distributions from a qualified retirement plan that are taken prior to retirement, death, disability, extreme financial hardship (in some plans) or as a loan under the provisions of IRC §72(p) are subject to immediate taxation at the employee's tax rate, plus a 10% penalty.[35] An employee could lose close to 50% of his or her retirement benefits to taxes and penalties as a result of an early withdrawal.

The mandatory rollover rules implemented by the IRS, which became effective on March 28, 2005, attempted to address the cash out problem. The rules amend § 401(a)(31) to provide, in

[34] Hewitt Associates, 2001, (Cite to be amended in next draft)
[35] IRC §72(t)

general, that a tax-qualified retirement plan must provide that if the plan makes a mandatory cash-out distribution of more than $1,000, and the participant does not elect to have the distribution paid to an eligible retirement plan or directly to the participant, the plan administrator must transfer the distribution to an individual retirement plan (an "IRA"). The plan administrator is required to notify the participant that the distribution may be transferred to another IRA.

The Hurdles

- The current mandatory cash out rules provide the vendor community with no incentive to create the small IRA accounts necessary to hold account balances of less than $5000.

- Participant-owners of IRAs transferred under the mandatory cash out rules will pay more to maintain the money in an IRA than they would have had to pay had the money remained in a qualified plan account.

- Workers will be lost over time. Workers who cannot be traced will never receive assets in their mandatory rollover IRA account, which will further exacerbate the "leakage" problem.

ERIC Action Strategies

- Congress should consider permitting employers to have small account balances of employees who have separated from service transferred to the PBGC, where supplemental accounts would be established for the employee, and distributed upon retirement.

- Increasing the mandatory cash out limit significantly would provide vendors with a greater incentive to maintain mandatory cash out IRAs.

- Plans that choose to retain the assets of employees who have not issued distribution, rollover, or transfer instructions should be able to release assets to the PBGC.

Conclusion

Congress and the administration need to take aggressive steps to control leakage from employee defined contribution accounts due to employee cash outs. Cash outs are as severe a threat to retirement savings levels as inadequate participation and contribution levels. While the mandatory roll-over rules are a good step in the right direction, more far-reaching reform of the laws related to employee distributions are necessary to control the rate at which employees are receiving distributions of their retirement assets upon separation from service. In addition, plan sponsors need more plan design options with regard to mandatory cash outs based on the individual demographics of their workforces, such as turnover rates and average plan balances.

ERIC Action Principle #2: Employees need more viable annuity options that work in a defined contribution environment.

In a recent study by Mercer Human Resource Consulting, 92% of 401(k) plans offered only a lump-sum distribution option.[36] While little research has been done on the effect of reduced distribution options on America's retiring workforce, the limited availability of options that provide for a steady income stream in retirement results in retirees running two possible

[36] Cite will be updated in next draft.

risks: either consuming their nest egg too quickly and running out of money before they die or consuming it too slowly and unduly restricting their standard of living in retirement.[37]

The detrimental impact of the premature depletion of retirement plan assets received in a lump-sum payment has yet to be fully determined. However, the risk of such depletion is evident, and the results are likely be seen in the rising popularity of alternative income sources among the elderly, such as reverse mortgages and home equity conversion mortgages. The lack of a robust annuity market for defined contribution plan assets clearly conflicts with the longer life expectancy of today's workers and the decreased availability of defined benefit annuity payments for current and future retirees.

Summary of Current Law

While defined contribution plans are not prohibited by law from offering annuity forms of distribution, few plans do, for several reasons. First, a plan that provides an annuity form of distribution is will encounter certain restriction if the plan later eliminates that form of distribution under IRC §411(d)(6). Employers who may find the annuity distribution option too costly or impractical for their current workforce are effectively handcuffed, and forced to provide the option indefinitely. Second, employers who offer an annuity option in a defined benefit or defined contribution plan are subject under ERISA to provide employees with the "safest available annuity". The possible fiduciary exposure associated with this requirement often outweighs the benefits of making annuity options a part of an employer's plan design. [38]Finally, the current high cost of most fixed-rate annuities can substantially deteriorate the value of the employee's account balance, and render the annuity distribution option fiscally impractical for

[37] *Coming Up Short: The Challenge of 401(k) Plans.* Alicia H. Munnell and Annika Sunden, Brookings Institution Press 2004, (pg. 13)
[38] DOL Advisory Opinion 2002-14A

many employees. While employees who take their defined contribution plan balances as a lump-sum are always free to convert the payment into an annuity subject to IRS rules, few employees choose to do so, largely due to the cost.

Currently, varying state laws control the sale of annuity contracts. This presents a particular problem for large employers considering an annuity distribution option within their defined contribution plans. Because many large employers have employees in several states who may participate in the same defined contribution plan, navigating state insurance and/or banking laws with regard to annuities creates an additional disincentive.

The Hurdle

- Employers currently have more disincentives than incentives to provide annuities as a form of distribution in a defined contribution plan.

ERIC Action Strategies

- Congress and the Administration need to fashion more favorable rules regarding the distribution of defined contribution assets in annuity form in an effort to encourage employers to include annuity options as a design feature in defined contribution plans.

- Workers need more education to help them understand the annuity market and the tax benefits associated with using an annuity.

- Congress needs to make annuity contracts more attractive such as by allowing insurance companies to use higher assumed interest rates in pricing annuities.

- Annuity providers should be permitted to pool retiree investment risks and coordinate payout with the pooled risk.

- Congress should pass legislation providing employees with tax incentives to purchase annuities with qualified plan assets.

Conclusion

Employees need more annuity options, and greater incentives to utilize them, in order to increase the chance that retirees will have an adequate income replacement stream. As the baby boom generation ages, the implications of outliving one's retirement savings will become more evident. The potentially detrimental economic impact of this phenomenon is heightened among employees who retire with most or all of their retirement savings in defined contribution plans. Employers need incentives, rather than disincentives, to include annuity distributions as a form of payment from their defined contribution plans. As more of the workforce retires with the majority of their retirement savings in defined contribution accounts, the lack of a robust annuity market will threaten the retirement security of millions of Americans.

ERIC Action Principle #3: Retirees need more options for the use of tax-deferred savings in a post-retirement atmosphere

Employer costs for retiree health coverage increased almost 13% between 2003 and 2004.[39] As a result, in 2004 approximately 8 percent of employers eliminated subsidized health

[39] Current Trends and Future Outlook for Retiree Health Benefits: Findings from the Kaiser/Hewitt 2004 Survey on Retiree Health Benefits

benefits for future retirees.[40] Since 1988, number of large employers offering retiree health benefits declined from 66 percent to 36 percent.[41] As a result, many future retires will find themselves paying for medical care and other essential post-retirement needs out of their retirement savings. Fidelity Investments estimates that the average 65-year-old couple retiring today will need as much as $190,000 to cover their medical costs over the next 15 to 20 years.[42]

Retirees currently do not have access to vehicle that would allow them to access medical care, prescription drugs, or long term care on a tax-favored basis. The same policy objectives that endorse tax-favored treatment for retirement savings lend support to the argument that such savings should also be tax-favored when used for certain, limited purposes.

Current State of the Law

Currently, no law exists that would permit retirees to take nontaxable distributions from their retirement plans to pay for post-retirement needs.

The Hurdles

- No real solutions have been proposed to handle the soaring cost of retiree health care, which has forced companies to either substantially scale coverage back or eliminate coverage completely.
- Retirees are forced to cover the cost of many essential post-retirement needs with limited retirement assets that are taxable upon distribution.
- The tax code provides few mechanisms for employers to purchase retiree healthcare.

[40] *Effects of Healthcare Spending on the U.S. Economy*, Office of the Assistant Secretary for Planning and Evaluation, United States Department of Health and Human Services, http://aspe.hhs.gov/health/costgrowth
[41] Id.
[42] Fidelity Investments, Press Release, *Fidelity Investments Increases Estimate for Retiree Medical Expenses*, March 28, 2005.

ERIC Action Strategy

- Allow defined contribution accounts to be used to pay for healthcare in retirement on a tax-favored basis.

Conclusion

The soaring cost of health insurance has a direct and profound impact on the retirement security of the American worker. Unless Congress chooses to confront the healthcare issue directly, many of the gains achieved through changes to retirement plan rules will be lost to the rising cost of healthcare. Retirees need access to tools that allow them to pay for healthcare related costs on a tax-favored basis in order to ensure their personal retirement security. If retiree health costs are ignored as an integral part of the retirement security debate, employees will be left with few, or no, options for affording the quality healthcare they will need during their later years.