401(k) PLANS

OPPORTUNITIES AND CHALLENGES FOR SMALL BUSINESS

U.S. CHAMBER OF COMMERCE

401(k) Plans: Opportunities and Challenges for Small Business

What It Takes to Start a 401(k) and Why We Need to Simplify Small Business Retirement Plans

Why Don't All Employers Offer a Retirement Plan? It Seems like a "Win-Win" Idea

Employers want to offer great retirement benefits, no matter how big or how small the business. After all, it seems like a "win-win" situation. Employees get good retirement savings opportunities, and they may get matching contributions and other tax-advantaged compensation. Employers get happier, more loyal workers, and are better able to compete for talent in a competitive labor marketplace. Especially in smaller businesses, the benefit interests of employers and employees are closely linked—owners and their families typically rely on the same tax-qualified plans as their workers for their own retirement. A 2012 MetLife study showed that retirement benefits are the third most important factor driving employee loyalty in small businesses, behind salary and health & medical benefits.[1] Why is it that not all employers offer a 401(k) plan? Why are larger businesses three times more likely to offer retirement benefits than small businesses with fewer than ten employees?[2]

The answer is straightforward—small business owners simply do not have enough resources. Resources measured in time, money, bandwidth, and risk. Most small business owners are working hard simply to stay in business and many are already their business's own CEO, CFO, and HR Director. Adding "retirement plan administrator" and "named fiduciary" to that list can be a

[1] "Why Small Firms Should Consider Setting Up 401(k)s," Charles Passy, *The Wall Street Journal*, September 30, 2013.

[2] "Employer-Based Retirement Plans: Access Varies Greatly," The Pew Charitable Trusts, May 27, 2016. Surveys show "…only 22 percent of workers at companies with fewer than 10 employees report having access to workplace retirement plans, compared with 74 percent of workers at businesses with at least 500 employees."

substantial burden. Small businesses already have an incredible amount of administrative and business tasks to focus on, including payroll and employment matters, insurance, monitoring cash flow and payment, complying with government regulations and requirements for their specific business, managing inventory, and marketing and advertising—all on top of actually running the business.

The unfortunate reality is that offering a retirement plan can be prohibitively expensive and time-consuming. Retirement plans, even familiar plans like the 401(k), can be complicated to run, requiring the acceptance of new legal obligations and liabilities. For small businesses in particular, these realities of cost and "red tape" are barriers to offering competitive benefits, despite the best intentions of employers and owners.

Policy makers should be simplifying the process, making competitive retirement benefits more widely available.

The Upside of Employer-Sponsored Plans

If employers already have all of these duties and obligations, you may ask, why would they want to be involved in retirement benefits as well? Should workers be responsible to save for themselves? Indeed, Individual Retirement Accounts (IRAs) allow individuals to save on their own using pre-tax money. In fact, some states are passing laws that would allow workers to use payroll deductions at work to fund their own IRAs without employers having to offer a retirement plan. Unfortunately, the reality is that these programs will not achieve the results needed to increase coverage—research has shown that employer-provided retirement plans result in the best outcomes for workers.[3]

Employer-Sponsored Plans: More Savings, Encouragement, and Matching Contributions

Employer-provided retirement plans offer better benefits for workers. A 401(k) plan, for example, allows workers to contribute about three times more

[3] "What Moves the Retirement Readiness Needle: Quantification of Risk and Evaluation of New Proposals," EBRI Issue Brief Vol. 37 No. 5 (April 2016), at 3. Universal employer-provided DC plans at historical participation rates three times more effective at reducing retirement saving deficits than an auto-IRA scenario based on state proposals.

money per year compared an IRA allows. This higher contribution limit can make a substantial difference in the amount of money an employee can save over the course of his or her career. Additionally, employers typically encourage workers to save, reminding them of the importance of making retirement contributions, and even offering automatic enrollment. Many employers make matching contributions on top of the amount a worker contributes, up to certain limits. An individual using only an IRA to save for retirement has a lower cap placed on the amount he or she can save, does not benefit from an employer's encouragement to save, and typically receives no matching contribution.

Employer-Sponsored Plans: ERISA Protection

Employers have a heightened legal duty under ERISA to ensure that fees are reasonable and that the investments available to workers in the plan are appropriate. In an IRA, a worker has to make these decisions on his or her own.[4] And while some new state laws may allow payroll deductions for IRAs, the fact is that none of these laws offer the same protections to workers that is provided by federal law governing retirement plans. In fact, those states considering such programs typically were unwilling to allow their new payroll deduction IRA programs to go into effect until they were assured that the federal laws protecting workers would not apply.[5]

For these reasons, studies show that the best and most effective way to improve retirement savings is through employer-sponsored plans like 401(k) plans—in fact, early research suggests that these plans could be three times more effective at reducing retirement savings deficits than state IRA programs.[6] This is not to say that IRAs are bad retirement savings vehicles. They are not.

[4] While the Department of Labor's recent fiduciary regulations, and accompanying exemptions, provide IRA owners with a little more protection against self-dealing and conflicts of interest from investment advisors, it is still up to the IRA owner to make these decisions.
[5] In November 2015, The Department of Labor released a Fact Sheet announcing a proposed regulation that would describe circumstances under which a state-required payroll deduction savings IRA program would not give rise to an employee benefit plan under ERISA. Department of Labor, Employee Benefits Security Administration Fact Sheet: State Savings Programs for Non-Government Employees. https://www.dol.gov/ebsa/newsroom/fsstatesavingsprogramsfornongovernmentemployees.html?utm_source=hootsuite
[6] "What Moves the Retirement Readiness Needle…"

It is that they are not as effective at encouraging retirement savings as 401(k) plans. In fact, most of the assets held by IRAs were saved and invested in 401(k) plans and "rolled over" into IRAs for portability or other retirement planning purposes. The fact is, an employer-provided plan, such as a 401(k), produces the best outcome for most workers.

401(k) Plans are Common, but They Can Be Complex: Illustrating the Problem Facing Small Businesses

The 401(k) is the most common type of retirement plan offered by private employers. It is a versatile tool that can be offered and utilized by small and large employers alike. 401(k)s are designed to provide the maximum tax benefits available to employees and businesses providing plans. Unfortunately, running a 401(k) can present a time and resource challenge, especially for smaller businesses.

There are starter plans for very small business using "simplified" plan designs, but these options are best-viewed as a stepping stone to a 401(k). As with IRAs, these "simplified" plans cannot offer the same savings opportunities for workers as 401(k) plans. For example, the "simplified" plan designs, such as a SIMPLE IRA or SIMPLE 401(k), reduce the administrative burden on the employer, but allow the workers to contribute only about two-thirds as much as they would be able to in a 401(k). Similarly, employers can only contribute only half as much to these plans. Simplification should not automatically result in reduced savings opportunities, and it is time to revisit the burden offering a retirement plan can place on a small business.

To improve access to retirement savings options for most Americans, we need to focus on making it easier for employers to offer plans. While offering a 401(k) plan may be more beneficial for an individual employee and employers alike, maintaining one can require a lot of time and attention, and often leads the employer sponsoring the plan to hire outside specialists to ensure things are done properly.

This paper looks at what is required to set up and operate a typical 401(k) plan and will provide an overview of the regulatory and administrative burdens facing employers that attempt to offer competitive retirement benefits.

401(k) Plans: A Case Study

The plan sponsor (i.e., the employer offering the 401(k) plan) must comply with a variety of federal laws and regulations to properly offer and run a 401(k) plan. Some of these rules must be complied with to ensure that employees and the plan sponsor receive the tax benefits of a retirement plan. As a group, these rules are referred to as **tax qualification issues** and include things like required plan features, minimum conditions for participant eligibility, mandatory vesting rules, and so forth.

Another set of rules govern the **reporting and disclosure requirements** of retirement plans. There are numerous required notices to participants—some annual, some periodic, and some triggered by specific events. These include requirements to provide a summary plan description (SPD) of the plan, which is a document that summarizes the terms of the plan, and periodic updates on plan changes. Plans must also file annual reports with the Federal Government, and plans with more than 100 participants must have an annual independent audit.

The last major categories of rules are called **fiduciary and prohibited transaction rules** and govern the conduct of the people running the plan. One or more persons must be designated as the named fiduciary and plan administrator for a 401(k) plan. This person or group will be responsible for acting solely in the interest of the participants or the plan when making prudent decisions about matters like hiring service providers or selecting plan investment options. A plan's fiduciaries should employ a thorough and well-documented process that takes into account all relevant factors when making these decisions. Whether a fiduciary has made a prudent decision is evaluated based on the process used to make that decision—imprudent decisions causing losses to the plan can result in personal liability for the responsible plan fiduciary. Prohibited transactions are protective rules designed to prevent fiduciaries and other persons involved in the plan's administration from taking advantage of their position. For example, a plan fiduciary cannot personally benefit from his or her fiduciary decision on behalf of the plan.

The First Big Challenge: Establishing a 401(k) Plan

Creating a 401(k) plan requires four initial steps:

1. Adopting a written plan document that complies with all of the many requirements;
2. Arranging a trust for the plan's assets;
3. Developing a recordkeeping system; and
4. Providing plan information to employees eligible to participate.

The written plan document serves as the foundation for the operation of the plan. It will dictate eligibility requirements, contributions, vesting (i.e., when participants have a legal right to benefits under the plan), and the form and timing of distributions, among many other things. The employer should regularly review the plan document for changes in the law and update it accordingly.

Once the plan document has been drafted, the employer must establish a trust for the plan's assets. Selecting a trustee is one of the most important decisions the employer will make in establishing the plan. The selection process may include nominating a single trustee or a board of trustees to manage the plan or hiring a financial institution, such as a bank, to serve as the trustee.

The recordkeeping system tracks and properly accounts for participant contributions, earnings and losses on investments, plan investments, expenses and benefit distributions. Employers have the choice to perform the recordkeeping functions themselves, but most elect to hire a contract administrator or financial institution to perform them. If a business hires an administrator, the employer still has to invest time and resources in a process that prudently selects and monitors any third party it hires to perform these functions for the plan.

There are many third party financial institutions and consultants who help employers draft plan documents, establish a trust and either provide recordkeeping services for the plan, or help the employer select a record keeper. These entities make the practical steps easier; however the employer is still ultimately responsible for the overall compliance with its fiduciary responsibilities associated with hiring a third party service provider (discussed in more detail below) and for monitoring and supervising any service provider it selects to provide trustee or recordkeeping services to the plan.

Lastly, employees who are eligible to participate in the plan must be notified about the benefits, rights, and features associated with participation in the plan. The SPD must also be provided to all participants.

Ongoing Administration Challenges: Maintaining a 401(k) Plan

Once an employer has established a 401(k) plan there are many elements to administer. On an on-going basis, a plan fiduciary must:

- ✓ Ensure all eligible employees are given the opportunity to participate;
- ✓ Collect participant contributions and deposit them timely into the plan's trust;
- ✓ Monitor when participants have a legal right to their benefits and to what portion of their benefits the right applies (vesting);
- ✓ Perform non-discrimination tests;
- ✓ Invest plan assets as directed by participants;
- ✓ Maintain prudent fiduciary processes and procedures such that plan fiduciaries comply with their obligations;
- ✓ Provide disclosures regarding plan information to plan participants as required by law;
- ✓ Report to government agencies; and
- ✓ Distribute plan benefits in accordance with the plan document.

Enrolment: Depending on the kind of 401(k) plan the employer adopts, employees may be automatically enrolled in the plan or given the opportunity to enroll once certain eligibility criteria are met. The employer must monitor the eligibility criteria and offer an employee participation in the plan when he or she becomes eligible. This includes eligibility for new-hires, re-hires, terminations, and compensation changes that may make an employee a highly compensated employee (for whom the plan's eligibility criteria may be different or whose status as a highly compensated employee may affect plan administration).

Contributions: In all 401(k) plans, participants can make contributions through salary deductions. The employer must know the types of contributions allowed into the plan and will typically deduct amounts from each participant's salary, as directed by the participant, and deposit it into the participant's account under the plan. Participants' contributions are always 100% vested. However, plans differ with respect to the vesting of any employer contributions made to participants' accounts. In a traditional 401(k) plan, employers may design the plan so that employer contributions become vested over time, according to a vesting schedule set forth in the plan document. The employer is tasked with monitoring this vesting schedule and ensuring that vested benefits are distributed in accordance with the plan document.

The employer must understand how benefits are paid from the plan, including what types of benefit payments and what forms of payment are allowed. In addition, the employer must keep track of the timing of distributions. In general, distributions can only be made upon leaving the employer, retirement, or death. And the law requires that plans must begin a minimum required distribution of benefits on April 1 of the following year after the participant reaches age 70½.

Non-Discrimination Rules: A 401(k) plan cannot discriminate in favor of executives or highly paid employees. Employers sponsoring a traditional 401(k) plan must perform annual testing to ensure that the amount of employer contributions paid into the plan for rank-and-file employees is proportional to employer contributions made for executives or highly-compensated employees. The law defines "highly-compensated" as an employee who makes more than

$120,000 per year. If employer contributions paid to highly-compensated employees are not proportional to those paid to rank-and-file employees, the plan could be "top heavy" and other rules and additional employer contributions may apply. For small businesses, these "top heavy" and related non-discrimination rules could easily apply if there are only a few rank-and-file employees beyond the owners and would require fairly complex calculations and can result in adjustments that affect people's taxes and withholding.

Disclosures: Additionally, the employer must give participants sufficient information about the plan and its investment options for them to make informed decisions about their retirement future. This disclosure includes the SPD, which is a plain-language explanation of the plan terms and benefits, a summary of material modifications, which is an addendum to the SPD communicating to participants any changes made to the plan or the SPD, an individual benefit statement that shows the participant's earned benefits under the plan, values of the investments made and information describing the ability of the participant to change the investments and how to do so.

Government Reports: Finally, the employer must prepare the Form 5500 annual return/report and file it with the Department of Labor (DOL) and the Internal Revenue Service (IRS). The DOL and IRS recently released proposed changes to the Form 5500 reporting process that would significantly increase the annual reporting obligations for nearly all retirement plans. If implemented these changes would greatly increase the administrative burden on a small business offering a 401(k) plan.

There are many third party financial institutions and consultants who help employers with various parts of plan administration. For example, tax accountants will help the employer with the Form 5500 filing, payroll companies help employers implement systems that manage the participant's salary deduction, and the record keeper may help the employer with distributions.   Although these entities make the practical steps easier, the employer is remains ultimately responsible for the overall compliance with its fiduciary responsibilities and for monitoring and supervising any service provider it selects to provide services to the plan.

Investing Challenges

Once a 401(k) plan has been established and plan administration set-up, the employer must decide what investment options to make available to its workers. Once these options are chosen, the employer is responsible to periodically monitor those investment options to ensure that they remain prudent for the plan and its participants. Often, although not required, this process involves the drafting and adoption of an Investment Policy Statement (IPS). The purpose of an IPS is to assist the employer in effectively supervising, monitoring, and evaluating the management of the plan's investment offerings. A typical IPS will address the employer's attitudes, expectations, and objectives for the investment of the plan's assets, establish a formal criteria to select, monitor, evaluate, and compare the performance results achieved by each investment option on a regular basis, and establish the number and characteristics of offered investment options.

Employers may decide to hire a third party investment advisor or investment manager to help the plan fiduciaries select and monitor the plan's investments and otherwise act in accordance with the IPS. However, as discussed below, the employer must use a prudent process to select the investment advisor, and has ongoing responsibilities to monitor the advisor's performance to ensure that it remains a judicious choice for the plan.

Legal Obligation: Fiduciary Responsibilities

Many of the actions required to maintain a 401(k) plan involve fiduciary decisions. Fiduciary status is based on the functions performed for the plan, not on someone's title. Individuals who control the assets of the plan or use discretion in administering and managing the plan are fiduciaries. The basic fiduciary responsibilities include:

- Acting solely in the interest of the participants and their beneficiaries;
- Acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan;

- Carrying out duties with the care, skill, prudence, and diligence of a prudent person familiar with such matters;
- Following the law and the plan documents; and
- Diversifying plan investments.

In addition to these general fiduciary responsibilities, there are specific rules that govern a fiduciary's actions that the employer must be aware of and follow. For example, the deductions from an employee's paycheck for a contribution to the plan must be deposited with the plan as soon as reasonably separated from the employer's assets, but no later than the 15th business day of the next month.

In order to adequately carry out these duties, fiduciaries must establish a prudent process that documents the decision making process to demonstrate the rationale behind each decision at the time it was made. Even if a third party service provider is hired to perform some of the administrative or investment functions discussed above, the act of selecting a service provider is a fiduciary act that requires a prudent process.

This process likely will include review of certain information about the services provided to the plan and the compensation the service provider will receive. The fiduciary must use this information to understand the services, assess the reasonableness of the compensation, and determine if any conflicts of interest exist. Other items the fiduciary must consider when working with a third party service provider include: the service provider's affiliations, financial condition, experience with 401(k) plans, and assets under its control; how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled; the identity, experience, and qualifications of the professionals who will be handling plan assets; and recent or pending litigation or enforcement actions that have been taken against the service provider, the firm's experience and performance record, and whether the firm has any fiduciary liability insurance.

Once a third party service provider is hired, the fiduciary still has the responsibility to prudently monitor that third party's performance on an ongoing basis. Steps may include evaluating any notices received from the service provider about possible changes to their compensation and other information they provided when hired; review of the service provider's performance; ready any reports they provide, check actual fees charged; ask about policies and practices (such as trading, investment turnover, and proxy voting); and follow up on any participant complaints.

Penalties for breaches of fiduciary duty or engaging in a prohibited transaction can be significant, including the personal liability of fiduciaries for losses to the plan and automatically arising excise taxes for the amounts involved.

Simplify Small Business 401(k) plans

There are a handful of legal and regulatory changes that the government can make to create more opportunities for working Americans to save and put people on the path to the retirement they have earned. Here are a few of the ideas that the U.S. Chamber of Commerce has endorsed to help small businesses offer quality retirement benefits to their employees:

- ✓ **Open Multiple Employer Plans (MEPs)**—a simple idea that could make a huge difference, MEPs allow unrelated employers to join together to be part of one large, professionally-managed 401(k) plan instead of having to sponsor many separate small plans. While MEPs currently exists, there are provisions that discourage their use. Changing these provisions and expanding small business access to MEPs would provide cost-savings from economies of scale, reduce the administrative burden facing each plan sponsor, and could expand access to more than 13 million small business employees.[7]

- ✓ **Small Businesses Tax Credits**—expand the small business tax credit for 401(k) startup costs by increasing it and making it refundable.

- ✓ **Streamlined Notice Requirements**—over the years, new notices were created for specific issues without material coordination with existing requirements. As a result, plan administrators face unnecessary

[7] "Retirement Plan Coverage by Firm Size: An Update," Social Security Bulletin, Vol. 75, No. 2, 2015. Social Security Administration, Office of Retirement and Disability Policy.

complexity and duplication. Streamlining these requirements would save workers money and reduce the burden of administering plans.

- ✓ **Default Electronic Disclosure**—the DOL does not permit electronic communication as a default for most plans. Allowing people to request paper notices and statements, but otherwise providing such information electronically would save workers money in unnecessary paper mailings.

- ✓ **Simplified Compliance Testing**—create new optional non-discrimination testing and eliminate or relax top-heavy rules to encourage greater implementation and maintenance of 401(k) plans.

- ✓ **Prevent Unintended Consequences from State-based IRAs**—ensure that state IRA programs do not undermine 401(k) plans by discouraging small businesses from offering 401(k) plans or by encouraging the adoption of plans that present worse options for workers.

- ✓ **Employee Stock Ownership Plans (ESOPs)**—encourage ESOPs and promote their benefits while protecting them from unnecessary litigation and excessive regulation.

While a 401(k) may be a common and familiar retirement plan, offering one is not always simple or realistic for small businesses. As this paper has shown, there is a lot of work required of employers—particularly small businesses—when offering a retirement plan. While we must protect workers, we could do a great deal to simplify the process of offering plans, making these valuable benefits more widely available to workers across America.

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