

**IMPACT OF TAX REFORM ON THE SMALL BUSINESS
RETIREMENT PLAN SYSTEM**

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IMPACT OF TAX REFORM ON THE SMALL BUSINESS

RETIREMENT PLAN SYSTEM

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The views expressed in this chapter are strictly those of the author.

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IMPACT OF TAX REFORM ON THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

§1.01 INTRODUCTION

More than 19 million American workers are covered by the small business retirement plan system.¹ These small business employees enjoy very generous annual retirement plan contributions from their employers, often in the range of five to ten percent of compensation. If some of the tax reform proposals being discussed by the Administration, Treasury and the Congress become law, it is highly probable that these company contributions will come to a halt and these small business employees will be at risk of losing this valuable retirement plan coverage in the future.

The *sine qua non* of small businesses is private ownership with any year end surplus

¹ Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 2. Employee Characteristics by Employer Retirement Plan Sponsorship, 2003 at CRS-5. This Table shows that there are approximately 5.4 million employees who work for businesses that sponsor a retirement plan and employ fewer than 10 employees, approximately 4.8 million employees who work for businesses that sponsor a retirement plan and employ between 10 and 24 employees, approximately 9.6 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees and approximately 12.6 million employees who work for businesses that sponsor a retirement plan and employ between 100 and 499 employees. Small business retirement plans are sometimes considered as those with fewer than 500 participants while others use a cut off number of 250 or 100. Obviously, if the cut off number is higher than 100 participants, then the small business retirement plan system covers more than 19 million employees. The actual participation rates in these plans is somewhat lower since not all employees are eligible to participate. Many plans require employees to work a year before becoming eligible and many require employees to work at least 1000 hours a year to be eligible to receive contributions. These numbers are different from those found in an earlier CRS report. See Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Pension Sponsorship and Participation: Summary of Recent Trends, September 10, 2004, Table 4. Participation in Retirement Plans by Size of Firm at CRS-10. This Table shows that there are approximately 5.8 million employees who work for businesses that sponsor a retirement plan and employ fewer than 25 employees and approximately 6.1 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees. There are approximately 31.5 million employees in companies that sponsor a retirement plan and employ more than 100 workers.

revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and “grow” the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the top-heavy and anti-discrimination rules set² forth in the Internal Revenue Code³ and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners will forgo the retirement plan option. Should “tax reform” significantly reduce the incentives available to small business retirement plan sponsors, it is highly

² Sections 401(k), 416 of the Internal Revenue Code of 1986, as amended and Treasury Regulation § 1.401(a)(4)-8.

³ The Internal Revenue Code of 1986, as amended, (hereinafter "Code" or "IRC").

probable that literally millions of workers employed by small business will lose a portion of their retirement income security; this at a time when the viability of the federal Social Security system is subject to a fair degree of doubt.

§1.02 MAJOR TAX REFORM AND THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

[1] **Overview**

It is clear that a major priority of the current Administration is to effectuate major tax reform. The President highlighted tax reform in his State of the Union address in February, 2005, saying in part, "Year after year, Americans are burdened by an archaic, incoherent federal tax code. I've appointed a bipartisan panel to examine the tax code from top to bottom. And when their recommendations are delivered, you and I will work together to give this nation a tax code that is pro-growth, easy to understand, and fair to all." President Bush established the Advisory Panel on Federal Tax Reform by Executive Order on January 7, 2005 and directed it to recommend ways to simplify the federal tax code and report its finding to Treasury Secretary Snow by July 31, 2005.⁴

Federal Reserve Board Chairman Alan Greenspan when testifying before this Advisory Panel, in March, 2005 stated,

I would not presume to suggest the best specific path for reforming the tax system. However, past experience suggests that as the panel's work gets under way, one of the first decisions that you will confront is the choice of tax base; possibilities include a comprehensive income tax, a consumption tax, or some combination of the two, as is done in many other countries. As you know, many economists believe that a consumption tax would be best from the perspective of promoting economic growth--particularly if one were designing a tax system from scratch--because a consumption tax is likely to encourage saving and capital formation. However, getting from the current tax system to a consumption tax raises a challenging set of transition issues.

⁴ For an informative analysis about the various tax proposals the Advisory Panel will be considering see Jim McTague, Barrons, *Trashing the Tax Code*, (February 14, 2005) at 21.

In 1986, tax reformers considered a consumption tax base and, despite the arguments in favor of such a system, they decided to enhance the comprehensiveness of the income tax system then in place. Circumstances are different today, and the right choice will require assessing anew the tradeoffs between complexity, fairness, and economic growth.

Former Senator John Breaux, co-chair of the Advisory Panel reported in April, 2005 that the group is “absolutely” intent on recommending a restructuring of the income tax system rather than a modest simplification or tinkering around the edges.⁵ He said that he favors limiting the number of tax-reform options that the panel will submit to the Treasury Department by July 31, to one or two, rather than four or five options that would include less extensive reforms. Breaux said the recommended options could include a restructuring similar to the sweeping legislation passed in 1986 or perhaps even a “new tax system” – likely featuring a consumption tax, such as a sales tax, or perhaps a flat tax, in which all income is taxed at one rate. The advisory panel issued a statement on April 13th calling the current tax code “unstable and unpredictable.”⁶

The Administration is in favor of sheltering at least some portion of savings from taxation. For the last 3 years, the Administration has included a proposal for Lifetime Savings Accounts (“LSA”) in its annual budget. A Lifetime Savings Account is essentially a non-deductible Individual Retirement Account (“IRA”) limited in this proposal to \$5,000 per person per year. There are no withdrawal limitations on this money. The Administration’s stated goal in promoting the LSA is to boost savings in the country and to simplify the tax code. Treasury Secretary John Snow stated in a

⁵ It is anticipated that the Advisory Panel will use the November 2002 Treasury Report prepared by former assistant Treasury Secretary, Pamela Olson, as the basis for its initial discussions. This report set forth five options: a national sales tax; two variations of a VAT added to a stream-lined income tax system, one aimed only at the very high income taxpayer and the other aimed at the existing group of income taxpayers; a flat income tax; and a major reform of the existing tax code (this is discussed in more detail below).

⁶ Washington Post, April 15, 2005, “U.S. Panel to Propose Restructuring Tax Code.”

Department of the Treasury Release, March 8, 2005,

These initiatives will give more hardworking Americans the opportunity to save so they can enrich their lives and strengthen their retirement security. These proposals make saving simple for everyone and for every purpose. No longer will individuals have to worry about the confusing alphabet soup of six different savings accounts. No longer will people have to worry about the endless maze of confusing rules. These simple accounts will have one powerful goal – making saving for everyday life and retirement security easier and more attractive. LSAs are good for average Americans because giving people the ability to access their money at anytime for any purpose will encourage more people to save. LSAs take away the hassle factor. The combination of universal eligibility and unrestricted tax-free distributions makes saving simple and makes it more likely that average Americans, especially those with less financial sophistication or lower income, will participate.

Presumably the LSA simplifies the tax code by getting rid of the deduction for contributions and removing the withdrawal limitations imposed on current IRAs. Whether or not the LSA would accomplish a boost in savings is something that would remain to be seen, many experts anticipate that enactment of the LSA vehicle would result in a decrease in savings rather than increasing savings, particularly for the low and middle income taxpayers. They believe that funds that are already being saved in other taxable accounts would simply be moved over to the LSAs rather than actual savings being increased. Further, since there are no limitations on withdrawals such as one finds in the 401(k) world or even with IRAs, LSAs would be accessed for spur of the moment purchases. Further, there is no evidence to suggest that low income taxpayers do not save in regular savings accounts just because the accounts are taxable, particularly given the fact that their effective tax rate is so low or even zero. In reality “high” taxes on savings is not the reason the low and middle income taxpayer doesn't save, rather it is the need to “make ends meet” that leaves nothing for savings.

The Administration also believes that dividends should not be subject to any income tax when received by an individual because income tax has already been imposed at the corporate level

(i.e. double taxation). Interestingly, the Administration is not concerned about double taxation when the dividends are received by a qualified retirement plan and then distributed out to the plan participant – under the proposal advanced by the Administration in 2004 and enacted into law, dividend income distributed from retirement plans continues to be fully taxed at ordinary income tax rates. Further, the Administration is also in favor of further reducing the capital gains rate, possibly to zero. Thus, we find ourselves in a situation where it is conceivable, even probable, that major changes to the Tax Code may be enacted in the near future which would have significant, if as yet little understood, impact on the voluntary small business qualified retirement plan system.

[2] National Sales Tax

The “sexiest” tax reform proposal is the national sales tax – referred to by its promoters as the “Fair Tax.”⁷ These advocates suggest that adoption of the national sales tax will “Kill the Tax Code” and “Kill the IRS.” Certainly, these slogans resonate well with the general public. Without going into an exhaustive analysis, it is worthwhile to review the broad outline of this consumption tax proposal to see how it would work.

⁷ It is interesting to note that Congressmen John Linder (R-GA), Steve King (R-IA), Charles Taylor (R-NC), Collin Peterson (D-MN), Tom Price (R-GA), Dennis Hastert (R-IL), Tom Delay (R-TX) and Senator Jim DeMint (R-SC), ran in the 2004 Congressional election in part on the Fair Tax proposal. All won the election (how much was due to the Fair Tax proposal compared to other issues is hard to determine). The proponents of the Fair Tax believed that these campaigns educated the public about the Fair Tax proposal and that the issue polled very well.

First, its promoters intend the new tax to replace all existing federal taxes – income tax, estate tax and corporate tax, as well as all payroll taxes, including Social Security and Medicare. In order to make sure that we do not end up with a consumption tax in addition to the existing income tax system, proponents have called for a repeal of the 16th Amendment.⁸ Advocates also claim that their replacement tax is allegedly structured so that it is revenue neutral – in other words it would generate the same amount of revenue that is received under the current federal income, estate and payroll tax systems.

The way this works is that whenever a new item or service is purchased at the retail level, there will be roughly 30 cents of federal sales tax added for every dollar of the price of the item purchased. No sales tax is imposed on a used item. The tax is only collected at the final point of sale.

In order to protect those at poverty level, it is proposed that *every* American will receive a monthly rebate check from the Social Security Administration which will be tied to the size of one's family and the U.S. Department of Health and Human Services' poverty level. So, for example under the Fair Tax system in 2004 based on the then current poverty level and the proposed sales tax rate, annual rebates of \$2,141 for a single person, \$2, 873 for a married couple and \$7,261 for a family of eight would have been paid.⁹ The rebate is apparently intended as a substitute for exempting "necessities" such as food, medicine and similar items, from the sales tax.

⁸ The 16th Amendment to the Constitution of the United States of America was ratified on February 3, 1913, and provides that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

⁹ Fair Tax, Frequently Asked Questions, July, 2004, question 3 at 1. For more information on this proposal, see www.fairtax.org.

Proponents of the Fair Tax claim that the federal bureaucracy necessary to send out rebate checks to every American and to collect the sales tax and to make sure all of the various collectors of this sales tax are collecting the tax correctly and submitting it all to the federal government will be minimal. They believe that the retail businesses will collect the tax from the consumer (just as they do in most states) and that they will send it on to the state taxing authority and the states will then send it on to the federal government. The Fair Tax proposal provides that all the businesses collecting the taxes and all the states will receive collection fees for collecting the tax. They also believe that it will be simple for the Social Security Administration to send out checks to every American every month.

This seems to be quite an optimistic assessment. Many who have thought about this policy believe that we will end up with a thriving black market¹⁰ and a huge agency similar to the IRS with tremendous enforcement powers to make sure that all of the sales tax is being collected and sent on to the federal government.

The Brookings Institute contends that the 30 cents on the dollar sales tax set forth in the Fair Tax proposal as revenue neutral (i.e., that it will generate the same amount as our current tax system) is based upon zero tax evasion. Our current tax evasion rate is between 15 and 20 percent. At a 15 percent tax evasion rate, the national sales tax would have to increase to 35 cents on the dollar instead of the proposed 30 cents on the dollar.¹¹ Brookings

¹⁰ Interestingly, proponents of the national sales tax system believe that people who now dodge the income tax system, such as drug dealers and other criminals, will pay the national sales tax so that the overall tax burden will be more evenly spread amongst all Americans. Others consider it naive to assume that criminals will begin to pay taxes instead of purchasing items on the black market. Of course, they will continue to “sell” their products outside of the tax system.

¹¹ Imagine that a good is to be sold for \$100 and there is a \$30 sales tax on the item. This would be a 30 percent sales tax if one calculated it as a tax exclusive rate. To determine the tax inclusive tax rate, the \$30 tax payment is divided by the total purchase price of \$130, making it a 23% tax rate. According to the Brookings Institute, sales taxes are usually quoted as tax exclusive

also asserts that,

The sales tax would generate tremendous opportunities for evasion. For example, in the income tax, the rate of evasion is around 15 percent. But income where taxes are withheld and reported to government by a third party has evasion rates of around 5 percent. For income where taxes are not withheld and there is no cross-reporting, evasion is around 50 percent. Since the sales tax would feature no withholding and no cross-reporting, the possibility of high evasion rates needs to be taken quite seriously.”¹²

State sales taxes already exist in the vast majority of states, with tax rates usually ranging from three to ten percent. Generally, states tax only about half of the private consumption of goods and services because of exemptions for food, medicine, electricity and so on. Few states tax services and all exempt the state government from paying the tax on goods or services it purchases.¹³

Some advocates suggest that a consumption tax would be the end of special interests on the Hill at least with respect to the Tax Code. Given the past history of the Republic, it is not hard to imagine that the Congress will nevertheless continue to be besieged with requests for tax exemptions or reductions for various laudable goals (e.g. fuel efficient cars vs. SUV’s). The often touted beneficial side effects of the national sales tax – eliminating tax lobbyists and a tax collection bureaucracy – are perhaps a bit too optimistic and utopian.

The architects of the consumption tax proposal do understand that even though the tax proposal is intended to be revenue neutral, that from a distributional analysis, less of the tax will be paid by those who are the wealthiest (though they claim that “after a few generations” the burden

rates and income taxes are normally quoted as tax inclusive rates. The Fair Tax proposal uses the 23% tax inclusive rate when describing the sales tax. For purposes of this chapter, the tax exclusive rate is used. William G. Gale, The Brookings Institution, Policy Brief # 31 –1998, Don’t Buy the Sales Tax, at 1.

¹² *Id.*, at 3.

¹³ *Id.*, at 2.

will be distributed more evenly because the descendants of the wealthy decedent will apparently dissipate the wealth by spending). Consider then a middle class couple with young children who basically spend every dollar they make – whatever income not expended for housing costs (e.g., mortgage payments or rent) is spent on food, clothing, doctors, schools, etc. Contrast this young, middle class couple to an older, single person with great wealth, say a billionaire, who consumes perhaps as little as 1% of his total wealth (\$10 million) or even less a year. It is highly probable that this latter individual would pay far more to the federal government under the existing Tax Code (where unearned income is taxed) as compared to the consumption tax, whereas the young couple would probably pay far less under the current system than under the sales tax proposal.

As mentioned above, the reason why the consumption tax becomes “more fair” when viewed over a number of generations is because the heirs of great wealth allegedly dissipate that wealth over a number of generations. Even if this is true, it is not so clear that the middle class couple would feel particularly more sanguine or comfortable with the fairness of the new tax system. Even though the tax does not appear fair from a distributional viewpoint, the proponents nevertheless believe it is ultimately fair inasmuch as they see this tax as voluntary in that the young couple or a poor, elderly person could choose to buy used goods and not be hit with the tax. (What happens when the country runs out of used goods? Unfortunately, there doesn't appear to be such a thing as used services.) They also believe that the rebate will effectively exempt necessary food, medicine, doctor visits and so on from the sales tax.

Nor are national sales tax advocates concerned about possible effects on new housing or new car sales; instead they posit that due to the reduction/elimination of income tax at the producer level, the cost of new items will decrease sufficiently to offset the consumption tax. How does that happen? Each company along the way that is contributing to the new item or service will voluntarily

reduce the price of their goods or services in recognition of the elimination of their corporate and payroll tax burdens so that in this world of the consumption tax – the new house, boat, car or whatever, would end up costing the end purchaser almost the same as it would before the imposition of the federal sales tax. Presumably the cost of goods and services will drop in roughly the same percentage as the consumption tax. On the other hand, it is equally plausible that companies will not reduce prices to reflect lower tax burdens, seeking instead to maximize stockholder value, at least for the short term.

The transition rules for the Fair Tax proposal are simple – it is effective six months after it is enacted and everything that is in the process of being made (presumably this would apply to services as well) would be exempt from the tax. For those of us who are a bit more cynical, it would seem that there would be a huge boom in the new housing market, new cars, boats, virtually all new goods during the six month transition period while people stocked up on everything they could in order to avoid the new federal sales tax. Then retail sales of new goods would probably decline significantly for the next several years.

Charities, national sales tax proponents contend, have nothing to worry about because charitable giving does not depend upon tax incentives but rather they say (and they say they have the data to prove it), depends only upon the economy. (Of course they can all open thrift shops for the sale of used items!)

According to its supporters under the Fair Tax proposal only good things happen – people continue to consume at the same rate because the prices of goods and services will be voluntarily reduced so that even with a national sales tax roughly one third of the old sales price, there will be no change in prices, while at the same time, savings increase because there is an incentive to save (i.e., savings are no longer taxed and if you do not consume, you do not have to pay the tax). Given

the plight of the lower and middle income wage earner, it is difficult to understand how consumption will remain steady while savings increase. Sales tax advocates, however, claim that take home pay would be higher because of the elimination of payroll taxes and that Americans will also save money by not paying accountants and attorneys for tax planning and preparing tax returns which would then be available for consumption and savings under their proposal. It is doubtful that middle to low income wage earners spend that much money on filling out tax returns or on tax planning. Again, remember a key assumption in the national sales tax model is that even after factoring in the sales tax, prices on goods and services are going to remain fairly constant because companies are going to lower their prices to take into account their savings from no longer paying payroll taxes or corporate taxes, if any, not to mention the savings in accountants' and attorneys' fees. The elderly and the poor are fine because they can buy all used items and the rebate will make sure that those at poverty level are able to afford food and presumably medicine.

What is not mentioned in their exhaustive material, is what would happen to the small business retirement system. Perhaps it is not mentioned because it did not even hit the radar screen of the economists who studied this proposal or perhaps in their view, it really does not matter if a large segment of small business employees (at least ten million employees) are hurt, because in their view the Country will be better off. In fact, it is clear that sales tax advocates are convinced that once the Country adopts the Fair Tax, it will enter a golden era. As their materials say,

Job creation will boom. Residential real estate will boom. Financial services will boom. Exports will boom. Retail will prosper. Farming and ranching will prosper. Churches and charities will prosper. Civil liberties will be enhanced. In short, it is difficult to imagine the far-reaching, positive effects of this change. Though this tax policy is exactly what our Founding Fathers counseled us to do with the *Federalist Papers* and the Constitution.¹⁴

¹⁴ *Id.*, at question 46 at 14.

Lest one throw up his or her hands in amusement or disgust and pronounce that something like this could simply not happen without serious study and a thoughtful national debate, think again. This proposal is backed by some of the most influential people in the Country and many with great, great wealth. Remember that lately we have seen far reaching tax proposals (such as eliminating all taxes on dividends) almost passed in Congress with little discussion.

On the other hand, it is possible that such a consumption tax could be passed with a five or ten year transition, where Americans would basically be paying taxes under both systems. One can easily imagine a tax bill passing Congress in the near future that would impose a very low percentage of national sales tax (with no exemptions or rebates) with the tax reforms to the existing Tax Code mentioned below. The national sales tax could be below the radar screen for many Americans, but could raise significant funds for the government. The problem with this type of transition is that it seems too easy for the government to never transition to the new tax system and we end up with both systems, like many of the European countries.

[3] Value-Added Tax (VAT)

A VAT is also a consumption tax but unlike the national sales tax, which taxes only the final product, the VAT applies to every stage of production, including the final product. Similar to the national sales tax proposal, used products would not be taxed. It is anticipated that the VAT would not be a substitute for all of the federal taxes but instead would be in addition to the federal income tax. The income tax, however, would be streamlined, simplified and flattened so that there would be fewer deductions. Proponents of the national sales tax dislike the VAT because they say it is more complex than the sales tax approach and would make it easier for Congress to impose different rates of taxes and exemptions to particular industries and/or products because the tax is generally hidden

from the ultimate consumer.¹⁵ Of course, there are many who believe that social engineering through the tax code should be encouraged, rather than discouraged – clearly the tax incentives in the tax code to promote long term savings in employer-sponsored retirement plans have worked admirably.

[4] Employer Sponsored Retirement Plans Most Effective Method to Promote Long Term Savings

Not only do small business retirement plans have a generous *employer contribution* (generally a profit sharing contribution) and/or an *employer matching contribution*, but they also often provide an attractive way for all employees to save for their retirement. 401(k) plans are so effective because employees are able to save for their retirement by having automatic deductions taken from their paychecks which reduces the amount of their taxable income. The money saved by the employees inside the plan grows tax free and the plan prevents easy access to the money by the employees so that the funds are able to grow and accumulate for retirement.

Employer sponsored retirement plans are the most effective method for encouraging savings by low to moderate income workers. According to data collected by the Employee Benefits Research Institute (EBRI), 77.9 percent of workers earning between \$30,000 to \$50,000 who were covered by an employer sponsored 401(k) type plan actually participated in the plan, while only 7.1 percent of “non-covered” workers in the same income level, saved in an individual retirement account. In other words, low to moderate income workers are almost *11 times* more likely to save when covered by a workplace retirement plan.¹⁶ Reasons for this striking disparity include the

¹⁵ FairTax, Frequently Asked Questions, July, 2004, question 45 at 13, *supra* note 6.

¹⁶ ASPPA, based on the EBRI data, developed a chart setting this statistic out in graph format which demonstrates far more ably than words how effective the employer-sponsored retirement plan is at

convenience of payroll deductions since it is much easier to save money that one has never had in hand, the convenience of having investments preselected, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer. Unlike the success of the 401(k) plan and other employer-sponsored retirement plans, personal savings in this country outside of the retirement plan area (and outside IRAs) are dismal – less than two percent.¹⁷

In a number of studies, behavioral economists have found that the easier it is for an employee to save, the more likely it is for that employee to do so. While this seems to be axiomatic, it is surprising the extent to which employees do whatever is easiest. For instance, an analysis conducted in 2000 found that workers, particularly low income workers, were far more likely to participate in a 401(k) plan if they were automatically enrolled than when they had to sign up for the plan. The numbers are rather startling: when enrollment was not automatic, 37.4% of all workers overall would sign up for the 401(k) plan, but when enrollment was automatic, the number jumped up to 85.9%. This trend was even more pronounced in workers making less than \$20,000 a year. Without automatic enrollment, 12.5% opted to join the plan, with automatic enrollment, 79.5% chose to

promoting savings for all workers.

¹⁷ Senator Craig Thomas (R-WYO) used this statistic in a press release (March 8, 2005) introducing the SAVE Initiative, which includes the LSA proposal discussed above. Interestingly, he believes, as well as the Administration and other LSA proponents, that the LSA will increase personal savings even though the data conclusively shows that the only effective savings vehicle is employer-sponsored retirement plans. Apparently, the proponents of the LSA proposal believe that individuals do not save in IRAs due to the imposition of the 10% early withdrawal penalty if one removes funds before age 59 1/2 for reasons other than disability, death, extraordinary medical expenses, etc. Other reasons they advance as to why the LSA will promote savings as compared to the regular deductible IRA are the complexity of IRAs (hard to imagine anything easier than an IRA) and the incentive of the current deduction not being meaningful to the average American. Most people expert in the retirement plan field believe that only those individuals who currently save in an IRA will have any interest in saving in an LSA and most of them would prefer the deductible IRA inasmuch as they are saving because they do not need the funds for current consumption and would prefer to get the deduction.

participate in the plan.¹⁸ This makes it clear that the way to encourage and increase savings, particularly for the low and mid-income worker, is to have an employer-sponsored plan, preferably with automatic enrollment and a preselected investment feature.¹⁹ Interestingly, when these factors are present, employees are willing to save in these plans which effectively “lock up” the funds for long term growth since they are designed to have contributions accumulate and grow tax free until retirement.²⁰

[5] **Impact of a Consumption Tax on the Small Business Retirement Plan System**

A reform of the current income tax system to a pure consumption tax would have a profound impact on the small business retirement system due to the elimination of the tax incentives which underpin the employer-sponsored retirement plan system. Absent an income tax, there would be no tax benefit to the employer to make plan contributions. The loss of the tax savings of deductible contributions combined with the out of pocket costs of mandatory and significant contributions for the non-owner employees when weighed against the new availability of non-plan tax free savings vehicles will likely lead small business owners to quickly conclude that continuation of the

¹⁸ Washington Post, April 18, 2005, Private Accounts Make for Hard Sell at A8.

¹⁹ *Id.*, This article also states that in the same analysis conducted in 2000 that overall 71.2% of all workers kept the default investment option offered by the plan and that 24.8% switched to their own choice. Among workers who made below \$20,000 a year, 89.3% stayed with the default investment option and 8.5% chose to select their own choice.

²⁰ It is important to note that the funding problems we have seen in some of the very large defined benefit plans are highly unusual in the small business retirement plan system – this is likely due to the fact that the owners’ retirement savings are also inside the plan so that the funding is adequate and the assets are carefully invested. Thus, not only are the plans highly effective as savings vehicles for the employees and provide significant employer contributions for the employees, they are also by and large properly funded with the assets prudently invested.

retirement plan is not cost effective. Thus, it is likely that millions of small business employees²¹ will lose their ongoing retirement plan contributions made by their employers *and* lose the opportunity to continue making 401(k) contributions by payroll deduction to plans with preselected investment choices. Under this tax model, owners would retain profits for themselves that might otherwise have been contributed into the company's retirement plan. Simply stated, absent the Tax Code's existing incentives, there would be absolutely no reason for the business owners to place their own savings into a vehicle which would lock in those savings until retirement – owners would surely prefer easy access to their savings. Finally, there would be no reason to incur ERISA mandated fiduciary responsibility or the legal and administrative costs associated with the upkeep of the plan, including the internal record keeping burdens inherent with the sponsorship of a retirement plan.

Not only is the existence of the plan dependent upon federal tax incentives, but to a large extent so are employee contributions to a 401(k) or a SIMPLE. Employee contributions to these retirement plans reduce one's taxable income. If reducing taxable income is no longer of any consequence, then making contributions becomes less important. Of course a company match to an

²¹ The top-heavy rules were added by the Tax Equity and Fiscal Responsibility Act of 1982 under I.R.C. ' 416. These rules mandate certain required minimum contributions for non-key employees. In a top-heavy defined contribution plan, the employer must make a plan contribution equal to 3% of compensation for every non-key employee who is a participant in the plan, (unless the highest plan contribution for a key employee is less than 3%, in which case the highest percentage contribution for any key employee becomes the minimum contribution for the non-keys). A top-heavy plan is virtually synonymous with a small business plan. Because of the mechanical mathematical tests utilized to determine top-heavy status, which largely depend upon the number of key employees who are employed by the company as compared to non-key employees, almost all small business plans are top-heavy. This is the base contribution an employee can receive in a top-heavy plan; generally because of the application of other non-discrimination tests, particularly when the owners wish to have significant contributions made for themselves, the contributions for the non-owner employees end up between five to ten percent of compensation. Employer contributions made to a SIMPLE plan are somewhat lower than those mandated by the top-heavy rules.

employee's contributions should also provide an incentive to save for one's retirement. However, if a small business were to stop all employer contributions, including the match, there would not appear to be *any* reason for an employee to save in a retirement plan. These plans are purposefully designed by Congress to make it difficult for employees to have access to the saved funds until retirement age.

Under a consumption tax system, the tax-free savings feature of the retirement plan would be available in any savings investment and plan contributions would yield no tax savings. Thus, it is highly unlikely that anyone would lock up their savings dollars for the long term when there is little or no tax incentive to do so.

A tax system that provides no tax incentives for long-term savings inherently favors short-term savings choices which provide easy access to such savings. Unfortunately, given the choice to consume or save, it seems that individuals tend to use readily accessible savings "for the moment" rather than leaving those dollars to grow over the long run in order to accumulate income for their long-term financial needs. Based on the dismal level of most Americans' savings outside the qualified retirement plan system, it would seem that only a tax system which provides tax incentives for long-term savings will, in fact, provide the retirement income security that individuals will require at retirement.

[6] Can Employer Sponsored Plans Be Promoted Under a Consumption Tax System?

Since it is reasonable to assume that companies will cut back all costs not deemed essential in order to stay competitive in a market place where new products and services will be hit with a substantial federal sales tax and it is likely that an employer-sponsored retirement plan would be considered to be an expendable cost, it will be important for the government to come up with incentives in the tax system to encourage small business owners to keep their plans. There are at least

two ways to promote a voluntary employer-based system retirement plan system for privately owned businesses in a consumption based tax system. One method would be for the federal government to issue “retirement certificates” (something akin to food stamps) to plan participants equal to all or some percentage of the funds that the participants had accumulated in the retirement plan which would entitle the holder to an exclusion from sales tax when purchasing goods or services with the certificates. A variant of the retirement certificate approach would be to issue such certificates at the time plan contributions are made to employers and plan participants. This could prove to be a sufficient tax incentive to keep the small business retirement plan system in place *and* for employees to continue making contributions to the retirement plan. Unfortunately, this would add a layer of complexity to a system whose primary attractiveness is based on simplicity, but since food stamps are workable, there is every reason to assume “retirement certificates” would also be workable. Another possible way to incentivize small business owners to retain the retirement plans and to continue making contributions for the employees would be to allow them to keep a portion of their collected sales tax, if they sponsored a retirement plan, rather than remitting it all back to the state and federal government. Unfortunately, this incentive would not be meaningful for any business not subject to the sales tax (for instance, under the national sales tax a company that provided parts to another company would not have its products hit by the sales tax and would not be responsible for collection of the sales tax). Also, additional exemptions to the sales tax, will unfortunately cause the overall tax rate to increase. Nevertheless, it is critical to at least ten million people that some way be found to preserve their retirement income security and that the Country do everything possible to promote the employer-sponsored retirement plan system.

[7] Simplification of the Existing Tax Code

The second most likely tax reform proposal will be to simplify the existing tax code. It is

probable under this proposal that the Alternative Minimum Tax (AMT) would be repealed. Many deductions would be eliminated, perhaps even the deduction for state and local taxes on federal income tax returns and for employer-provided health insurance. According to sources familiar with the Administration's goals and priorities, the White House plans to push for Tax Code changes that would shield interest, dividends and capitals gains from taxation and expand tax breaks for business investment.²² Of the possible simplification proposals, the reduction or elimination of taxes on savings income would have the greatest impact on the existing small business retirement system.

[8] Impact of Tax Reform that Eliminates or Reduces Taxation from Savings on the Small Business Retirement System

A recent survey of individuals familiar with the small business retirement plan system²³ confirm how important tax incentives are to small business owners with respect to the sponsorship of retirement plans. A vast majority (87%) of those polled thought that companies with fewer than 10 employees would close down their plans if the tax system were changed so that savings were no longer taxed, even if the deduction from income would remain for contributions made to the plan. Only ten percent (10%) of those polled believed that the small businesses would retain the retirement plans and continue making employer contributions in to the plan. A majority (66%) of those polled expected companies with fewer than 25 employees to close down their plans if savings

²² Washington Post.com, Bush Plans Tax Code Overhaul, Jonathan Weisman and Jeffrey Birnbaum, 11/18/04 at E01.

²³ This survey is set forth in full at the end of this chapter. It was conducted by the Small Business Council of America (SBCA) in early 2005. The survey was sent out to 241 individuals who work with small business owners and know first hand how entrepreneurs reach decisions and were also familiar with retirement plans. This included small business advisors, as well as accountants and attorneys who concentrate in the small business area. 55 individuals responded generating a response rate of almost 23%. When asked approximately how many retirement plans the advisor worked with and how many employees were covered by those plans, 29 individuals responded with data or nearly 53% of the number of respondents. These 29 individuals worked with small businesses that sponsored approximately 10,400 retirement plans and covered approximately 337,400 employees.

were no longer taxed and twenty-five percent (25%) thought the retirement plans would be retained. Not until the company has more than 50 employees do half of those polled believe the company would keep the plan in place and even with 50 employees, 34% of those polled thought the plan would be closed down.²⁴ Clearly, significantly reducing taxation on savings would have a devastating impact on the small business retirement system unless additional incentives were put back into the system to promote the continuation of retirement plans. If business owners are able to invest in assets outside the plan which are tax advantaged and easily accessible, there is little reason to continue to accept the costs (including the costs of mandatory contributions for non-highly compensated employees) and burdens of the retirement plan, particularly when distributions from a retirement plan are subject to ordinary income tax rates.

When those surveyed were asked whether they thought a \$5,000 per person LSA would impact the decision of a small business owner to sponsor a retirement plan, 49% thought that the owners would forgo the plan and 45% thought such an LSA would have no impact on the decision of an owner to sponsor a retirement plan. Obviously, the smaller the company contributions made to the retirement plan, the more likely it is that a small business owner would turn to the LSA as the savings vehicle of choice. The owners would weigh the benefits of moving to an LSA (easy accessibility to the funds, no required contributions for non-highly compensated employees, no administrative expenses or burdens and no fiduciary responsibility) as compared to the costs (loss of the deduction for the contribution made and possibly lower contribution level for the owner –

²⁴ It is reasonable to assume that these numbers would have been even more skewed towards discontinuance of plans if the advisors to small businesses had been asked about whether the plans would be retained by small businesses under a consumption tax model where deductions from income would have no economic effect and the same tax free treatment on earnings could be obtained in freely accessible savings accounts.

\$10,000 for a married couple).

When asked, however, if they thought a \$15,000 LSA for each owner with an additional \$15,000 for the owner's spouse would impact the decision of a small business owner to sponsor a retirement plan, the numbers were dramatically different. 91% thought that the owners would discontinue the plan and move over to an LSA and 7% thought such an LSA would have no impact on the decision of an owner to sponsor a retirement plan. The explanation for this dramatic change in numbers is that under the larger \$15,000 LSA, a married business owner would be able to shelter \$30,000 a year from income taxation without having to incur any of the costs of sponsoring a retirement plan. Under any tax analysis, the owners come out better with an LSA than they do sponsoring a retirement plan – unfortunately their employees do not.

Some Treasury economists contend that in the final analysis it is irrelevant if a small business retirement plan is terminated because they believe that the owners of the business will increase employee compensation by the amount of the former retirement plan contribution and the employees will in turn commit these funds to savings.²⁵ The problem with this theory is that it does not square with reality. Small business owners understand that the price of admission into a retirement plan for themselves is required contributions for the staff. Small business owners view employees' salary as the true worth of the employee in the marketplace and retirement plan contributions for employees as a necessary cost to make the desired retirement contributions for themselves. Responding to a survey of small business advisors, more than half stated that employee compensation would not be increased if plan contributions were terminated; indeed, less than 6% suggested that employee

²⁵ This hypothesis is apparently based upon the premise that the real value of an employee to a business is the total compensation paid to the employee, including retirement plan contributions. Thus, it is assumed by these economists that companies will continue to pay the total compensation to the employees, though no longer required to do so.

compensation would increase; one-fourth stated that only the key employees would receive the additional compensation and less than 12% believed employees would receive the additional compensation, but then only for the first year following plan termination.²⁶

Moreover, even assuming *arguendo* that the small business owners would voluntarily increase compensation in lieu of terminated plan contributions, it is highly doubtful that the employees would in fact save those dollars. Despite Treasury economists suggestions that the employees receiving the additional compensation would save those dollars for retirement, the data discussed above is clear that the only effective savings vehicle is an employer sponsored retirement plan. This is due in large part to the fact that funds inside a retirement plan cannot be easily accessed and employee involvement is “passive”, i.e., funds are automatically contributed into the plan by the employer.

[9] Can Employer Sponsored Plans Be Promoted Under a Tax System that Removed or Reduced Taxation on Dividends, Capital Gains or on Other Forms of Savings?

If capital gains, dividends or other income from savings were subject to a much lower tax rate or none at all, there would be several ways the Tax Code could be amended to provide incentives for small business owners to maintain employer sponsored retirement plans. For instance, the Tax Code could provide that distributions from retirement plans instead of being subject to regular income tax rates would be subject to the same or lower rate than that on capital gains or dividends. When the small business advisors were asked “If the tax law were changed so that in

²⁶ More than 90% of the small business advisors ranked the number one reason why small business owners sponsor retirement plans is the fact that the plan provides a tax advantaged method of saving for retirement for the owners. Less than half suggested the second reason is that the plan assists in the recruitment and/or retention of employees. However, based on their responses as to whether a plan would be terminated if the tax incentives were significantly decreased or eliminated, this second reason was clearly not deemed sufficiently important for the plans to be maintained.

addition to removing savings from taxation, retirement plan assets were taxed at a very low rate, say 3 to 5% when they were removed from a retirement plan,” 73% thought that would be enough of an incentive for owners to retain the retirement plan. 24% thought that the owners would still terminate the plan since that same rate could be earned outside the plan with other investment choices and that the deduction for contributions did not offset the costs and burdens of running the plan. When the question was modified so that in addition to the Tax Code removing savings from taxation, retirement plan assets were taxed at a very low rate, say 3 to 5% when they were removed from a retirement plan, *and* there was a \$500,000 to \$1 million exemption on retirement plan assets from estate tax,” 87% thought the business owners would keep the plan and 11% thought the owners would still terminate the retirement plan.

§1.03 CONCLUSION

The current employment-based retirement plan system has allowed millions of small business employees to participate in “privatized” retirement investment vehicles²⁷ which have been remarkably free from the “insolvency” concerns surrounding the Social Security system and the large multi-employer plan retirement programs. A perhaps unintended, not fully understood, consequence of pending tax reform proposals may be the dismantling of the highly successful small business retirement system that is presently providing meaningful accumulation of funds for the retirement security of more than ten million workers.

Prudent retirement policy suggests that the most efficient and effective tax retirement policy system must continue to provide long-term tax incentives to employers to establish and maintain retirement plans for their workers. It would be tragic to risk the retirement security of working

²⁷ As of July 2003, an estimated 36.4 million U.S. households, or almost half of all U.S. households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, U.S. Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

Americans by creating a tax system that fails to recognize the need to encourage long-term retirement savings over short-term savings vehicles.
