COST AND IMPACT OF FEDERAL REGULATION ON SMALL VERSUS LARGE BUSINESS RETIREMENT PLANS

FINAL REPORT

June 1990

Submitted To:
Office of the Chief Counsel for Advocacy
Small Business Administration
Contract No. SBA-3058-0A-88

Submitted By:
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Executive Summary

Introduction

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, there have been eleven major legislative initiatives that substantially changed the regulatory requirements for retirement plans. The effects of these recent changes in regulatory requirements on plan formation, termination, administration and costs in small businesses have yet to be assessed.

The purpose of this study is to examine the administrative burden and costs of retirement plan regulation on plans sponsored by small versus large businesses. Key evaluation questions and issues that this study addresses include the following:

- How do plan administrative costs as a percentage of total pension contributions and per employee compare between small and large firms? What factors are most responsible for high administrative costs in small plans?

- What are the administrative costs of complying with various regulatory requirements for small businesses (compared to large businesses)?

- How have regulatory requirements affected the rate of formation of new retirement plans and rate of termination of existing plans in small businesses?

- What regulatory requirements and provisions have small businesses found to be most burdensome and most beneficial?

- What regulatory or policy alternatives could (1) ease regulatory burdens, (2) reduce complexity and costs of administering plans and (3) expand retirement plan coverage for small businesses?

To address these questions, data were collected on the actual costs of (1) plan formation, (2) on-going administration, and (3) compliance with regulatory change from
over 50 pension plan service providers. These data provide estimates of administrative costs as a percentage of total pension contributions and average cost per employee. At the same time, information was also collected about what service providers felt were the most burdensome and costly aspects of plan administration and pension plan regulations. Case studies of eleven small and two large businesses were also conducted, which were intended to provide the practical experience and detail necessary to conduct in-depth analyses of major aspects of administering plans. These interviews, which were typically with the owner-operator and/or benefits administrator of the firm, also provided detail on the ways in which plans have been (and will be) affected by changes in pension plan regulations. Finally, existing data sources were used to analyze recent trends in plan formation and terminations.

Recent Trends in Pension Plan Formation and Termination

Since 1982, there has been a substantial decrease in the number of plans formed, accompanied by a substantial increase in the number of plan terminations.\(^1\) Internal Revenue Service (IRS) data indicate that since the peak of 85,400 new plan establishments (letters filed) in 1982, overall pension plan formations have declined by 71.1 percent to an estimated 24,700 in 1989. This trend is even more pronounced for defined benefit plans whose formations dropped by 84.0 percent to 4,500 in 1989. In part, these trends reflect the increasing costs of establishing, administering, and revising

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\(^1\)An estimate of plan formations and terminations was made from IRS determination letter data. However, determination letter data may reflect an underestimate of the number of new plans formed and terminations because some plan sponsors will not request a determination letter. This may occur because they are confident of their plan's tax favored status or they are filing a standardized plan upon which the IRS has already favorably ruled.
Table ES-1: IRS Qualified Applications and Terminations of Employer-Sponsored Pension Plans (Plans in '000)

<table>
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<tr>
<th>IRS Qualified Applications</th>
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<tr>
<td></td>
<td>Defined Contribution</td>
</tr>
<tr>
<td>1976</td>
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<td>1978</td>
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<td>45.1</td>
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<tr>
<td>1988</td>
<td>41.2</td>
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<tr>
<td>1989 est.</td>
<td>20.2</td>
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SOURCE: Internal Revenue Service determination letter statistics: for 1976 through 1986, data obtained from various IRS News Releases; for 1988 and 1989, IRS data files were utilized.

Since the low point of 13,300 plan terminations (letters filed) in 1980, plan terminations have increased by more than 100 percent to 26,900 in 1989. Defined benefit plan terminations rose continuously and most dramatically, increasing from 4,300 in 1980 to 14,500 by 1989 or by 237 percent. In fact, by 1988 the number of defined benefit plan terminations exceeded the number of defined contribution plan terminations even though, at the time, there were only a third as many plans. In 1989, the estimated number of plan terminations exceeded the number of plan formations (by 9 percent) for the first time. It is notable that in 1989, there were 10,000 more terminations than establishments of defined benefit plans; said another way, terminations exceeded
formations by more than three times for such plans. These trends are displayed in Table ES-1.

Initiation and On-Going Administration of Pension Plans in Small Firms

The cost and burden of initiating a plan depends upon the type of plan selected (for example, defined benefit plans are generally more costly and difficult to establish) and whether the plan is a prototype plan or individually-designed plan. Regardless of whether the small employer chooses a prototype plan or an individually-designed plan, some level of expert assistance will almost certainly be required to select the most advantageous plan and properly complete all the steps needed to establish a plan.

In recent years, the cost, complexity and burden of initiating pension plans in small businesses has been reduced substantially with the introduction of a wide variety of prototype plans. For example, one major investment firm will prepare all of the documents necessary for establishing a plan and provide a guide to administration for $300. This has represented a major breakthrough for small businesses, many of whom were unwilling to absorb the costs (and the efforts) of developing an individually-designed plan. Prototype plans, which previously had been offered only through insurance companies, banks, investment companies, and other financial institutions, now may be offered by employee benefit consultants through the IRS’s new regional prototype program. Many benefit plan consultants felt that the IRS’s regional prototype program is the most positive development in the pension area in recent years.

Some small employers hire an actuary, attorney, or employee benefits consultant to individually design a plan for the firm. As might be expected, the costs of setting up this type of plan are considerably higher than those for prototype plans. The key
advantage is that the firm is able to structure the plan in a way that is most advantageous to the firm and its employees (particularly key employees, such as the owner-operator).

On-going administration of pension plans involves two major types of activities: (1) administrative activities related to the plan as a whole, and (2) administrative activities related to plan participants. Small plan sponsors approach the administration of plans in several different ways, depending upon the particular expertise within the firm, type of plan that is administered and the size of the pension fund. Some small firms (primarily those with relatively straightforward defined contribution plans) conduct nearly all administrative tasks in-house. Other firms choose to delegate responsibility for plan administration and asset management to other firms that specialize in plan administration (e.g., an accounting or investment firm). Finally, some firms contract with an outside firm to do some of the more difficult aspects of plan administration, but retain an active role in other aspects of administration and investment.

Effects of Regulation on Plan Formation, Termination and Administration

Changes in the regulations governing pension plans during the past decade -- particularly during the past five years -- have had a significant effect upon formation, termination and on-going administration of pension plans in small firms. In-depth interviews with pension plan service providers, as well as the case studies with small firms, revealed the extent to which pension plan regulation has affected the actions of small plan sponsors, including the following:

- **Frequency and Complexity of Regulatory Changes Cited as the Most Important Problem.** The frequency of changes in the law and the complexity of those changes were cited by nearly all of those that were
interviewed -- both small employers and pension plan service providers -- as the "number one" problem with pension regulation. Small employers could simply not stay up with or understand the many changes that have occurred. They viewed these changes as not only increasing the burden and costs of plan administration, but also creating great uncertainty about what the plans will cost in the future.

- Rules Relating to Changes in Pension Regulation Are Not Issued in a Timely Fashion and Are Difficult to Understand. The frequency and complexity of the changes are further exacerbated by the fact that the issuance of specific rules by the IRS and other regulatory agencies governing the changes in pension laws is often untimely. In fact, in some cases the specific rules are not even published prior to the date that the change is to go into effect.

- Regulatory Changes Have Substantially Affected Formation and Termination of Defined Benefit Plans. There is little doubt that changes in regulation over the past decade -- particularly the Tax Reform Act of 1986 (TRA) and Omnibus Budget Reconciliation Act of 1987 (OBRA'87) -- have had a serious impact on the formation, termination and on-going expense of administering defined benefit plans. Those interviewed for this study provided a number of explanations -- all related to changes in regulations -- for the precipitous decline in defined benefit plans in small firms:
  - the stringency of OBRA’87 full funding limitations;
  - recent increases in the Pension Benefit Guaranty Corporation (PBGC) premium;
  - overall complexity and expense of administering plans; and
  - the need to make almost continual and costly revisions to plan documents.

- Changes in Statutory Requirements Have Significantly Reduced the Benefit of Pension Plans to Key Personnel. In recent years, Congress has introduced a series of statutory requirements that have been intended to curb abuses in plans and to limit the ability of key individuals to shelter income within plans. The combined effect of these changes -- while increasing the fairness of plans to workers -- has reduced some of the motivation for owners of small firms to establish plans. In particular, the following have been identified as having an effect upon plan formation and termination in small plans:
  - limitations on plan contributions and benefits (Section 415 Limits),
• Social Security integration rules,
• Top-heavy rules, and
• lower (overall) tax rates.

**Other Regulatory Concerns.** There were numerous other areas of regulatory concern cited by small firms and pension plan service providers, including:

• discrimination testing for 401(k) plans,
• Age Discrimination in Employment Act (ADEA) accruals, and
• IRS user fees for plan formation and amendments.

 Costs of Pension Plans to Small Businesses

In order to assess the relative fixed and variable costs of small and intermediate size employers, informal interviews of over 50 geographically-dispersed pension plan service providers throughout the U.S. were undertaken. Service providers were asked to assume that two different employers came to them wishing to establish a new pension plan. One employer was assumed to own a small business with 25 employees and the other an "intermediate" size business with 200 employees. The service providers were also asked to assume that each employer wishes to decide between establishing a relatively simple defined contribution plan (either a money purchase or profit sharing plan) or a relatively straightforward defined benefit plan. Service providers were then asked what the "full service" administrative costs would be for administering each of the plans exclusive of any revisions and compliance costs related to legislative or regulatory

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²The Small Business Administration defines a "small business" for research purposes as a firm with less than 500 employees. For purposes of this study, we have compared the costs of providing pension coverage for a "small" firm of 50 employees, with those of (what we have termed) an "intermediate" size firm of 200 employees.
changes. Finally, service providers were asked what the cost of revising each plan for each employer would be to bring it into compliance with the Tax Reform Act of 1986.

Table ES-2 provides a summary of the findings on the costs of plan formation, administration and plan revisions. As this table shows, the set-up costs for defined contribution plans increase from $2,018 on average per plan for a small plan to $4,278 on average for an intermediate size plan. In other words, average set-up costs for defined contribution plans only slightly more than double as the number of plan participants increases by 700 percent. This indicates a substantial per participant cost difference for small versus intermediate size employers. This is reflected in the fact that the per participant costs are $81 in the small plan versus $21 in the intermediate plan -- nearly a four-fold cost disadvantage per participant for small plans. It should be noted that these per participant cost disadvantages would be even more pronounced if we had examined businesses with plan participation significantly larger than 200.

When considering defined benefit plans, total set-up costs are 37 percent to 43 percent higher in comparison to similar sized defined contribution plans because of their complexity and the need for actuarial consultation. Set-up costs increase from $2,755 on average per plan for small defined benefit plans to $6,117 on average for an intermediate size defined benefit plan. This implies average costs of $110 per participant for small plans and $31 per participant for intermediate size plans -- a three and one-half fold per participant cost disadvantage.

Similar to set-up costs, per participant on-going annual administrative costs were considerably higher for small firms compared to intermediate size firms. As shown in Table ES-2, average annual administrative costs for defined contribution plans increase by 183 percent from $1,767 for small plans to $4,997 for intermediate plans; this is in
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<td>Cost Per Participant</td>
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**SOURCE:** Lewin/ICF interviews of pension plan service providers, December 1989.

contrast to a smaller 112 percent increase in costs for average plan set-up costs. The increase in administrative costs is greater in comparison to set-up costs because administrative charges are more closely linked to the number of plan participants. However, on a per participant basis, small plans are still faced with a significant per participant cost disadvantage of almost three times: the annual cost per participant is $71 for small plans and $25 for intermediate plans. In perspective, this $71 per participant charge for small plans represents about four percent of annual average total
employer and employee contributions for defined contribution pension plans in 1987.³

Average annual administrative costs per plan are 192 percent higher for intermediate size defined benefit plans, at $7,747 versus $2,651 for small plans. This translates into per participant costs of $106 for small plans and $39 for intermediate plans. For small defined benefit plans, this annual administrative cost represents 12 percent of average annual total employer and employee contributions for defined benefit pension plans in 1987.⁴

Small employers face significant additional per participant administrative costs in order to keep up and comply with the plethora of changing laws and regulations affecting private pension plans. For small employers, the additional administrative costs of complying with the Tax Reform Act of 1986 represent on average more than 50 percent of annual administrative charges and more than 50 percent of pension plan set-up costs for both defined contribution and defined benefit plans. For example, the additional costs of complying with TRA'86 for a small employer defined contribution plan were estimated to be $1060 (see Table ES-2), representing 53 percent of annual administrative charges and 60 percent of pension plan set-up costs. On a per participant basis, costs are about four and one-half times higher for the small employer ($42 per participant) versus the intermediate size employer ($9 per participant). The compliance costs for defined benefit plans, on a per participant basis, are also about four and one-half times higher.

³According to Department of Labor analysis of Form 5500 data, annual average total employer and employee contributions for defined contribution pension plans in 1987 was $1,683 per participant.

⁴According to Department of Labor analysis of Form 5500 data, annual average total employer and employee contributions for defined benefit pension plans in 1987 was $880 per participant or nearly half the level for defined contribution plans.
for the small employer ($59 per participant) versus the intermediate size employer ($13 per participant).

Implications and Conclusions

Small employers lag substantially behind large employers in offering pension benefits to their employees. If pension coverage in the United States is to expand, much of the growth must come through expanded coverage in small firms because most large firms already have plans. However, this study (and others before it) has pointed to a variety of barriers that small firms face in establishing and maintaining pension benefits for their employees.

The final chapter of this report focuses on two major questions: (1) Are there ways to reduce the burden and costs of administering pension plans in small firms? and (2) Would a reduction in administrative burden and cost lead to an increase in pension coverage in small businesses? A series of alternatives are presented. These alternatives are based upon our interviews with pension plan service providers, small businesses and other experts in the field of pension plan policy.

The alternatives are primarily intended to reduce the burden and/or costs of administering plans in small businesses. It is likely that some of these alternatives would also expand the level of coverage of pension benefits in small businesses. However, expansion of coverage does not come without costs. Many of the recent legislative and regulatory changes that Congress enacted were implemented to address perceived abuses and/or to reduce the federal budget deficit. Attempting to change these laws for the sake of increasing pension coverage must be done carefully, with political and economic tradeoffs fully considered.
1. **Reduce the Need to Constantly Modify Plans**

Many small businesses complain about the frequent shifts in regulations and the resulting need to make almost constant revisions to plans. For example, small plan sponsors often have a difficult time understanding the changes in regulations. In addition, modifying plans, particularly defined benefit plans, can be costly and time-consuming. There are several possible alternatives that would reduce the need to constantly modify plans:

- **Alternative #1: Slow the Pace of Regulatory Changes.** Several options emerged for slowing the change of regulations, including: (1) exempting existing plans from rule changes, (2) delaying the period of compliance to rule changes for existing plans, (3) establishing a "moratorium" of rule changes for a period of five years, and (4) allowing firms to revise plans to comply with new laws only once every five years.

- **Alternative #2: Mandate that the IRS and other Regulators Publish New Regulatory Requirements Prior to the Effective Date of New Laws.** The IRS should be required to issue final rules and regulations well before the effective date of the change in the law. The effective date of laws should be sufficiently deferred after the date of law passage so that IRS and other regulators have adequate time to write well-considered and easily understood regulations.

2. **Reduce the Cost of Plan Establishment and Administration**

Some of the reluctance of small businesses to form plans appears to be associated with the generally higher per participant costs of setting up and administering plans.

Alternatives for reducing administration costs to small firms include:

- **Alternative #3: Provide a Tax Credit toward Plan Administration.** A tax credit or a "negative income tax" for small employers would reduce administrative costs, thereby encouraging plan formation. A tax credit, for example, might enable plans with fewer than 100 participants to credit (against taxes) up to some specified amount (e.g., $1,000) per year of administrative costs.

- **Alternative #4: Reduce IRS User Fee Schedule.** The IRS user fee could be based on the number of plan participants. Another alternative would
be for the fee to be waived for plans with fewer than 100 employees.

- **Alternative #5: Reduce PBGC Premiums for Fully Funded Plans.** The premium for fully funded plans could be reduced or eliminated (to reflect the risk that fully funded plans have of terminating with an unfunded liability). In addition, employers could have the option of buying fully insured deferred annuities for these former employees and no longer having to pay PBGC premiums.

- **Alternative #6: Reduce Filing Requirements.** The administrative costs of filing reporting forms could be reduced if plans were required to file only once every five years. This change would be particularly appropriate if plans were required to update their plan provisions to meet regulatory changes once every five years as discussed above.

3. **Simplify Pension Plan Regulations and Increase Benefit of Offering Pension Benefits for Small Firms**

A frequent complaint from small businesses and pension plan service providers is that the pension plan laws and regulations are excessively complicated. In addition, many of the recent changes in regulations are costly to comply with and have reduced some of the incentives for owners to offer retirement benefit plans. Several alternatives for reducing the complexity or increasing the incentives for offering pension benefits include the following:

- **Alternative #7: Modify the OBRA'87 Full Funding Limitation.** There are several ways in which it would be possible to reduce the adverse impact of the full funding limitation: (1) the limit could be based on the interest rates used by the PBGC for plan terminations; (2) the added margins and lower interest assumptions needed by small plans could be recognized by using a 200 percent limit for small plans; (3) funding after a plan comes out of full funding could be simplified by letting the same rules be followed as for the old full funding limit; and (4) funding flexibility could be preserved by maintaining the old credit balance plus interest or by increasing the old credit balance by waived contributions and interest at the plan's funding rate.

- **Alternative #8: Simplify or Eliminate Top-Heavy Requirements for Small Plans.** Three changes could be made to simplify top heavy rules reducing the burden on top-heavy plans, but not changing the spirit of the law: (1) delete the top-heavy vesting schedule now that TRA'86 has essentially required all plans to have a schedule that is almost as demanding; (2) clear
up the administrative burden placed on career average defined benefit plans by permitting the use of the career average definition of compensation for top-heavy accruals in career average plans; and (3) reduce the excessive impact of top-heavy rules on modest plans where the increase from the plan formula to top-heavy accruals is far greater than a plan that may already accrue at a rate of 2 percent of pay per year (the top-heavy minimum). Other changes could be made to lessen the severity of the top-heavy definition.

- Alternative #9: Modify Section 415 Limits on Plan Contributions and Benefits. To reduce the stringency of the Section 415 limits, consideration could be given to reverting back to prior law, under which the dollar limit reduction began for retirement prior to age 65. In addition, the compensation considered for benefit calculations could be increased from its current limit of $200,000.

- Alternative #10: Modify Social Security Integration Rules. One option would be to eliminate the 35-year limit on the three-quarter percent integrated portion of benefits in defined benefit plans, as specified in Section 401(l)(4) of the Internal Revenue Code. The regulations on the reduction of excess benefits for early retirement could also be simplified.

- Alternative #11: Modify OBRA'86 Age Discrimination in Employment Act (ADEA) Accruals. Employers could be permitted to either actuarially increase benefits or add five percent of compensation to the lump sum value of benefits. The benefit purchased by the five percent of pay could be added to the previously accrued benefit. The amount purchased by the five percent of pay could be calculated based on PBGC equivalence assumptions.

4. Increase Knowledge of Small Businesses About Pension Plans and Expand the Availability of Simplified Plan Options

Many small businesses are unaware of the many choices that are available at a relatively low cost. Hence, there is a need for added emphasis on disseminating information to small firms about the many choices that are available in establishing plans. Because of the constant formation of new small businesses, it is important that information about pension plan alternatives be regularly disseminated to the small business community. In addition, there is still much more that could be done to enhance and simplify the types of plans that are available to small firms. There are several
alternatives for increasing knowledge of small businesses and enhancing the pension plan offerings available to small firms:

- **Alternative #12: Conduct Joint Department of Labor/Small Business Administration (DOL/SBA) Outreach to Inform Small Employers About Pension Plan Alternatives.** DOL and SBA could expand their efforts in providing information to small businesses about various options. This information could be provided directly to small employers and/or through pension plan service providers. Recent publications by DOL (e.g., "What You Should Know About the Pension Law") and SBA (e.g., "Simplified Employee Pensions: What Small Businesses Need to Know") are examples of the type of outreach that is needed.

- **Alternative #13: Increase Flexibility and Encourage Use of Simplified Employee Pensions (SEPs).** The utility of SEPs to small businesses could be enhanced by: (1) removing some of the restrictions on such plans; (2) further streamlining reporting and disclosure requirements; or (3) requiring businesses that do not have pensions to establish SEPs at the request of the employee.

- **Alternative #14: Establish a Voluntary Federal Retirement Plan for Smaller Firms.** The federal government could create a voluntary national retirement plan for small businesses that do not elect to set up a plan on their own. Such a plan might operate much like Social Security currently does, with the employer making additional deductions from those employees that choose to join the plan.

Given the variety of factors that go into the decision of whether to offer pension benefits, it is not certain that any of the alternatives discussed above would substantially change the level of coverage in small businesses. However, given the slow growth in plan formations in recent years and the acceleration in the rate of plan terminations, it is unlikely that in the absence of some change in pension plan regulations that there will be a major increase in the level of pension plan coverage in small firms.
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Finally, this report could not have been completed without the assistance of businesses and the pension plan services providers, who provided us with valuable information and insightful comments on the ways in which regulations have affected pension plans in recent years.
Chapter 1
Introduction

A. Background

In its final report in 1981, the President's Commission on Pension Policy recommended that all employers be required to establish retirement plans for their employees because, under current policies, pension coverage was unlikely to increase significantly. The major reason they thought coverage was unlikely to expand was the "lack of pension offering in small businesses."¹

The substantially lower levels of coverage in small businesses have been documented by the Small Business Administration (SBA) and in many other studies. For example, in the State of Small Business: A Report of the President (March 1984), the SBA reported that:

...Employer or union pension plan coverage increases steadily with the size of firm. Pension coverage ranges from about 20 percent of workers in the smallest firms to over 88 percent of wage and salary workers in large firms with more than 500 employees.²

A 1984 study by James Bell Associates, Inc. and ICF Incorporated for the Small Business Administration³ identified four key reasons for lower provision of retirement benefits in


small firms: (1) lack of sustained profitability; (2) start-up costs; (3) complexity of plans and the need for costly expert advice; and (4) constantly changing regulations that create uncertainty about future costs and benefits of retirement plans.

Underlying many of these reasons is the higher per capita administrative costs faced by small businesses in establishing and maintaining plans. These relatively higher administrative costs have been documented in several empirical studies. For example, Emily Andrews and Olivia Mitchell found that administrative expenses per participant in small pension plans were seven times larger than for large plans. Holding other factors such as asset size constant, they reported that administrative expenses per participant declined from $138 for plans with only 1000 participants to $13 for plans with 20,000 members. In a study of multiemployer plans conducted for the International Foundation of Employee Benefit Plans, Cooper reported operating costs in 1983 to be $56 per participant for plans averaging 12,000 members and $170 per participant for plans averaging 375 participants. In addition, Cooper found that administrative costs for smaller plans had escalated more rapidly than those for larger plans -- between 1978 and 1983, operating costs of large plans increased by 118 percent compared to 143 percent for small plans. In a study of large pension plans, ranging from 1,000 to 650,000 employees, Pope identified significant economies of scale as plan size increased. For

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example, he reported that average administrative costs (in 1980) for a plan with 2,500 participants ranged from $50 to $63 per participant, compared to costs of between $26 and $32 per participant for plans with 25,000 participants and between $12 and $16 for plans with 300,000 participants.

Many of these cost differences stem not only from the true costs of administering small retirement plans, but also from the additional fixed-cost burden imposed by government regulation. For example, a study conducted for the Department of Labor found that as a result of The Employee Retirement Income Security Act of 1974 (ERISA), the average administrative costs for small plans (less than 100 participants) increased by 72 percent. Added costs are only part of the story because small businessmen in many instances also do not have the expertise or the time necessary to complete all of the government forms accurately, whatever the cost to do so.

ICF Incorporated, in a study for the Department of Labor, showed that not only was the percentage increase in administrative costs of ERISA for small firms greater, but the added costs of complying with ERISA's participation, vesting, joint and survivor, and benefit accrual provisions were also relatively higher for small plans.

The impact of regulatory costs on the decision not to offer pension and health plans by small businesses has also been studied. A Department of Labor study prepared


by Abt Associates, Inc., evaluated the effects of ERISA on the decision to form a new pension plan and found that ERISA was significant in the plan establishment decision.\textsuperscript{10} A later Battelle study found that regulatory costs were an important factor in not offering plans.\textsuperscript{11}

Since the passage of ERISA in 1974, there has been a series of legislative initiatives that have substantially changed the regulatory requirements for retirement plans, including: (1) Multiemployer Pension Plan Amendments Act of 1980 (MEPPAA), (2) Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), (3) Deficit Reduction Act (DEFRA), (4) Retirement Equity Act of 1984 (REA), (5) Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA), (6) Tax Reform Act of 1986 (TRA), and (7) Omnibus Budget Reconciliation Acts (OBRA) of 1986, 1987, and 1989.\textsuperscript{12} The effects of these recent changes in regulatory requirements on plan formation, termination, administration and costs in small businesses have yet to be assessed.

B. Purpose of the Study

The purpose of this study is to examine the administrative burden and costs of retirement plan regulation on plans sponsored by small and large businesses. Key evaluation questions and issues that this study addresses include the following:


\textsuperscript{11} Battelle Human Affairs Research Centers, "Study to Develop Methods of Encouraging the Growth and Maintenance of Employee Benefit Plans among Firms with No Such Plans," June, 1980.

\textsuperscript{12} The provisions of these legislative initiatives and their effects on small businesses are discussed in detail in Chapter 2.
• How do plan administrative costs as a percentage of total pension contributions and per employee compare between small and large firms? What factors are most responsible for high administrative costs in small plans?

• What are the administrative costs of complying with various regulatory requirements for small businesses?

• How have regulatory requirements affected the rate of formation of new plans and rate of termination of existing plans in small businesses (compared to large businesses)?

• What regulatory requirements and provisions have small businesses found to be most burdensome and most beneficial?

• What regulatory actions or policy changes could be implemented to (1) ease regulatory burdens, (2) reduce complexity and costs of administering plans, and (3) expand retirement plan coverage for small businesses?

This study is intended to provide the SBA, other policy-makers, small business organizations and small businesses with detailed analyses of how employee benefits offered by small businesses have been affected by legislative and regulatory changes. Further, it provides analyses of the ways administrative burden and costs have been affected by frequent and complex regulatory changes. Based on these analyses, this study provides recommendations to assist the SBA in formulating policies to help reduce the burden and cost of administering pension plans for small businesses.

C. Study Methodology

In developing the research and analysis plan, we determined the research questions could be answered most effectively by combining (1) analysis of existing aggregate data with (2) in-person and telephone interviews with pension plan service providers and (3) case studies of a select group of small and large businesses. This approach is intended to produce both (1) results that are statistically generalizable to all
employers (from the secondary data analyses) and (2) an in-depth understanding gained from detailed discussions with pension plan service providers and case study examination of individual employers.

We have collected data on the actual cost of plan formation and on-going administration from over 50 pension plan service providers. These data provide estimates of administrative costs as a percentage of total pension contributions and average cost per employee. At the same time, we collected information about what service providers felt were the most burdensome and costly aspects of plan administration and pension plan regulations. We also conducted case studies of eleven small and two large businesses which were intended to provide the practical experience and detail necessary to conduct in-depth analyses of major aspects of administering plans. These interviews, which were typically with the owner-operator and/or benefits administrator of the firm, also provided detail on the ways in which plans have been (and will be) affected by changes in pension plan regulations.

D. Organization of the Report

The remainder of this report is divided into five chapters. Chapter 2 reviews the many recent changes that have been made in the laws governing retirement benefits beginning with the passage of the ERISA in 1974. In addition to discussing key aspects of each legislative initiative, this chapter also assesses the impact of each major change on small businesses.

Chapter 3 examines the formation, termination and on-going administration of pension plans in small businesses. It begins with a statistical analysis of plan formation and termination between 1976-89. This is followed by a discussion of reasons that small
firms establish plans and the steps that small firms typically go through to set up plans. The chapter concludes with a discussion of on-going administration of plans.

Chapter 4 assesses the effects of recent changes in the regulations on formation, termination and on-going administration of pension plans in small firms. In-depth interviews with pension plan service providers, as well as the case studies with small firms, are used to identify aspects of current regulations that are most troublesome for small employers.

Chapter 5 examines the costs of establishing and administering pension plans in small businesses compared to large businesses. Based on interviews with over 50 pension plan service providers, this chapter provides data on the costs of establishing and on-going administration of defined benefit and defined contribution plans. This chapter particularly focuses on the disparities in per participant costs of plan formation and administration faced by small firms.

The final chapter provides recommendations on how current pension plan laws and regulations might be changed to encourage plan formation in small firms and reduce the burden and costs of plan administration.
Chapter 2
Regulations Affecting Pension Plans
in Small Businesses

This chapter discusses the many changes that have been made in pension plan regulation beginning with the passage of the Employee Retirement Income Security Act of 1974. It examines the specific aspects of each of the major legislative initiatives and identifies areas which are most likely to have a disproportionate effect upon small businesses. Table 2-1 summarizes major changes enacted by each legislative initiative.

A. Overview of Major Legislative Initiatives Affecting Pensions

1. The Employee Retirement Income Security Act of 1974 (ERISA)

This landmark legislation substantially reformed the laws governing private pensions in the United States. The Conference Report on ERISA indicates "It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal court ... It is hereby further declared to be the policy of this Act to protect interstate commerce, the Federal taxing power, ..."

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13A major reference for this chapter was Emily Andrews, Pension Policy in Small Employers: At What Price Coverage?, Employee Benefits Research Institute, 1989.

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<th>Year Enacted</th>
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| 1974       | Employee Retirement Income Security Act (ERISA) | • vesting standards, stronger reporting and disclosure requirements, and participation standards  
<p>|            |                                                 | • stricter fiduciary requirements                                               |
|            |                                                 | • established the Pension Benefit Guaranty Corporation (PBGC)                  |
|            |                                                 | • raised Keogh contribution limits                                            |
|            |                                                 | • established individual retirement accounts (IRAs) for those not participating in an employer-sponsored plan |
| 1978       | Revenue Act                                     | • established simplified employee pensions (SEPs with tax-exempt contributions) |
|            |                                                 | • established cash or deferred arrangements (401(k) plans)                    |
| 1980       | Multiemployer Pension Plan Amendments Act (MEPPAA)| • increased multiemployer plan premiums                                       |
|            |                                                 | • required faster funding                                                    |
|            |                                                 | • imposed liability on employers leaving the plan                            |
| 1981       | Economic Recovery Tax Act (ERTA)                | • established universal IRAs for all workers                                 |
|            |                                                 | • increased Keogh contribution limits and increased SEP compensation limits    |
|            |                                                 | • placed a 10 percent tax on early withdrawals                               |
| 1982       | Tax Equity and Fiscal Responsibility Act (TEFRA)  | • made compensation and benefit limits the same among all pension plans (increased self-employed limits to equal those of corporations) |
|            |                                                 | • tightened ability to integrate defined contribution plans with Social Security |
|            |                                                 | • placed a penalty on early distributions to key employees                   |
|            |                                                 | • introduced top-heavy rules                                                 |
| 1984       | Deficit Reduction Act (DEFRA)                   | • reduced limits on maximum plan contributions and benefits in real dollar terms |
|            |                                                 | • placed a penalty on early distributions to 5 percent owners                |
|            |                                                 | • changed 401(k) rules and top-heavy rules                                   |
| 1984       | Retirement Equity Act (REA)                    | • reduced age of plan participation and vesting and extended definition of break-in service |
|            |                                                 | • required written spousal consent to choose to stop pension benefits upon death of participant |
|            |                                                 | • provided benefits to surviving spouses of worker who dies before retirement age |
|            |                                                 | • provided that private pensions could be divided in divorce                 |</p>
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<th>Year Enacted</th>
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| 1986       | Single Employer Pension Plan Amendments Act (SEPPAA) | • limited terminations to those who could cover commitments and those in distress  
|            |                                                 | • raised PBGC single-employer premium                                        |
| 1986       | Tax Reform Act (TRA)                             | • reduced vesting requirements, established minimum coverage and participation rules  
|            |                                                 | • imposed 10 percent penalty on all pre-retirement distributions and 15 percent excise tax on pension distributions above a certain level  
|            |                                                 | • reduced averaging period for calculating taxes on lump-sum distributions  
|            |                                                 | • capped 401(k) pre-tax contributions and compensation used in contribution or benefit calculations, and changed contribution limits for profit sharing plans  
|            |                                                 | • 415 limits maximum benefits  
|            |                                                 | • restricted IRA eligibility  
|            |                                                 | • changed rules on Social Security integration  
|            |                                                 | • new definition for highly compensated employees for non-discrimination rules  
|            |                                                 | • permitted some SEPs to act like 401(k) plans with elective pre-tax contributions  
| 1986       | Omnibus Budget Reconciliation Act (OBRA '86)     | • contributions and accruals continue regardless of age  
| 1987       | Omnibus Budget Reconciliation Act (OBRA '87)     | • increased single-employer premiums and added a variable portion dependent on plan's funded status  
|            |                                                 | • required defined benefit plans to make quarterly contributions  
|            |                                                 | • required faster funding of past service liabilities  
|            |                                                 | • made plan contributions over 150 percent of termination liability no longer tax deductible  


and the interests of participants in private pension plans and their beneficiaries by improving the equitable character and soundness of such plans by requiring them to vest the accrued benefits of employees with significant periods of service, to meet minimum standards of funding and by requiring plan termination insurance."
While preserving the tax-deferred nature of pensions, ERISA provided a basic structure within which retirement plans were required to operate. ERISA generally specified that employees could not be excluded from a pension plan unless they worked fewer than 1000 hours annually or were under 25 years of age. Vesting standards were established, with several different standards allowed. The predominant was 10-year cliff vesting, under which a plan participant was entitled to benefits only after 10 years of participation in the plan.

ERISA specified fiduciary and funding requirements. This legislation created the Pension Benefit Guaranty Corporation (PBGC) to insure retirement benefits under defined benefit plans. If a defined benefit plan terminated with insufficient funds to cover benefit liabilities, the PBGC had claim on 30 percent of company's net worth. The PBGC was insured through premiums paid on a per participant basis by sponsors of defined benefit plans. Initial premiums were set at $0.50 per year per plan participant.

ERISA also strengthened reporting and disclosure requirements for plans. Firms sponsoring pension plans were required to file annual reports to the federal government (e.g., Form 5500), as well as provide information to plan participants on an on-going basis. Finally, ERISA permitted workers who were not included in employer-sponsored plans to establish individual retirement accounts (IRAs).

2. Revenue Act of 1978

The Revenue Act of 1978 established simplified employee pensions (SEPs) with tax-exempt contributions and established cash or deferred arrangements through the addition of Section 401(k) to the Internal Revenue Code. Similar to IRAs, SEPs provide individual accounts for employees. However, contribution limits are higher (currently
$30,000) than for IRAs and contributions are generally provided by the employer. Employer contributions are not subject to Social Security, unemployment insurance, or income tax withholding. At the time this legislation was enacted, SEPs were viewed as a low-cost method for small employers to establish retirement benefits for employees.

For taxable years beginning in 1987, the Tax Reform Act of 1986 permits employees to elect to have SEP contributions made on their behalf or to receive the contributions in cash. Employees will also be able to contribute part of their salaries to the SEP under terms generally similar to a salary reduction plan. Effective January 1, 1990, elective deferrals under a SEP are limited to $7,979. This limit, which is adjusted annually for inflation, is the maximum amount an employee can elect to defer for any taxable year under all cash or deferred arrangements.

The Revenue Act of 1978 also sanctioned cash or deferred arrangements through the addition of Section 401(k) to the Internal Revenue Code. Plans established under this Section of the Code are generally referred to as 401(k) plans. Such plans allow for employees to make contributions, which are often matched (according to a pre-specified formula) by the employers. While such plans have been very popular with large employers, according to Employee Benefits Research Institute (EBRI) just five percent of small employer plans had established 401(k) plans by 1985. While such plans can be advantageous for small employers because they share plan cost with their employees, relatively high administrative costs and special nondiscrimination laws appear to discourage the use of such plans in small firms.\textsuperscript{15}

\textsuperscript{15}Andrews, p.114.

In passing MEPPAA, Congress intended to "amend the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1954 to improve retirement income security under private multiemployer pension plans by strengthening the funding requirements for those plans, to authorize plan preservation measures for financially troubled multiemployer pension plans, and to revise the manner in which the pension plan termination insurance provisions apply to multiemployer plans..."\(^{16}\) This legislation was designed to address the under funding of multiemployer pension plans.\(^ {17}\) MEPPAA increased per participant premiums used to finance the PBGC multiemployer trust fund and also required faster funding of unfunded liabilities in multiemployer plans. MEPPAA also required employers who withdrew from multiemployer plans to continue funding the benefits of workers they had hired in the past. This was a liability that many employers never realized they had and one that could be financially disruptive to small employers.\(^ {18}\)


In order to stimulate the economy and encourage savings (and therefore investment), Congress enacted ERTA. This Act was the largest tax cut bill ever enacted


\(^{17}\)A multiemployer benefit or pension plan covers the workers of two or more unrelated firms usually engaged in the same type of employment. These plans are often negotiated by unions and are prevalent in small businesses that employ union workers and are too small to justify individual plans.

\(^{18}\)Andrews, p. 115.
ERTA initiated universal Individual Retirement Accounts (IRAs) for workers. It also raised the limits on IRAs from $1,500 to $2,000 per worker. To encourage savings for retirement, the top limit for a one wage-earner couple was set at $2,250. ERTA also introduced other changes that were intended to encourage small employers to establish pension plans regardless of the legal structure of their business.\textsuperscript{19} Keogh contributions and benefit limits were increased and the dollar limit on contributions to SEPs was raised from $7,500 to $15,000 per participant. The maximum cash compensation used for calculating SEP contributions was raised from $100,000 to $200,000.


In contrast to ERTA, TEFRA was the largest revenue raising bill ever enacted by Congress. It is not surprising that TEFRA introduced a number of important changes which were primarily intended to limit the benefits that highly compensated owners and managers received under pension plans. It also gave equal treatment to self-employed businesses and corporations by making contribution and benefit limits the same for all pension plans.\textsuperscript{20}

First, TEFRA imposed lower annual limits than ERISA had established on the dollar amount that could be contributed to tax-qualified retirement plans or accrued as a plan benefits. Contribution limits for defined contribution plans were reduced from the lesser of 25 percent of compensation or $45,475, to the lesser of 25 percent of

\textsuperscript{19}Andrews, p. 115.  
\textsuperscript{20}Andrews, p. 115.
compensation or $30,000. Maximum annual pensions from tax qualified defined benefit plans were lowered from the lesser of 100 percent of cash compensation or $136,425 a year, to the lesser of 100 percent of cash compensation or $90,000 a year.

Second, this legislation reduced the ability of defined contribution plans to integrate benefits\(^{21}\) with Social Security. Prior to TEFRA, the difference between the percentage contribution applied to earnings above and below the Social Security wage limit (i.e., $32,400 in 1982) could be up to 7 percentage points under a defined contribution plan. With TEFRA, the maximum contribution differential was reduced to 5.4 percentage points.\(^{22}\)

Third, and perhaps most important for small employers, TEFRA introduced "top-heavy" rules. Under these rules, plans have to apply special standards if more than 60 percent of accumulated benefits are earmarked for key employees. For defined benefit plans, the calculation is made according to the present value of accrued benefits; for defined contribution plans, the calculation is based on account balances. Key employees are defined for the current year and over a four-year "look-back" period as: officers (revised in 1984 to exclude those earning less than 1.5 times the dollar limit on contribution in defined contribution plans -- currently $30,000); the 10 employees with the largest ownership share in the company (having at least a one-half of one-percent

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\(^{21}\)ERISA permits private pension plans to have benefit formulas which provide for the "integration" of pension benefits with Social Security benefits. In other words, the amount of a private pension benefit may be affected by the amount of Social Security to which the beneficiary will be entitled. Generally, in integrated plans, the monthly pension benefit is determined. Then, a percentage of the expected monthly Social Security benefit is subtracted from the pension amount. The amount remaining is the actual monthly pension benefit. See page 66 for more detail on "integration" of benefits.

\(^{22}\)The maximum contribution differential rose to 5.7 percent after 1983. These amounts were the employer-provided portion of Social Security benefits.
ownership interest and earning more than $30,000 a year); those with more than a five
percent interest in the company; or those with more than a one percent ownership
interest in the firm who receive cash compensation in excess of $150,000.

Top-heavy plans are required to comply with the following special standards:\textsuperscript{23}:

- **Vesting Requirements:** Each year a plan is top-heavy, it must meet one of
two special vesting schedules. One alternative is three-year, 100 percent
vesting. The other is six-year graded vesting, under which top-heavy
participants must vest at least 20 percent of the accrued benefit by the end
of the second year of service, and 20 percent each succeeding year, with
full vesting at the end of six years.

- **Minimum Benefits/Contributions:** Top-heavy plans must provide minimum
benefits (expressed as straight-line annuities at age 65) or contributions
that are not integrated with Social Security to plan participants that are not
key employees. The minimum benefit for those who are not key
employees in defined benefit plans is 2 percent of average annual cash
compensation for the five years of consecutive service with the highest
compensation, not to exceed 20 percent of average annual cash
compensation. The minimum contribution for those who are not key
employees in defined contribution plans is the lesser of 3 percent of cash
compensation or the highest contribution rate for a key employee.

- **Considered Compensation:** Only the first $200,000 of compensation can be
taken into account in determining benefits for a top-heavy plan. This
figure is adjusted annually for inflation (beginning in 1986).\textsuperscript{24}

- **Non-integrated Benefits/Contributions:** Top-heavy plans cannot count
Social Security benefits or the OASDI portion of FICA taxes paid on
behalf of employees against the minimum benefits/contributions they must
provide.

- **Aggregate Limit on Multiple Plans:** Employers maintaining top-heavy
defined benefit and defined contribution plans have to make special
adjustments to the Sec. 415(3) aggregate limit. No "extra" benefits under
the "125 percent" rule can be paid unless (1) both minimum benefits and
contributions on behalf of non-key employees are increased another
percentage point, and (2) no more than 90 percent of the aggregate

\textsuperscript{23}Prentice-Hall, Inc., Handbook on the Tax Equity and Fiscal Responsibility Act of 1982:

\textsuperscript{24}However, Congress froze the adjustment for inflation before it went into effect.
benefits and account balances are provided to key employees.

It has been argued that small plans are more likely than large plans to be top-heavy because the ratio of shareholders to employees is likely to be higher. For example, in small firms five percent owners, who are just members of the management team, are likely to be a higher proportion of total employees. In addition, small firms may also fail the top-heavy requirement if their employees have shorter average job tenure and lower average wages than those of large employers. 25

6. Deficit Reduction Act of 1984 (DEFRA)

DEFRA delayed TEFRA inflation adjustments until 1988. 26 This legislation also placed a penalty on early distributions to key employees, made changes to 401(k) rules and some technical changes to the top-heavy rules introduced by TEFRA.

7. Retirement Equity Act of 1984 (REA)

With the passage of REA, Congress intended to "amend the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1954 to improve the delivery of retirement benefits and provide for greater equity under private pension plans for workers and their spouses and dependents by taking into account

25 Andrews, p. 117

26 TEFRA froze the former inflation adjustments on annual plan contribution limits as part of an overall attack on "excessive tax sheltered accumulations." TEFRA capped the defined contribution limit at $30,000 and the defined benefit annual benefit payout limit at $90,000 until January 1, 1986. Then, adjustments would have taken into account post-1984 inflation. Further, COLAs would have been geared to the Social Security benefit amount then in effect. The overall effect was to reduce plan accumulations by making retirement benefits "inflation protected" rather than "inflation proof." To do away with indexed benefits completely would have put to great a burden on the already stressed Social Security system.
changes in work patterns, the status of marriage as an economic partnership, and the substantial contribution to that partnership of spouses who work both in and outside the home...\textsuperscript{27}

This Act was intended to provide greater pension equity for women and for all workers, their spouses and dependents by taking into account changes in work patterns and in the status of marriage as an economic partnership.\textsuperscript{28} Specifically, the Act was designed to reflect that women were a larger share of the labor force and that due to maternity, among other factors, many women took leaves of absence from their jobs. This Act amended ERISA to reduce from 25 years to 21 years of age the maximum age a plan generally can require an employee to attain as a condition for becoming a plan participant. It also reduced the minimum age at which vesting service begins to apply from 22 years to 18 years of age. REA extended the definition of a break-in-service from one to five years. As a result, a worker could now leave his or her job for up to a five-year period (more in some cases) and still receive credit for participation and vesting purposes when he or she returned to work after the break-in-service. This added a substantial administrative burden relating to the need for employers to keep track of former employees.

This legislation also required written spousal consent to choose a more generous pension form that might stop pension benefits upon the death of the participant. The legislation also amplified the provisions for providing benefits to surviving spouses of


\textsuperscript{28}Commercial Clearing House, Inc., \textit{Retirement Equity Act of 1984: Law and Explanation}.
workers who die before retirement age. Hence, unless both spouses waive the pre-retirement survivor option, benefits are provided to a vested worker's surviving spouse whether or not the participant was retired or was eligible for retirement at the time of death. REA also specified that in the case of certain domestic relations orders (including divorce settlements and legal separations), private pensions could be divided upon divorce. Other changes introduced by REA involved maternity leave, exceptions to ERISA's spend-thrift provisions, cash-out of accrued benefits, notices of forfeiture and rollover possibilities, and reduction in accrued benefits. Overall, this Act imposed an additional paperwork burden on all plan sponsors -- requiring them to issue new forms (e.g., waiver of retirement survivor option) and track participants over a longer period (i.e., five years).


Through the passage of SEPPAA, Congress recognized that "Single-employee defined benefit pension plans directly affect the retirement income security of millions of workers. A sound termination insurance program is essential to that security. The Committee is mindful of the original purposes of Title IV, and ERISA in general, to encourage the establishment and maintenance of defined benefit plans while providing for the security of promised pension benefits. The Committee believes, after intensive study, that continued achievement of these goals requires structural reform to the single-employer termination insurance program."29

SEPPAA made substantial changes in the PBGC rules governing plan terminations, insurance premiums, procedures, employer liability for unfunded benefits, enforcement and related provisions. According to the Act, Congress found that these changes were necessary because the PBGC's termination insurance system, in some instances, allowed employers to terminate pension plans and thus evade their obligations to fund plan benefits by shifting unfunded pension liabilities onto the PBGC's termination insurance system and other premium payers.

This concern was heightened due to the PBGC's increased estimates of its unfunded liabilities and because of several highly publicized incidents, of perceived abuses, particularly by the LTV Corporation. In the case of LTV, the firm declared bankruptcy and terminated its unfunded pension plan, thus transferring the unfunded liability to PBGC. The company then reestablished a pension plan almost identical to the previous plan. In effect, LTV transferred some of its on-going operating expenses to the PBGC, at little or no cost to the company or its workers.

By modifying the current termination insurance system, the Act was intended to increase the likelihood that participants would receive their full benefit, limit claims against the termination insurance program to cases of severe hardship, maintain PBGC premiums at a reasonable level, and assure that the program is prudently financed.30

Specifically, this Act raised the PBGC premium for single-employer plans from $2.60 to $8.50 per plan participant per year, effective January 1986. In addition, SEPPAA fundamentally changed the way in which employers could terminate plans. Prior to this Act, an employer could terminate a plan at will, regardless of the financial

condition of the firm or the plan. With the passage of SEPPAA, only two types of voluntary terminations were recognized:31

- **A Standard Termination**: Plans could terminate voluntarily through a standard termination if their assets could meet their benefit commitments.

- **A Distressed Termination**: Other plan terminations would be permitted only as distress terminations contingent upon a determination from the PBGC. Distressed terminations required the plan administrator to show, using specific criteria, that the firm was financially unable to continue the plan.

In a distressed termination (or a PBGC-instituted termination), a plan sponsor was made liable to the PBGC for the sum of: (1) the total amount of all unfunded guaranteed benefits up to 30 percent of net worth and (2) an amount equal to the excess (if any) of (a) 75 percent of the total amount of all unfunded benefits minus (b) the 30 percent of net worth figure. The Act also imposed new employer liability for benefit commitments in excess of PBGC guarantees payable to plan participants through use of a special trust established by the PBGC.


In 1986, Congress introduced sweeping reforms to the tax laws, which at the same time lowered tax rates and broadened the base of taxation. Virtually every IRS Code section was affected. This landmark legislation also included key changes in the laws governing private pensions (and employee benefits in general). Changes that significantly affected private pensions included the following:

- **Vesting Rules**: Vesting rules were changed so that qualified plans must vest at least as rapidly as under one of two vesting schedules:

31Plans could also be involuntarily terminated by the PBGC.
Five-year cliff vesting, under which a plan must have 100 percent vesting upon completion of five years of service by the plan participant; or

Graded vesting, under which a plan must have 20 percent vesting after the completion of three years of service with an additional 20 percent each subsequent year and full vesting after seven years of participation.

**Taxation on Early Distributions:** Beginning in 1986, a 10 percent additional income tax was applied to distributions from any qualified retirement plan made prior to death, disability, or age 59 1/2. However, distributions rolled over into an IRA escaped current taxation, including the 10 percent penalty.

**IRA Contributions:** Participants in employer pension plans, whose adjusted gross income was $25,000 ($40,000 for married couples filing jointly) were no longer eligible to make contributions to an IRA on a pre-tax basis.

**Maximum Compensation:** The amount of cash compensation that could be included in pension benefit or contribution calculations was limited to $200,000, the same as top-heavy plans and SEPs.

**Maximum Early Retirement Benefits:** Maximum early retirement benefits were actuarially reduced, in line with maximum benefit amounts for normal retirement. A 15 percent excise tax was placed on all pension distributions above a certain level.

**Maximum Defined Contribution Plan Contributions:** The maximum defined contribution plan contributions were capped at $30,000, with no further adjustment for inflation until the maximum allowable defined benefit plan limit reaches $120,000 through inflation indexing.

**Taxation of Retirement Distributions:** The ten-year period over which lump-sum distributions could be allocated for tax calculation purposes was reduced to five years for most participants.

**Social Security Integration:** TRA revised the way in which benefits could be integrated under Social Security. Employers no longer could take full credit for the amount they had contributed to Social Security. A new concept was added to Social Security integration -- "permitted disparity." The amount of benefit provided on income over the amount covered by Social Security could be no larger than twice the amount provided below the level.

**Minimum Coverage Rules:** New coverage rule requirements were introduced which required that qualified plans meet one of three tests: (1)
at least 70 percent of all non-highly compensated employees are to be covered by the plan; (2) the coverage percentage for non-highly compensated employees is at least 70 percent of the coverage percentage for highly compensated employees; or (3) the plan benefits qualifying employees in a nondiscriminatory classification and the average benefit provided non-highly compensated employees is at least 70 percent of the average benefit to highly compensated employees, based on percentages of compensation.

- **Highly-Compensated Employees**: TRA applied a slightly different definition for highly-compensated employees than top-heavy rules. Under TRA an employee is treated as highly-compensated in a year, if, at any time during the year or preceding year, the employee (1) was a five percent owner; (2) earned over $75,000 in compensation; (3) earned over $50,000 in compensation and was a member of the top-paid employee group (the top 20 percent by pay in the same year); or (4) was an officer that received in compensation over 150 percent of the defined contribution plan annual addition dollar limit. As a result of TRA, employers must test their plans for nondiscrimination according to two different definitions -- one under TRA and one under the top-heavy rules.

- **Contributions to Profit Sharing Plans**: Under TRA, profit sharing plans could no longer apply the unused part of their prior-year contribution limits to exceed their contribution limit in another year. As a result, low contributions in past unprofitable years could no longer be balanced against large contributions in profitable years once the annual contribution limit had been reached. This annual contribution limit was 15 percent of aggregate cash compensation of plan participants. However, under TRA, plan contributions could be greater than the employer's current or accumulated profits.

- **Elective Pre-Tax Contributions to SEPs**: TRA allowed some SEPs to act like 401(k) plans, with elective pre-tax employee contributions up to a $7,979 contribution cap.

The provisions of TRA had substantial impacts upon both small and large businesses. As a result, all plans had to be amended. The costs of such amendments were substantial for many small plan sponsors, particularly for those with defined benefit plans. According to Andrews and others, certain provisions of TRA were particularly likely to impact small businesses. For example, with profit sharing plans accounting for nearly a third of all small plans, the inability of profit sharing plans to balance
contributions in profitable and unprofitable years was likely to have a disproportionate effect on small plans. Various other TRA provisions tightened the ability of firms to discriminate in their plans toward upper-income employees and owner-operators of firms. Such provisions -- such as those limiting maximum contribution to plans and discrimination testing -- could affect decisions to form and/or terminate plans in small firms.

10. Omnibus Reconciliation Act of 1986 (OBRA’86)

This legislation stipulated that benefit contributions or accruals were to continue regardless of the age of workers participating in defined contribution or defined benefit plans. Regulations issued by the IRS make the law retroactive for current workers in defined benefit plans who passed their plan’s normal retirement age before 1988; retroactive allocations were not required for defined contribution plans.

11. Omnibus Reconciliation Act of 1987 (OBRA’87)

OBRA’87 included a significant number of pension and employee benefit provisions that were aimed chiefly at improving the financial status of the PBGC. The changes introduced by this legislation substantially affected defined benefit plans -- particularly those with unfunded liabilities. The PBGC premium was increased from $8.50 to $16.00 per participant beginning in 1988. An additional premium of $6 per $1,000 of unfunded vested liability could also be added to the basic premium for underfunded plans. However, the maximum premium that could be charged per participant was capped at $50.

This Act also imposed tighter funding requirements. Employers with underfunded
pension plans were required to increase their funding and make quarterly installments of
estimated plan contributions. The period for amortizing experience gains or losses was
reduced from 15 to five years. To ensure that excessive contributions were not made,
the "full funding limitation" was capped at 150 percent of current liabilities.
Contributions in excess of 150 percent were no longer a tax-deductible expense.
Employers seeking funding waivers were required to establish that the financial hardship
was temporary, and the number of waivers that may be granted during a 15-year period
was reduced from five to three. The result of this legislation was not only that employers
with defined benefit plans were faced with a much narrower funding range, but also that
they generally faced higher costs associated with actuarial calculations.

12. Omnibus Budget Reconciliation Act of 1989 (OBRA'89)

The details of OBRA'89 are just becoming available. However, OBRA'89 is
intended to make technical corrections to prior legislation (e.g., TRA'86 and OBRA'87).
For example, plan sponsors no longer are required to demonstrate to the PBGC that a
plan is fully funded, if the funding calculation required by the IRS already shows that the
plan is fully funded. While this does not effect the level of premium paid to the PBGC,
it does slightly reduce the administrative cost by eliminating yet another actuarial
calculation.

B. Summary

Throughout the period since the enactment of ERISA in 1974, there has been
frequent and complex changes in the laws governing pension plans. Some of these
changes have sought to increase the number of workers covered by pension plans.
Others have sought to reduce abuses within the pension system. Legislative changes, such as shorter vesting requirements, more inclusive participation requirements, and non-discrimination rules, have been aimed at ensuring that workers are fairly covered under plans and that plans are not simply tax shelters for key employees. Other legislative initiatives have focused on providing adequate insurance for plans to ensure that benefits are available for workers at the time of retirement (e.g., formation of the PBGC and PBGC premiums). Finally, some changes have been aimed (in part) at reducing federal budgetary deficits (e.g., restrictions on IRA's, caps on maximum includible compensation and IRS user fees).

Many of these changes have substantially affected the way in which private pensions are provided to workers in small firms. Some laws have had a significant impact on the willingness of firms to form new plans and the types of plans selected. For example, as will be discussed in later chapters of this report, the full funding limits have substantially affected the willingness of small firms to establish defined benefit plans. Some changes have resulted in a change in the rate of plan terminations. Finally, some legislative initiatives -- such as top-heavy requirements and changes in reporting and disclosure laws -- have resulted in significant changes in the burden and costs of administering plans.
Chapter 3

Formation, Termination and Administration of Pension Plans in Small Businesses

This chapter examines the formation, termination and on-going administration of pension plans in small businesses. It begins with an analysis of plan formation and termination since 1976. This is followed by a discussion of reasons that small firms establish plans and the steps that small firms typically take to set up plans. The chapter concludes with a discussion of on-going administration of plans. The analysis in this chapter is based on findings from case studies conducted with small businesses, detailed discussions with pension plan consultants and actuaries, and findings from the literature.

A. Recent Trends in Pension Plan Formations and Terminations

An estimate of the number of new pension plans formed and existing plans terminated may be made based on Internal Revenue Service (IRS) determination letter data. When an employer forms or terminates a pension plan, a letter of determination is usually requested by the plan sponsor of the IRS. The letter puts in writing to the plan sponsor the results of a review of the plan’s provisions by the IRS as to whether the plan is in compliance with existing laws and regulations. However, determination letter data may reflect an underestimate of the number of new plans formed and terminations of existing plans because some plan sponsors will not request a determination letter. This may occur either because they are confident of their plan’s tax favored status or they have a standardized plan which the IRS has already favorably ruled upon. With these caveats in mind, summary determination letter statistics for the total number of IRS-
approved (qualified) pension plan applications over the period 1976 to 1989 are presented in Table 3-1.

Table 3-1: IRS Qualified Applications for Employer-Sponsored Pension Plans (Plans in '000)

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent of Existing Plans</td>
<td>Number</td>
</tr>
<tr>
<td>1976</td>
<td>18.9</td>
<td>8%</td>
<td>2.6</td>
</tr>
<tr>
<td>1978</td>
<td>56.0</td>
<td>15.7%</td>
<td>9.7</td>
</tr>
<tr>
<td>1980</td>
<td>50.5</td>
<td>12.3%</td>
<td>18.8</td>
</tr>
<tr>
<td>1982</td>
<td>57.2</td>
<td>11.2%</td>
<td>28.2</td>
</tr>
<tr>
<td>1984</td>
<td>28.3</td>
<td>5.3%</td>
<td>12.8</td>
</tr>
<tr>
<td>1986</td>
<td>45.1</td>
<td>7.3%</td>
<td>22.1</td>
</tr>
<tr>
<td>1988</td>
<td>41.2</td>
<td>6.2%</td>
<td>13.6</td>
</tr>
<tr>
<td>1989 (est.)</td>
<td>20.2</td>
<td>3.0%</td>
<td>4.5</td>
</tr>
</tbody>
</table>

SOURCE: Internal Revenue Service determination letter statistics: for 1976 through 1986, data obtained from various IRS News Releases; for 1988 and 1989, IRS data files were utilized.

Pension plan applications reached a peak of 85,400 in 1982. At that time, there were approximately 730,000 private pension plans in existence, so applications represented 11.7 percent of total existing plans. Of the 85,400 applications, 57,200 were for defined contribution plans (11.2 percent of total then-existing defined contribution plans) and 28,200 were for defined benefit plans (12.8 percent of total then-existing defined benefit plans). Since the peak of new plan formations in 1982, overall pension plan formations have declined by 71.1 percent to an estimated 24,700 in 1989. This trend is even more pronounced for defined benefit plans whose formations dropped by
84.0 percent to 4,500 in 1989. In part, these trends reflect the increasing costs of establishing, administering, and revising pension plans (which will be discussed in the chapters that follow).

Table 3-2: IRS Qualified Terminations of Employer-Sponsored Pension Plans (Plans in '000)

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent of Existing Plans</td>
<td>Number</td>
</tr>
<tr>
<td>1976</td>
<td>0.3</td>
<td>0.1%</td>
<td>0.1</td>
</tr>
<tr>
<td>1978</td>
<td>10.7</td>
<td>3.0%</td>
<td>4.6</td>
</tr>
<tr>
<td>1980</td>
<td>9.0</td>
<td>2.2%</td>
<td>4.3</td>
</tr>
<tr>
<td>1982</td>
<td>10.1</td>
<td>2.0%</td>
<td>5.0</td>
</tr>
<tr>
<td>1984</td>
<td>11.0</td>
<td>2.1%</td>
<td>9.2</td>
</tr>
<tr>
<td>1986</td>
<td>14.6</td>
<td>2.4%</td>
<td>10.7</td>
</tr>
<tr>
<td>1988</td>
<td>13.8</td>
<td>2.1%</td>
<td>14.1</td>
</tr>
<tr>
<td>1989 (est.)</td>
<td>12.4</td>
<td>1.8%</td>
<td>14.5</td>
</tr>
</tbody>
</table>

SOURCE: Internal Revenue Service determination letter statistics: for 1976 through 1986, data obtained from various IRS News Releases; for 1988 and 1989, IRS data files were utilized.

Pension plan terminations (Table 3-2) reflect the same trends mentioned above for pension plan formations. Considering trends since 1978, pension plan terminations reached a low point of 13,300 in 1980 (slightly more than 2 percent of total then-existing plans). Of the 13,300 plan terminations, 9,000 were defined contribution plans (2 percent of total then-existing defined contribution plans) and 4,300 were defined benefit
plans (2 percent of total then-existing defined benefit plans). Since the low point in plan terminations in 1980, plan terminations have increased by more than 100 percent to 26,900 in 1989. Defined benefit plan terminations rose continuously and most dramatically, increasing from 4,300 in 1980 to 14,500 by 1989 or by 237 percent. In fact by 1988, defined benefit plan terminations exceeded defined contribution plan terminations even though, at the time, there were only a third as many plans. Defined contribution plan terminations increased from 9,000 in 1980 to a high of 14,600 in 1986 and have actually declined to 12,400 in 1989.

Table 3-3: Net Plan Formations and the Ratio of IRS Qualified Terminations to Applications for Employer-Sponsored Pension Plans

<table>
<thead>
<tr>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
<th>Total Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Plan Formations</td>
<td>Net Plan Formations</td>
</tr>
<tr>
<td></td>
<td>(in '000)</td>
<td>(in '000)</td>
</tr>
<tr>
<td></td>
<td>Ratio of Terminations</td>
<td>Ratio of Terminations</td>
</tr>
<tr>
<td></td>
<td>to Applications</td>
<td>to Applications</td>
</tr>
<tr>
<td>1976</td>
<td>18.6</td>
<td>2.5</td>
</tr>
<tr>
<td>1978</td>
<td>45.3</td>
<td>5.1</td>
</tr>
<tr>
<td>1980</td>
<td>41.5</td>
<td>14.5</td>
</tr>
<tr>
<td>1982</td>
<td>47.1</td>
<td>23.2</td>
</tr>
<tr>
<td>1984</td>
<td>17.3</td>
<td>3.6</td>
</tr>
<tr>
<td>1986</td>
<td>30.5</td>
<td>11.4</td>
</tr>
<tr>
<td>1988</td>
<td>27.4</td>
<td>-1.1</td>
</tr>
<tr>
<td>1989 (est.)</td>
<td>7.8</td>
<td>-10.0</td>
</tr>
<tr>
<td></td>
<td>0.61</td>
<td>3.20</td>
</tr>
</tbody>
</table>

SOURCE: Internal Revenue Service determination letter statistics: for 1976 through 1986, data obtained from various IRS News Releases; for 1988 and 1989, IRS data files were utilized.

Table 3-3 presents net plan formations and the ratio of plan terminations to
applications. Net plan formations in both defined contribution plans and defined benefit plans have fallen rather steadily since the early 1980s. By 1988, net formations for defined benefit plans had turned negative. These trends are reflected in the ratio of terminations to applications which reached its low point of 0.18 in 1982 and has increased substantially to 1.09 in 1989, indicating that for pension plans overall there are no net plan formations. Defined benefit plan terminations heavily influence this result: in 1989 such plan terminations were more than three times greater than plan formations. On a net basis, there were 10,000 net defined benefit plan terminations in 1989.

B. Reasons that Small Businesses Establish Pension Plans

There are a variety of reasons that small businesses form pension plans. Case studies conducted with small firms and our interviews with plan service providers confirmed most of the factors that have been identified in the literature. In contrast to larger firms, personal motivations of the owner-operator often play an important role in both the decision to establish a plan and the type of plan that is selected.

Firm Profitability. Particularly in the case of small firms, profitability is a precondition for establishing plans. Without such profitability, reduction in corporate taxes on profits is not a major motivating factor and the firm does not have the necessary resources to set-up or fund a plan. In many instances, such as the one described below, a small firm will wait several years after incorporation before it is sufficiently profitable to set up a plan.

**Steel Wire Manufacturing Firm (33 Employees), Cleveland, Ohio.** A defined benefit plan was set up in 1974, four years after the firm was established. The owner-operator of this firm (which had about five employees at the time of formation) noted that like many other entrepreneurs when they first get started, he had little access to capital for just running the firm. Hence, he did not have
the firm resources to invest in a plan. However, as the firm became more profitable and he became more concerned about retirement income (for himself and his workers), he decided to establish a plan.

**Desire to Remain Competitive in the Labor Market.** Some small firms establish a pension plan to enhance their ability to attract and keep valuable employees. Because of competition for workers within the market place, some firms may adopt pension plans to help them in their efforts to recruit new workers. Pension benefits provide an additional, tax-deferred method for compensating new employees. Once the firm hires an employee, pension plans serve as an inducement to stay with the firm. This is particularly the case where plans have longer vesting schedules. Particularly in sectors where firms must invest in developing skills in their workforce (e.g., highly-skilled machinists), the retention of workers is likely to be an important motivating factor. With projections of labor shortages in the near future, it is possible that this reason for providing pension benefits will become even more important.

**Concern for the Welfare of Employees.** Small firms are also often motivated to provide pension benefits out of a concern for the future of their employees and to protect them at the time of retirement. Particularly in the case of small firms -- where the owner-operator is likely to know his workers personally and to work with them over a long period of time -- this desire to "look-out for the well-being of employees" appears to be a powerful motivating factor. In most of the case studies of small firms, owners mentioned that they were concerned that their employees were provided for in their retirement. Several of the interviewees noted that they did not feel that Social Security would provide adequate coverage and that they did not feel that employees would save adequately on their own. The desire to help employees was cited as an important motivating factor in several of our case studies.
I

Building Contractor (14 Employees), Capitol Heights, Maryland. This plan was initiated by the firm's president in 1975 to "look after the guys." In the past, the firm had provided employees with a sizable Christmas bonus each year (instead of the retirement plan). However, the president was looking to provide a benefit (which was tax deductible) that would provide for the future retirement of his workforce. The firm has a primarily "blue collar" workforce, which works from pay check to pay check, and typically does not put away savings for retirement.

Steel Wire Manufacturer (33 Employees), Cleveland, Ohio. The owner indicated that his motivation in establishing the plan was to provide retirement income for all employees. He was very concerned about the well-being of his workforce (which numbered 4 or 5 at the time). He did not feel that they would adequately provide for their own retirement.

Machine Shop (55 Employees), Cleveland, Ohio. A profit sharing plan was set up shortly after the firm was established to provide a retirement benefit for the owner and the employees. The owner felt it was very important to provide retirement benefits for employees, who he felt were unlikely to save enough on their own.

Oil Drilling and Distribution Company (44 Employees), Shreveport, Louisiana. This plan was set up to reward long service employees and to take advantage of the tax incentives offered to qualified plans. A defined benefit structure was adopted to permit credit for service prior to 1980 to reward those who had been long-standing employees.

Desire to Provide Retirement Benefits for a Key Employee. Particularly within small businesses, the owner-operator or other key management personnel often play a central role in determining whether a pension plan is initiated. Often the decision to form a plan in a small business is directly related to the personal needs of key personnel. For some firms (such as the one described below) an overriding consideration in the decision to establish a pension plan is that a certain key employee (often the owner) is reaching an age at which he is concerned about retirement.

Steel Wire Manufacturer (33 Employees), Cleveland, Ohio. At the time the plan was set up, the owner was in his late-40's and was particularly concerned with setting aside adequate retirement income. At the time, he had no other pension plan coverage for himself. In addition, he was very concerned about the well-being of his workforce, which numbered four or five employees at the time.

Deferral of Corporate and/or Personal Income Taxes. Employer contributions to
plans are fully tax deductible from company income as a business expense. In the case of small businesses -- particularly those that are closely-held, owner-operated firms -- pension plans provide an opportunity to reduce corporate income taxes and defer payment on taxes to a later date.³² The owner of a small firm has several options when the firm is profitable. The owner, as a stockholder, may receive the company's cash surplus by declaring a dividend to stockholders. Alternatively, he may provide bonuses. In both circumstances, income taxes must be paid immediately. For example, a bonus, while expensed at the corporate level (so no corporate taxes are paid), is taxable as ordinary income to the owner (and employees, if employee bonuses are paid). A qualified retirement plan provides a third option. Like a bonus, a contribution to a qualified plan is tax deductible to the firm. Unlike a bonus, which is taxed immediately as personal income, there is a deferral of personal income taxation on pension contributions and earnings on investments within the pension fund until the funds are withdrawn (i.e., through an elective withdrawal or at the time retirement benefits are received).

Thus, many small firms establish retirement plans in order to reduce taxation on profits. Some types of pension plans, such as profit sharing plans (which are discussed later in this chapter), provide considerable flexibility for firms to reduce corporate income tax when they are profitable, without making the commitment to fund plans when firms are not profitable. This feature of pension plans is particularly important for

³² It is interesting to note that some of those interviewed felt that personal tax rates were at a historic low and could only increase in the future. These interviewees wondered whether tax deferral of personal income was a good idea with such low tax rates. They felt it was likely that the rates would increase in the future and that when the retirement income was actually received that it would be taxed at a higher rate.
those firms that face cyclical trends in the demand for their services. One example from our case studies illustrates this factor:

**Electrical Contracting Firm (45-50 Employees), Cleveland, Ohio.** This company replaced an earlier defined benefit plan with a profit sharing plan in 1987. According to the owner, the flexibility of the profit sharing plan is important, because it enables the firm to make contributions when it is profitable. Although the firm has been able to make contributions in each of the years since plan formation, the owner noted that the electrical contracting business is cyclical and the flexibility of varying contribution levels is important.

**Other Factors.** Several other factors influence the decision to offer pension plans. For example, pension plans frequently result from union negotiations. However, none of the firms interviewed for this study indicated that this was a factor. Some employers view pension plans, particularly profit sharing plans, as a means to motivate employees and to share profits resulting from their efforts.

**C. The Process of Establishing a Plan**

Once a small firm has decided to form a retirement plan, it must select a particular type of plan and complete a series of steps to initiate the plan. This section examines the typical steps that firms go through to establish plans and some of the ways in which regulation affects firms' choices.

1. **Selection of a Plan**

Small firms are faced with a broad and complex range of available plans. Firms must decide which plan best suits the needs of the company and its employees. At the time of initiating a plan, most owners of small firms have relatively limited knowledge of pension plans -- the types of plans available, the advantages or disadvantages of various plans, or administrative requirements. Generally, if the most advantageous plan is to be
selected some level of outside expertise from a pension plan service provider is required. Costs associated with selecting the wrong type of plan can be high and burden the company for many years into the future. For example, recent changes in regulations governing full funding of defined benefit plans may make such plans a burden for small employers who experience periods of low profitability but must still fund their plans.

Even if the "right" plan is selected, many small firms complain that with the rapid changes in pension plan regulations, the firm cannot be certain that the plan selected today will be the best plan in the future. As discussed in the next chapter, this uncertainty about future regulations and the potential impact on plan provisions (particularly funding liability) is a major concern to many small businesses. This is so much of a concern that in some instances, small firms are reluctant to consider even setting up plans.

Initially, firms must choose between two major types of qualified retirement plans:

- a defined benefit plan, in which each employee's benefit is predetermined, usually based on the employee's earnings and/or length of services; or
- a defined contribution plan, in which the employer's contributions are predetermined.

The advantages and disadvantages for small businesses of these two major types of pension plans are discussed below.

a. Defined Benefit Plans

Defined benefit plans can be an advantage for the small firm that has an older, long-tenured workforce. As discussed earlier, small firms may lack the capital and profitability to sponsor a pension plan during their early years. More so than in the case of a defined contribution plan, a defined benefit plan can provide benefits to plan participants retrospectively, through past service credits, for those years when no plan
Historically, many pension plan service providers have regarded defined benefit plans as being the most effective type of retirement plan for actually delivering retirement benefits to employees. For example, under such plans it is more difficult for employees to receive funds prior to retirement age (i.e., in comparison to most defined contribution plans). However, because of the imposition of full funding limits (as part of OBRA'87) and other recently imposed restrictions on defined benefit plans, many service providers (and employers) have concluded that defined benefit plans have significant drawbacks.

Prior to the enactment of OBRA’87 full funding limits, defined benefit plans had considerable flexibility in funding which made these plans attractive to many small businesses. In a profitable year, a plan could contribute the maximum deductible amount and build up a "credit balance" in its funding standard account. In an unprofitable year, the plan could draw on that "credit balance" and not have to contribute to the plan.33

Defined benefit plans also provided flexibility in funding as a result of funding assumptions. Small employers used to employ very conservative interest and other assumptions to avoid the unexpected impact of adverse plan experience, such as having lower-than-expected earnings on assets. For example, they would assume that assets would earn 5 percent or 6 percent. This would require a larger contribution than a higher interest assumption would. With higher assets, the plan could withstand a period

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33Profit sharing plans are often considered the most flexible type of plan from the point of view of funding. Prior to OBRA ’87, the defined benefit situation was more flexible because employees would continue to accrue benefits even in unprofitable years when the employer might not put any money into the plan.
of bad investment performance or high pay increases.

Not only have recent changes in the permissible funding of defined benefit plans (particularly OBRA’s full funding limit) significantly curtailed the flexibility of funding, but recent changes have also impeded the ability of defined benefit plans to anticipate liabilities. In the past, an employer could predict plan liability with confidence. The unabated pace of change in pension plan regulations over the past decade has now taught small and large businesses alike that there is no way to predict what unexpected liability might be added to the firm’s plan in the future.

Generally, defined contribution plans do not have such unexpected liabilities added retrospectively. For example, a defined contribution plan might be required to provide benefits to those employees retired after age 65. The employer can terminate the plan and avoid any added liability. Or, if he is unable to make a timely termination, his liability is only one year’s contribution.

For a defined benefit plan, failing to make a timely termination could cost hundreds of thousands of dollars in liability and bankrupt the employer. While large plans often can absorb the adverse effect of such unexpected liabilities to their pension plans, small employers do not have the flexibility or resources to do so. For example, recent studies for the SBA suggest that small firms are less profitable and have greater variability in their profits from year-to-year. Small businesses also typically pay a premium of 2 to 3 percent on loans compared to rates paid by larger businesses.34 As a result these two factors, small businesses may be less able to generate needed resources to cope with unexpected liabilities to their pension plans. In addition, a small firm is

more likely to have its viability connected to one key owner-employee. If an unexpected liability is added to a small firm at about the time that key employee is ready to transfer ownership, the added liability may make the ownership transfer impossible and effectively eliminate the company and the jobs (and pension benefits) that it provides.

According to all of the pension plan service providers interviewed during this study and as shown in the IRS statistics (see Table 3-1 earlier in this chapter), businesses have become increasingly reluctant to establish defined benefit plans in recent years because of the increased cost of complying with regulations governing such plans. These experts also note that a large number of smaller businesses that have had defined benefit plans have terminated their plans in recent years and either replaced them with defined contribution plans or simply eliminated pension coverage as a fringe benefit.

b. Defined Contribution Plans

As shown (earlier in this chapter) in Table 3-2, in place of defined benefit plans, small firms are increasingly turning to defined contribution plans. A major reason for initiating such plans is that there is considerably less administrative cost and burden to such plans. There are a wide variety of defined contribution plans available for small businesses. The four major types of plans and their relative advantages and disadvantages for small businesses are briefly discussed below.

Profit sharing plans are the least restrictive of the four types of defined contribution plans available to small firms. These plans allow contributions to vary both absolutely and as a share of profits and compensation. Such plans are a good choice for less established businesses, because they can make higher contributions in profitable years and lower (or no) contributions in unprofitable years. However, statutory limits on per participant contributions are lower in profit sharing plans (the lesser of 15 percent of
earned income or $30,000 annually) than some other defined contribution plans and the
fact that contributions need not be made (but cannot be made up for in future years)
limit the retirement income a profit sharing plan can provide. These plans are easier to
set up and administer than most other types of plans. For example, small businesses can,
without much expense or commitment of time, set up a prototype profit sharing plan.

Compared to defined benefit plans (and some defined contribution plans, such as 401(k)
plans), on-going administration is considerably less burdened by recordkeeping, reporting
requirements or complicated funding formulas. In addition, unlike defined benefit plans,
profit sharing plans can allow for early withdrawal and employer or employee
contributions for non-retirement purposes under certain circumstances.

Money purchase plans allow firms to make higher per participant contributions
than profit sharing plans (i.e., the lesser of 25 percent of earned income or $30,000
annually), but contributions must be made regardless of the firm's profitability. This type
of plan requires fixed annual contributions -- usually a percentage of payroll -- hence, it
can be a burden for firms with varying levels of profitability. They offer less funding
flexibility than defined benefit plans, which usually have a range of contribution levels
even after the funding restrictions added by OBRA'87. These plans are often
contributory, with the employer's contribution either matching or being a multiple of the
employee's contribution.

Section 401(k) plans allow employees to contribute a portion of their
compensation that would otherwise be taxable (in the form of income) to a qualified
plan. The employer may match all or a portion of the employees' contribution. The
employer's per participant contributions plus elective employee deferrals may not exceed
the lesser of 25 percent of earned income or $30,000. One of the major advantages of
this type of plan is that it permits each employee the flexibility of choosing between take-home pay or retirement contributions on an annual basis. However, these plans have complicated nondiscrimination requirements and can be more costly and complex to administer than other types of defined contribution plans. While such plans provide maximum flexibility for employees (i.e., they may decide whether to contribute, how much up to a specified maximum per year, and whether to withdraw funds under specified circumstances), this flexibility may result in employees not accumulating adequate savings for retirement purposes. In fact, many actuaries view 401(k) plans more as savings plans than retirement plans. This may account for the fact that many firms use the 401(k) plan to supplement their pension plan. Several firms among our case studies had 401(k) plans in tandem with profit sharing plans. The owners of these firms felt that in combination with other plans, these plans provided their employees (and themselves) with an opportunity to build their savings.

**Simplified Employee Pensions.** Simplified employee pensions (SEPs), established by the Revenue Act of 1978, were intended to be used by small employers as a low-cost method for starting a retirement plan. SEPs are individual accounts similar to IRAs, but have higher contribution limits ($30,000). Unlike IRAs, contributions are generally provided by the employer. These contributions are not subject to Social Security, unemployment insurance, or income tax withholding. Employers that sponsor SEPs can omit contributions in years when contributions are unaffordable and avoid the administrative costs and most of the reporting requirements of corporate plans. In addition, the Tax Reform Act of 1986 established a salary reduction feature for SEPs maintained by employers who have 25 or fewer employees. If certain tests are met, plan participants can make voluntary tax deferred contributions to a SEP. There are,
however, some restrictions on the SEPs, which limit eligibility of small firms or make SEPs less desirable than other types of plans for some small employers (or their employees):

- Employers with other pension plans cannot establish model SEPs.
- Employers who have terminated defined benefit plans cannot establish SEPs.
- Employers cannot use the IRS "Model SEP" if they have any eligible employees for whom accounts have not been established, if they have leased employees, or if they are a member of an affiliated group of employers unless all the eligible employees of the group participate in the SEP.
- Model SEP benefits cannot be integrated with Social Security.
- To ensure that all eligible employees are included, SEP contributions must be made for eligible workers who left the firm during the plan year.
- Immediate vesting is required and SEPs cannot include loan provisions that enable participants to borrow money from the plan.35

2. Initiating a Plan

Once a small firm has decided upon a plan, it must execute a series of steps to initiate the plan. The cost and burden of initiating a plan will depend upon the type of plan selected (for example, defined benefit plans are generally more costly and difficult to establish) and whether the plan is a prototype plan or individually-designed plan. Regardless of whether the small employer chooses a prototype plan or an individually-designed plan, some level of expert assistance will almost certainly be required to select the most advantageous plan and properly complete all the steps needed to establish a

35For more detail on SEPs, the Small Business Administration and the Department of Labor have jointly published a pamphlet entitled "Simplified Employee Pensions (SEPs): What Small Businesses Need to Know."
a. Prototype v. Individually-Designed Plans

In recent years, the cost, complexity and burden of initiating pension plans in small businesses have been reduced substantially with the introduction of a wide variety of prototype plans. This has represented a major breakthrough for small businesses, many of whom were unwilling to absorb the costs (and the efforts) of developing an individually-designed plan. In the 1960s and 1970s, insurance companies were very active in the prototype plan market, providing prototype pension plans as an incentive for firms who partially funded through insurance products. Subsequent to ERISA, other financial institutions (e.g., investment firms) became involved in the prototype market. Revenue Procedure 76-15,36 issued in 1976, established "a means whereby certain practitioners may submit pattern plans with requests for notification letters that will enable such pattern plans to be used repeatedly on behalf of several or more adopting employers represented by such practitioners." This Revenue Procedure provided a program whereby a law firm was able to obtain approval from an IRS district director of a "pattern plan which the law firm contemplates using in submitting determination letter applications on behalf of several or more adopting employers." It was followed by a series of other Revenue Procedures which sought to further clarify the rules governing prototype plans.37

36This Revenue Procedure sets forth the procedures of the Internal Revenue Service for issuing notification and determination letters relating to certain qualified corporate defined contribution plans, and any related trusts or custodial accounts, under Sections 401 and 501(a) of the Internal Revenue Code of 1954, as amended by ERISA.

37This includes the following Revenue Procedures: 77-23, 79-28, 80-30, 83-36, 84-23, 84-86, 88-42, and 89-9.
In 1989, the IRS issued regulations governing "regional" prototype plans, which is intended to expand the types of firms that can offer prototype plans and removes some of the restrictions on such plans. Revenue Procedure 89-13 "sets forth the procedures of the Internal Revenue Service for issuing notification letters relating to the qualification, as to form, of certain regional prototype defined contribution and defined benefit plans..." Principal features of the "regional prototype program" include the following:

- greater flexibility in the elections available to adopting employers;
- reciprocity, so that a regional prototype plan approved in one region of the IRS will be automatically accepted in other regions;
- a "mass submitter program"\textsuperscript{38} under which the National Office of the IRS may approve plans of mass submitters and such plans may then be adopted by regional prototype plan sponsors;
- provision for standardized regional prototype plans, with respect to which adopting employers generally do not need to request a determination letter in order to obtain reliance as to the qualified status of the plan as adopted, and paired standardized defined contribution regional prototype plans;
- a sponsor registration program that provides continued reliance to adopting employers in the event amendments are needed because of subsequent changes in plan qualification requirements; and
- modification of the user fee schedule by adding new subcategories and related fees.

The regional prototype plan particularly affects the types of firms that can develop and sponsor prototype plans. Such plans can now be sponsored through a firm\textsuperscript{39} which: "(1) has an established place of business in the United States where it is accessible during

\textsuperscript{38}A "mass submitter" is any person which can establish that, if it receives a favorable notification letter within respect to a regional prototype plan, there are at least 40 unaffiliated sponsors that will adopt the plan on a word-for-word identical basis.

\textsuperscript{39}The term "firm" is defined by this Revenue Procedure as a "partnership or corporation at least one of whose members or employees is authorized to practice before the Internal Revenue Service with respect to employee plans matters, or individual who is so authorized."
every business day, and (2) either has at least 30 clients that have their principal place of business within the jurisdiction of not more than two regions of the IRS and are expected to adopt the sponsor's regional prototype plan, or has at least three clients that are expected to adopt a "mass submitter regional prototype plan." In other words, regional prototype plans can be developed and submitted to the IRS for determination by employee benefit consultants, actuarial firms, and accounting firms who have at least one employee authorized to practice before the IRS on employee plans matters and can show that they have a sufficiently large group of clients that are interested in such a plan. Many benefit plan consultants interviewed for this study felt that the regional prototype program is one of the most positive developments in the pension area in recent years.

Prototype plans, which have already been approved by the IRS, are considerably less expensive to establish than individually-designed plans. For example, one major investment firm will prepare all of the documents that are necessary to put the plan into effect, as well as provide a guide on administration and necessary administrative forms for the follow cost:

- New plan formation -- $300 (except 401(k) plans, which are $500)
- Replacement plan -- $400 (except 401(k) plans, which are $500)

While prototype plans are much less expensive than individually-designed plans and reduce the time and effort that small employers expend in designing a plan, their major drawback is that they may limit the employer's options at the time of plan design:

... For example, several prototype money purchase and profit sharing plans ... provided for immediate vesting and no integration with Social Security. Qualified plan rules, in contrast, permit integration and up to five year cliff or seven year

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40Chapter 5 provides cost estimates for establishing individually-designed defined benefit and defined contribution plans.
graded vesting. Employers offering immediate vesting may defer participation for two years after an employee has been hired. Deferred participation can eliminate the costs of providing benefits for short-term employees. An employer implementing a retirement plan to increase employee retention might prefer graded vesting with immediate participation, however, giving employees a stake in the plan early in their employment.  

For most small employers, however, the prototype plan is an effective method for reducing both the burden and cost of establishing retirement plans.

Some small employers hire an actuary, attorney, or employee benefits consultant to individually design a plan for the firm. As might be expected, the costs of setting up this type of plan are considerably higher than those for prototype plans. Because of their greater complexity (particularly with regard to funding), firms establishing defined benefit plans, are more likely than those establishing defined contribution plans to have individually-designed plans. The key advantage is that the firm is able to structure the plan in a way that is most advantageous to the firm and its employees (particularly key employees, such as the owner-operator).

b. Plan Installation

Regardless of whether a prototype plan or an individually-designed plan is developed, the firm must take a number of steps to install the plan. The key difference between the prototype plan and the individually-designed plan is that the former plan has already been reviewed (generically) by the IRS and approved.

Prototype Plans. Preparation of the required legal documents is the first step in the installation of the plan. In the case of the prototype plan, the employer will typically

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42 The costs of plan establishment are discussed in detail in Chapter 5.
return a questionnaire to the vendor which will be used to structure the prototype plan. This questionnaire typically includes the following:

- background information on the firm (e.g., employer ID number, type of business, ownership of other businesses);
- information about each employee (e.g., name, title, whether an officer, shareholder or self-employed, percent of voting stock, sex, date of hire, date of birth, annual salary, bonus, full-time/part-time);
- preferences on plan provisions (e.g., type of plan, average contribution level expected, retirement age from plan, types of employees to be included, and other special requirements).

Such a questionnaire (depending upon the number of employees for which information must be submitted) might take between one and three hours to complete. This is likely to be followed by telephone contact, written correspondence or in-person visits from a pension plan specialist to clarify various options. Based on the choices that are made, the vendor will return the (1) Prototype Plan and Adoption Agreement, (2) Summary Plan Description, (3) Form 5302, Employee Census, and (4) Form 5307, Short Form Application for Determination for Employee Benefit. These four items must be submitted by the employer (along with a check for the IRS user fee) to the Internal Revenue Service for approval. In addition, the employer must complete and sign a corporate resolution and post a "Notice to Interested Parties" that an application has been made to the IRS for an advanced determination on the qualification of a employee retirement plan. The employer must provide notice to all plan participants and a Summary Plan Description (SPD) when the plan is initiated. The SPD must also be filed with the Department of Labor.

The IRS will review the submission and issue a favorable letter of determination authorizing that the plan is fully qualified and, thus, that contributions to the plan are tax
deductible. From the point that the questionnaire is returned to the vendor to receipt of the favorable letter of determination from the IRS is likely take from three to six months. The cost and burden to the employer of adopting a prototype plan is minimal - perhaps involving as little time as a day.

**Individually-Designed Plan.** The process of initiating an individually-designed plan is essentially the same. However, because of the generally wider range of options available to the employer and the emphasis on tailoring the plan to the needs of the employer, it is likely that the initiation process will involve considerably more time on the part of the employer. The actuary, accountant, lawyer, or employee benefits consultant will typically work closely with the owner or employee benefits manager of the firm to analyze the specific needs and circumstances of the firm and its employees (e.g., is there a desire to reward past service? what level of contribution does the employer desire to make on an annual basis?), then recommend a plan that is tailored to meet these specific requirements.

Once the plan is designed, it will be submitted to the IRS for qualification. The following items must be submitted: (1) Individually-Designed Plan and Adoption Agreement, (2) Summary Plan Description, (3) Form 5302, Employee Census, and (4) Form 5300, Application for Determination for Defined Benefit Plan for Pension Plans other than Money Purchase Plans, or Form 5301, Application for Determination for Defined Contribution Plan for Profit Sharing, Stock Bonus and Money Purchase Plan. Similar to prototype plans, plan participants must be notified and provided with a SPD when the plan is initiated. The SPD must also be filed with the Department of Labor. This submission will be reviewed by the IRS and the firm will be notified by a favorable determination letter if the plan is approved.
As discussed in Chapter 5, these plans are considerably more expensive to establish than prototype plans. They also generally take longer to implement than prototype plans because the design phase is longer and the IRS needs more time to review the submission.

D. On-going Administration of Plans

Administration of pension plans involves two major types of activities: (1) administrative activities related to the plan as a whole, and (2) administrative activities related to plan participants. Small plan sponsors approach the administration of plans in several different ways, depending upon the particular expertise within the firm, type of plan that is administered and the size of the pension fund. Some small firms (primarily those with relatively straightforward defined contribution plans) conduct nearly all administrative tasks in-house. Other firms choose to delegate responsibility for plan administration and asset management to other firms that specialize in plan administration, such as a local bank, accounting firm, investment firm, insurance company or actuarial firm. Finally, some firms contract with an outside firm to do some of the more difficult aspects of plan administration, but retain an active role in other aspects of administration and investment.

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44 These three models of administration -- internal, external and shared administration -- are discussed in further detail in James Bell Associates, Inc., and ICF Incorporated, Coverage, Characteristics, Administration and Costs of Pension and Health Care Benefits in Small Businesses, March 1984, pp. 88-92.
1. Administration Related to the Plan as a Whole

a. Reporting Requirements

Under ERISA, employers and administrators of public and private retirement plans must file certain annual returns or reports with the Internal Revenue Service (IRS), the Department of Labor (DOL) and the Pension Benefit Guaranty Corporation (PBGC). To reduce duplication of reporting and the burden of compliance with ERISA, the IRS, DOL and the PBGC have designed consolidated annual return/report forms, the Form 5500 series. These forms are filed with the IRS and satisfy the annual reporting requirements of all three agencies. These agencies, however, also require special reports upon the occurrence of particular events.

Pension plans with fewer than 100 participants have a simplified filing requirement. They are required to file the Form 5500 (C) or Form 5500 (R) annually:

- The Form 5500 (C), Return/Report of Employee Benefit Plan, is due 7 1/2 months after the close of the plan’s fiscal year. It is due the first plan year, and triennially according to the last digit in the Employer Tax ID Number. This form reports on (a) the type of plan, (b) number of plan participants, (c) whether new plan amendments were adopted, (d) whether the plan terminated, (e) detail on plan assets, liabilities, and net worth, (f) detail on plan income, and (g) whether the plan has complied with fiduciary requirements.

- The Form 5500 (R), Registration Statement of Employee Benefit Plan, is due any year the 5500 (C) is not required (i.e., two out of every three years). It is considerably more streamlined than the 5500 (C), reporting in much less detail on (a) the type of plan, (b) number of plan participants, (c) whether new plan amendments were adopted, (d) whether the plan terminated, (e) summary of plan assets, liabilities, and net worth, and (f) summary of plan income.

Firms may also be required to file the Schedule SSA and the Form 1099R:

- Small employers are also required to file a Schedule SSA (Form 5500), Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits, for certain separated participants. If the employer is holding any vested amounts for any participants who have left
the firm, the employer must file this form for the year of their departure along with the Form 5500, showing the participant's name, Social Security Number, and amount being held.

- The employer must complete a 1099R, Statement for Recipients of Total Distributions from Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, etc., for each beneficiary who receives a distribution during the year. This form is due 30 days after the end of the year.

If the firm has a defined benefit plan, a Schedule B (signed by an enrolled actuary) must be included with the Form 5500. The plan must also file the PBGC Form 1, Annual Premium Payment, which is used to pay PBGC premiums. This report is due each year by the last day of the seventh month following the close of the previous plan year.

b. Managing and Reporting on Plan Assets

Small firms generally require outside expertise to manage and track plan contributions and assets. Decisions must be made regularly on how the assets of the plan are to be invested. It is also necessary to (1) account for plan income, (2) allocate plan assets to participants, (3) prepare a plan financial statement, (4) prepare employee reports on fund balances, and (5) determine distributions for participants that terminate from the plan.

c. Recordkeeping

Recordkeeping requirements will depend upon the type of plan that the firm has. For most types of plans it is necessary (at a minimum) to maintain the following records:

- a list of current employees and participants, including their date of birth, date of hire, and marital status,
- hours worked by each employee,
- each employee's and participant's compensation, broken down by type (bonuses, commissions, etc.),
For many types of defined contribution plans (such as 401(k) plans) the employer must make and keep track of payroll deductions (i.e., the employee’s contribution to the plan). In some plans, these deductions can change periodically -- e.g., in many 401(k) plans employees can change their level of contribution twice a year or even more often.

2. Administrative Activities Related to Individual Participants

There are variety of activities that must be undertaken by the plan administrator that relate to individual participants of the plan. Some of the key activities include the following:

- **Enrolling New Participants**: The plan administrator must decide who has met the standards for eligibility and officially enroll them in the plan. Once an employee becomes eligible to participate, the firm must: (a) inform the employee that he/she is now eligible, (b) have the employee complete an application for membership and a beneficiary designation form, (c) furnish the employee with any other necessary administrative forms, (d) provide the new participant with a copy of the SPD within 90 days of becoming a plan participant.

- **Reporting to Plan Participants**: Each plan participant must be given a participant statement as soon as practical after the plan year. This statement must contain beginning balance, employer contribution, employee contribution (if applicable), forfeitures credited (if applicable), investment gain or loss, ending balance and amount or percentage vested to the participant.

- **Termination of Participants from the Plan**: The procedures vary according to the specific type of plan and specific requirements of the plan. In a typical defined contribution plan the procedure would be as follows: If the participant terminates employment and has no vested interest, he/she is simply furnished with a form acknowledging that he/she has no vested interest in the plan. If the participant has a vested interest, then it is necessary to furnish the employee with a form describing the amount of his/her vested interest. The employee has several choices at this point --
have the vested benefit distributed immediately, have the plan hold the amount until a later date (e.g., retirement), or rollover the amount to another qualified plan. At the time of any distribution, the firm must provide the participant with notice describing tax withholding.

- **Administering Loans:** If under a defined contribution plan the employer elects to allow loans, then there are a fairly specific set of procedures that the employer must complete to make a loan. Typically, there is a formal application made by the participant to the person or persons who approve or disapprove of loan requests. If the loan is approved, a promissory note is completed. It is also necessary to obtain a notarized agreement from the spouse at the time the application for a loan is made.

- **Other Activities:** Some other types of activities that may be necessary include (a) changing the level of employees contributions (every six months), (2) processing a change in the participants direction of investments (every six months), (3) providing employees with statement of contributions (quarterly).

Within a plan, there are many internal non-governmental forms that must periodically be completed by the plan administrator. Table 3-4 lists forms that are used periodically in administering a prototype profit-sharing plan (which is typically among the most straightforward plans to administer).

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<th>Table 3-4: Typical Administrative Forms for a Defined Contribution Pension Plan</th>
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<tr>
<td>Designation of Beneficiary</td>
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<td>Waiver of Participation</td>
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<td>Revocation of Beneficiary Designation</td>
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<td>Election of Options by the Plan Administrator</td>
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<td>Application to Self Direct Investments</td>
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<td>Application for Loan</td>
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<td>Spousal Waiver of Benefits in Lieu of Loan</td>
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<td>Loan Approval Letter</td>
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<td>Loan Payment Authorization</td>
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<tr>
<td>Promissory Note</td>
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<tr>
<td>Statement of Loan Disclosure</td>
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<tr>
<td>Notice of Survivor Annuity Option</td>
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<tr>
<td>Waiver of Joint and Survivor Annuity</td>
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<td>Waiver of Annuity in Favor of Lump Sum Distribution</td>
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<td>Special Tax Rules for Lump Sum Distribution</td>
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<td>Payment Instructions to Trustee</td>
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<td>Application for Withdrawal of Employer Contributions</td>
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<td>Application for Hardship Withdrawal of Employer Contributions</td>
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Chapter 4
Effects of Regulation on Plan Formation, Termination and Administration

Changes in the regulations governing pension plans during the past decade -- particularly during the past five years -- have had a significant effect upon formation, termination and on-going administration of pension plans in small firms. In-depth interviews with pension plan service providers, as well as the case studies with small firms, revealed the extent to which pension plan regulation has affected the actions of small plan sponsors. The key trends and aspects of the regulation that are most troublesome for small employers are discussed below.

A. Frequency and Complexity of Regulatory Changes a Major Problem

The frequency of changes in the law and the complexity of those changes were cited by nearly all of those that were interviewed -- both small employers and pension plan service providers -- as the "number one" problem with pension regulation. Small employers could simply not stay up with or understand the many changes that have occurred. In the nine case studies conducted with small employers, nearly all cited the frequency and complexity of changes in regulations as their primary concern. They viewed these changes as not only increasing the burden and costs of plan administration, but also creating great uncertainty about what the plans will cost in the future. The sentiment of small employers is reflected in the following comments from our case studies.

Machine Shop (55 Employees), Cleveland, Ohio. The owner noted that he "could not keep up with all the changes in regulation ... it seems that every couple years
there is a major change." He is aware of the changes that come along because he gets "all that paperwork announcing the change," but is unsure of the specific changes. He leaves the understanding and interpretation of the rule changes to the pension plan consultant and "hopes that the consultant knows what he is doing." He said that he "hated regulation" in the pension area and placed most of the blame with Congress.

Electrical Contracting Firm (45-50 Employees), Cleveland, Ohio. This owner felt that "Congress should make up its mind (about pension regulations) and stick with them." He viewed the frequent changes in recent years as a major irritant and a costly one for most small firms. He noted that each change costs a plan a "couple thousand dollars". In setting up a plan, he noted that you "try to anticipate the changes" in the future, but that this is nearly impossible.

Commercial Printing Firm (20-25 Employees), Arlington, Virginia. The major problem for the plan is the constant changes in the law and the lack of regulations defining what has to be done to meet the law. This plan had to change its formula to meet TRA 1986 integration rules. Benefit levels to participants were slightly reduced, particularly to middle to upper level (non-owner) employees. This was a major problem for the respondent because he had to spend over 50 hours in the past year meeting with the plan's pension consultant, preparing for these meetings and deciding what to do about changing the plan to comply with TRA 1986. This is time that otherwise could be spent generating company revenue.

Jobbing Machine Shop (55 Employees), Cleveland, Ohio. The interviewee indicated that the pace of change in pension plan regulation was "unbelievable." As a small businessman it was impossible to keep up with and understand the frequent changes. Hence, it is necessary to rely upon pension plan experts (who are expensive) to ensure that the plan meets regulatory requirements. The interviewee noted that he had had "enough bull" and that there was a need to slow the rate of change and simplify pension plan administration.

Biotechnology Consulting Firm (4 Employees), Potomac, Maryland. The owner-operator of this small high-technology firm has found pension plan administration and regulation "confusing." According to this owner-operator, there is "no way someone with a small business can keep up with changes in the regulations" governing pension plans. He said that he doesn't understand or "know all of the rules." He felt that constantly changing regulations were a "serious problem" and a major "irritation" for the small businessman. He felt that "they are not consistent in Congress" and that Congress has made "so many funny changes" in recent years.

However, it is not just the small firms that have had problems with the rapid pace of change, but large firms have also felt the effects and complained:
Natural Gas Distribution Firm (1700 Employees), Denver, Colorado. This company has had to go to great expense to deal with constant changes in the pension laws. The benefits manager (the interviewee) has been with the firm for 24 years and involved with plan administration for the last 10. He said that in the early years after ERISA there were not a lot of plan changes required. However, in the last seven years, with TEFRA, DEFRA, REA, TRA (particularly Section 89) and OBRA 87, there have been constant plan changes taking place. This has been a very noticeable burden.

An actuary summarized the problems that his clients expressed to him:

Businesses can live with a bad law if they know that it is a law that they have to live with. But when you don’t know what the laws are going to be, when you have indecision, then businesses are unable to make commitments. In making a commitment to employees (just as any other business decision), the key for a businessman is that he knows the nature of the commitment he is getting into. When the laws continually change and he doesn’t know the nature of the commitment, he doesn’t want to get involved.

For his clients, constantly changing laws not only added administrative expense to plans, but also created uncertainty about what the regulations will be in the future. He noted that because the law is too complex, small business owners have a difficult (if not impossible) time understanding it; when these owners finally understand the regulations they have often changed. Even pension plan consultants have had a very difficult job of keeping up with the changes and in providing their clients with expert consultation on how to cope with these changes.

B. Rules Relating to Changes in Pension Regulation Are Not Issued in a Timely Fashion and Are Difficult to Understand

The frequency and complexity of the changes is further exacerbated by the fact that the issuance of specific rules by the IRS and other regulatory agencies governing the changes in pension laws is often untimely. In fact, in some cases the specific rules are not even published prior to the date that the change is to go into effect. Even the IRS
can not keep up with the changes in the law. For example, one pension actuary was concerned about how to calculate the interest rate on the new current liability for the OBRA '87 full funding limitation, so he called the IRS's Pension Benefit Plans Actuarial Hot Line. The call was made in early February 1988, one month after the change in the law became effective. When asked the question, the IRS expert said "Oh, you've got the wrong number, you want the Treasury Bond section of the Treasury Department." Upon insistence that this was a pension actuarial question, the IRS pension actuarial expert referred the call to a colleague. This second actuarial expert indicated that while he did understand the question, the regulations in that specific area had not yet been written. This was despite the fact that the law had taken effect four weeks earlier.

A number of the pension plan consultants that we interviewed felt that such delays were a serious problem because they made it very difficult (if not impossible) for firms to judge the impact of the regulation on their plan or to initiate necessary modifications to the plan or procedures for administering the plan. The problem of delayed issuance of regulations was summed up best by a benefits manager in one of the large firms that we interviewed:

Life Insurance Company (1400 Employees), Arlington, Virginia. One of the biggest problems for firms that must make changes in their plans is the absence of written regulations. For example, the Tax Reform Act of 1986 calls for plans to be amended in 1989 to come in compliance. Many required regulations will not be written until 1990. Plans should be told in 1989 that they do not need to comply until 1991, since regulations will not be written until 1990. The IRS should be required to get their rules and regulations signed and final before the effective date of the law.

C. Regulatory Changes Have Substantially Affected Formation and Termination of Defined Benefit Plans

As shown in Chapter 3, there is little doubt that changes in regulation over the
past decade -- particular the TRA'86 and OBRA'87 -- have had a serious impact on the formation, termination and on-going expense of administering defined benefit plans. Small employers are clearly unwilling to establish defined benefit plans in the first place. If they have a defined benefit plan already established, then they are increasingly likely to terminate the plan.

In the nine case studies conducted with small firms as part of this study, there were experiences that clearly illustrated the difficulties faced by small firms in responding to new regulations governing these plans and in the tendency toward termination of defined benefit plans. One manufacturing firm had in the past year been seriously affected by changes in regulation which substantially affected the funding liability of the plan. The changes in regulation were a major and costly "surprise" for this firm:

**Steel Wire Manufacturer (33 employees), Cleveland, Ohio.** According to the owner, the most recent change in the defined benefit plan in response to regulatory changes (in response to the TRA '86) has been the "most disconcerting and bitter" of all. Because of recent changes in the pension laws, it was necessary for the actuaries to recompute the benefits for employees. During the past month, the owner found that the firm was "in for a big surprise." Where it was previously estimated by actuaries that the benefit to a recently retired employee would be $175,000, the new requirements of the law resulted in an actual pay out of $250,000 -- a difference of $75,000.

This difference between what was the expected payout and what was actually paid out angered the owner. He did not begrudge the additional payment to the worker -- he felt that workers should get everything that they are entitled to under the law -- but he was very upset by the "unpredictability" of the expense. He termed the recent changes in law -- which precipitated the revisions in the firm's defined benefit plan and subsequently higher funding requirements -- as "one of the most disgusting things" he had encountered in business. He emphasized that in business matters that you "need to be able to predict" the financial impact of decisions -- but the way that pension laws have been implemented in recent years has made this impossible.

With the large, unexpected payout, the owner now worries that the plan may be underfunded. He noted that the actuaries felt that over the next few years it is possible to make up the difference, but that it will be costly. He lamented that he had not known earlier of the effects on benefit distribution of the new laws,
because he would have increased the level of contribution to the plan, rather than paying corporate tax. He considered the changes that were initiated as a "breach of trust": the laws should not simply introduce "changes mid-stream" which have a sizable impact on benefits. He noted that he was uncertain whether, with the three years left until his own retirement, the plan would be able to fully recover from this unexpected payout.

Two other small firms had recently terminated their defined benefit plan in favor of a defined contribution plan. In one case it was because there was a fear that the plan might become underfunded and in the other case the defined benefit plan was no longer applicable to most employees:

**Electrical Contracting Firm (45-50 Employees), Cleveland, Ohio.** A decision was made to terminate a defined benefit plan just prior to the establishment of the Profit Sharing/401(k) plan. All of the funds from the defined benefit plan were transferred to the new plan. This defined benefit plan had been set up in 1956, but with the changes in rules in the 1980s, it was felt necessary to terminate the plan. The owner noted that the government had kept "tightening" the regulations and that there was a possible funding problem. In particular, there was concern about possible liabilities to make payments to the fund, even if the firm was not profitable. So the owner wanted greater flexibility to make contributions. He also feared that other changes in the future might impose additional problems for funding the plan.

**Machine Shop (55 Employees), Cleveland, Ohio.** A decision was made to terminate a defined benefit plan just prior to the establishment of the 401(k) plan. This plan had been initiated with an express purpose of assisting those that exceeded the Social Security limits during a given year. In setting up the plan, the owner wanted to provide a retirement benefit on the portion of income above the Social Security limit (at the time $7,000). He felt it was unfair that the more highly paid employees did not receive retirement benefits after they reached $7,000 in income and did not feel that Social Security provided adequate income for his employees on which to retire.

But as the Social Security limit increased from the $7000 level at the time of plan formation, fewer employees were receiving the benefits of Social Security integration. By the time of termination, only the owner was making sufficient income and he did not know, given the expected increases in the Social Security limit, whether he would even benefit from the integration provision in the future. The owner came to feel that the plan was of little use so the plan was terminated.

A third firm planned to terminate its defined benefit plan within the next three years, at the time that the owner retired. The reason for termination was the stringent regulations
concerning fiduciary responsibilities:

Steel Wire Manufacturer (33 employees), Cleveland, Ohio. The owner expected to terminate the plan in three years, when he plans to retire. This is because he has 100 percent fiduciary responsibility for the plan and it was his perception that this responsibility could not be transferred to another person. Because of the potential liability and uncertainty about how the laws might change after his retirement, he feels that he would be a "fool" not to terminate the plan. But for the sake of his employees -- some of whom he fears will spend the distribution rather than wait until retirement -- he feels that plan termination is not the best outcome. He expects that termination and the actuarial services required for distributing the benefits of the plan will cost an estimated $6,000. It would be much better if the plan could stay in place, but given the fiduciary responsibilities he is not willing to take the chance.

The trends in the aggregate data and illustrations from our case studies were further reinforced by the recent experiences of the pension plan service providers that we interviewed. They were unanimous in the observation that small businesses were generally unwilling to establish defined benefit plans. In fact, even though most pension plan service providers felt that defined benefit plans were still the most effective method for delivering retirement benefits to employees, in most cases they were not recommending that their clients set up such plans. For example, actuaries and pension plan consultants interviewed for this study in many parts of the country -- including Shreveport, Little Rock, Memphis, State College, Detroit, Washington, Baltimore, and Arlington (Virginia) -- indicated that accountants in their areas were recommending against defined benefit pension plans.

Added to the reluctance to form new defined benefit plan is the clear trend toward termination of such plans. In our discussions with pension plan experts, most had experienced a sudden and substantial number of terminations among their small business defined benefit plans. Most indicated that they had lost between one-third and one-half of the defined benefit plans in firms with fewer than 100 employees. For example, one
actuary indicated that he had recently terminated 310 of the 600 defined benefit plans he serviced with fewer than 100 plan participants.

Those interviewed for this study provided a number of explanations -- all related to changes in regulations -- for the precipitous decline in defined benefit plans in small firms.

**OBRA'87 Full Funding Limitations.** With OBRA'87, employees now face a narrower funding range. This legislation stipulates that plan contributions in excess of 150 percent of the current liability are no longer a tax deductible expense and are subject to a 10 percent excise tax penalty. In some cases, this 150 percent is less than what would be needed to fully fund the plan on termination.

| Table 4-1: Demonstration of the Inadequacy of Current Liability Definition: Comparison of the Value of a Benefit of $1,000 a Month Payable at Age 65 to an Employee Now Aged 30, 40 and 50 |
|--------------------------------------------------|-----|-----|-----|
|                                                  | Age 30 | Age 40 | Age 50 |
| Value at 8%                                      | $6,500 | $14,000 | $30,000 |
| 150 Percent of Value at 8%                       | $9,750 | $21,000 | $45,000 |
| Termination Liability                           | $15,000 | $23,000 | $35,000 |

Note: The values shown above are based on the applicable current liability and plan termination assumptions for January 1, 1990. Current liability is based on UP84 male mortality and 8 percent interest, which is the minimum interest rate allowed for current liability calculations; thus, giving the largest allowed current liability. Termination liability is based on PBGC assumption set F for a male. Thus, giving the smallest amount of assets required by the PBGC to pay the promised benefits.

For example, Table 4-1 demonstrates that under the current liability definition 150 percent of the current liability covers termination liability for employees over age 50. However, for employees under age 40, 150 percent of the current liability is less than 100 percent of the plan termination liability. Notice that this table shows that the largest
amount of funding allowed without tax penalty is less than the amount of money that PBGC feels is necessary to provide for the benefits. Furthermore, the benefit valued is for the simplest possible pension plan benefit. Pension plans by law must include certain ancillary benefits such as qualified, pre-retirement survivor annuity. In addition, most plans provide other benefits, such as early retirement and optional forms of benefit payouts. These all are in addition to the plan termination liability calculated. Current liability calculations in many cases inadequately reflect these additional liabilities. Further, calculations of these additional liabilities are quite complex. Added margin should be available for these ancillary benefits without requiring time-consuming and expensive calculations. Thus, for the case shown above, PBGC's measure of plan liabilities finds 150 percent of the current liability to be adequate for a 50 year old male. For a pension plan with ancillary benefits even the 150 percent of current liability for the 50 year old may be inadequate.

It is also important to recognize that current liability measures only accrued benefits. It does not recognize the adverse impact to funding that expected pay increases will have or the added cost of benefits when employees become older and closer to the retirement age. The previous concept of "acceptable funding method" required recognition of these future liabilities. Plan actuaries interviewed for this study defended the prior concept and emphasized the shortsightedness of the current liability definition.

This has two adverse effects on small plans. First, small plans have traditionally been funded on conservative assumptions in order to insulate them from potential adverse experience. This important security net has been removed. Second, under the new funding rules, the employer contributions can swing dramatically from one period to
the next. For example, during a profitable period a plan sponsor may be prevented from making any contribution to the plan, while during an unprofitable period the plan sponsor may have to contribute more than was projected. For many small plan sponsors the full funding limitation can be a serious issue. According to experts interviewed for this study, the full funding limit is the most significant factor adversely affecting small plan formation and termination of defined benefit plans.

**Recent Increases in the PBGC Premium.** OBRA'87 increased the basic premium from $8.50 per plan participant to $16 for well-funded plans\(^4\) to a maximum of $50 for those with large unfunded liabilities. Firms with well-funded plans, which have complained in the past about subsidizing underfunded plans, now complain that they must pay $16 even if they can not contribute to the plan because of full funding. Those plans with large unfunded liabilities complain about the exorbitant cost of the PBGC premium. This comment by one of the actuaries interviewed for this study typifies concerns over the PBGC premium:

> ...not only have administrative costs gone up but also PBGC premiums are over 30 times what they were some years ago. PBGC premiums may be 100's of times the former amount in the case of plans forced to cover marginal employees and/or which have unfunded liabilities.

Another plan consultant noted that "if PBGC premiums are increased again it will be the straw that broke the camel's back."

**Administration Too Complex and Burdensome.** With all of the recent changes in regulations governing defined benefit plans, many small employers have concluded that these plans are much too complicated and expensive to administer. Constantly changing

\(^4\)For example, most funding methods require funding of an amount greater than the present value of accrued benefits to provide for future pay increases and to recognize the added expense of benefits for older employees.
rules create confusion and uncertainty about how to administer defined benefit plans. The formulae for calculating funding liability are extremely complicated, requiring costly outside actuarial assistance. Internal recordkeeping for defined benefit plans and reporting requirements are more complex and costly than for defined contribution plans (with the possible exception of 401(K) plans). Many of the pension plan service providers viewed escalating problems with administration of defined benefit plans as a major factor in plan termination. For example, one actuary noted:

... Some plans terminate because of the complexity of the rules and the reporting requirements. Some don't understand what's going on with all of the rule changes. They ask "Why pay the added cost for a defined benefit plan, and the added PBGC premium rate, and the increased administration cost required by constant law changes when they can't contribute to the plan because the new rules say that the plan is fully funded?" They just want to get out from under it.

Need to Make Almost Continual, Costly Revisions to the Plan Document. Many small employers complain that their defined benefit plan has had to be revised frequently in recent years. Because defined benefit plan rule changes are so complex, it is necessary for the firm to pay for expert assistance to make the revisions even in the case of prototype plans. Therefore, not only can the regulatory change have a substantial effect on the funding liability (or other aspects of the plan), but it can be costly (and time-consuming) to make the necessary revisions to the plan document. Perhaps worst of all, plan sponsors have difficulty understanding the rules even with the help of experts.

D. Changes in Regulations Have Significantly Reduced the Benefit of Pension Plans to Key Personnel

In recent years, Congress has introduced a series of regulations that have been intended to curb abuses in plans and to limit the ability of key individual to shelter
income within plans. The combined effect of these changes -- while increasing the fairness of plans to workers -- has reduced some of the motivation for owners of small firms to establish plans. Many of the regulatory changes have meant that key management personnel in small firms (in particular owner-operators) have less to gain personally by offering pension benefits. In small firms it is often the owner-operator and a small group of other highly paid individuals who make the decision of whether to offer a pension benefit or not. When their ability to benefit from the pension benefits is reduced, then they are less likely to offer such benefits or to limit the level of contribution to plans. In particular, the following have been identified as having an effect upon plan formation and termination in small plans.

Limitations on Plan Contributions and Benefits (Section 415 Limits). To limit tax deductibility in qualified retirement plans for highly paid employees, Section 415 of the Internal Revenue Code imposes limits on the amount of benefit that defined benefit plans can provide and on the amount of annual additions that can be made to defined contribution plans during a year. Generally, under Section 415, as amended by TRA'86, a defined benefit plan cannot provide an "annual benefit" on behalf of any participant that exceeds the lesser of $90,000 (reduced for retirement age less than the Social Security retirement age which in most cases is age 67) or 100 percent of his or her average compensation during the participant's highest paid three-consecutive year period while employed and a participant in the plan. Contributions to a defined contribution plan for the year cannot exceed the lesser of $30,000 or 25 percent of compensation for the year. These limits are adjusted for inflation.

Pension plan providers and small businesses complain that these limits are too low. They may, in some instances, discourage employers from offering qualified plans in
Social Security Integration Rules. ERISA permits private pension plans to have benefit formulas which provide for the "integration" of pension benefits with Social Security benefits. In other words, the amount of a private pension benefit may be affected by the amount of Social Security to which the beneficiary will be entitled. Generally, in integrated plans, the monthly pension benefit is determined. Then, a percentage of the expected monthly Social Security benefit is subtracted from the pension amount. The amount remaining is the actual monthly pension benefit. Benefits of retired employees already in pay status and vested benefits of terminated employees cannot be decreased because of increases in Social Security benefits or wage base levels.

TRA modified the ERISA integration rules with regard to benefits accruing in plan years beginning in 1989. Under TRA, a single employer defined benefit pension plan meets the requirements for integrated offset plans if it provides that a participant's accrued benefit derived from employer contributions may not be reduced by more than 50 percent of the face value of the final pension benefit that would have accrued without the offset. Multiemployer plans are rarely integrated.46

Because of TRA's more stringent limits on integration, firms have been less able to make higher pension contributions for those employees whose salaries have exceeded the Social Security limit. These higher paid employees generally include the owner-operators and managers that make decisions about whether to form plans. Several pension plan service providers noted that the tightening up of these restrictions have made small businesses less willing to set up plans.

46U.S. Department of Labor, Pension and Welfare Benefits Administration, "What You Should Know About the Pension Law," p. 32.
Top-Heavy Rules. Top-heavy rules, which are discussed in detail under TEFRA in Chapter 2, were instituted by Congress to ensure that rank-and-file employees receive benefits from their employer pension plans and that the plans are not simply tax shelters for the owners and managers. Under these rules, plans must apply special standards (e.g., stricter limits on allowable benefits for key employees and larger minimum benefits for all employees), if more than 60 percent of accumulated benefits are earmarked for key employees. It is generally argued that the top-heavy requirements are more likely to impact small firms, because of the generally higher ratio of owners to employees than large employers. In addition, small employers may also suffer from the top-heavy requirement if they have higher rates of turnover or lower average wages. Studies have shown that smaller firms typically do have about twice as high turnover rates as large firms and have lower average wages.

It is also argued that the top-heavy requirement does not take into account modest plans. For example, a career average plan (basing benefits on annual compensation to a plan participant) that has a 0.5 percent of pay per year of service formula, must provide the same top-heavy minimums as a final pay flat percentage formula that might give a benefit of 4 percent of final pay per year of service in some cases.

Some pension plan service providers question the need for special top-heavy vesting requirements given the faster vesting requirements under TRA’86. They view this requirement (applied to top-heavy plans) as an unnecessary administrative burden to

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47 Andrews, p. 117.

plans. A recently published GAO study\textsuperscript{49} found that, in fact, TEFRA's top-heavy vesting rules did make a difference for many plan participants, but that the effect on retirement income was small:

...Many more participants, men and women alike, would have had smaller or no vested benefits if TEFRA's top-heavy vesting rules had been repealed and replaced with TRA's vesting rules in the 55,000 top-heavy plans in our study population. However, the effect of this change in vesting status on participants' retirement income would likely have been small and would only have occurred if these participants left their jobs before becoming fully vested. This is because these participants probably would have been vested in a relatively small pension benefit at that point in their careers.

For plan sponsors, the cost to administer these small benefits is often larger than the dollar value of the benefits. Given the relatively low dollar benefit to plan participants and the administrative costs of the top-heavy vesting requirement, some have suggested that this requirement could be eliminated.

It is also argued that even if a small plan is unaffected by the top-heavy requirement, it is still complex and costly to make the calculation to determine if the plan is in compliance with the top-heavy requirement. One pension plan service provider termed it an "administrative nightmare." Others, however, noted that once the firm has purchased the appropriate computer software the calculation is not all that difficult.

**Lower Tax Rates.** Lower tax rates in recent years have reduced some of the tax advantage of providing pension benefits. According to several pension plan service providers, some owners may feel that tax rates are at their lowest level, and that they can only go up in the future. They may be reluctant to set up plans or make maximum

contributions to retirement plans that may, in the future, be taxed at a higher rate than the present. Added to this is the uncertainty that has resulted from the nearly constant flux in pension plan regulations over the past five years. Some owner-operators fear that if they set up a plan, that sometime in the future they will be impacted with some type of retrospective liability that they are unable to meet. Hence, they may feel that it is better to provide employee bonuses and other forms of compensation at the current low tax rates.

E. Other Regulatory Concerns

There were several other areas of regulatory concern identified by firms and/or pension plan service providers.

**Discrimination Testing for 401(k) Plans.** The administration of 401(k) plans is generally more complicated and burdensome than other types of defined contribution plans. In fact, before actual testing for discrimination, it is necessary to determine highly compensated individuals and family groups. This step alone can be quite burdensome. This complexity of discrimination testing is, in part, due to the flexibility of these plans (e.g., ability of individuals to change the level of contributions) and the need to make additional deductions from employees' salaries. However, some of those that offer 401(k) plans complain about the burden and complexity of the discrimination testing required under these plans. The burden of the discrimination testing is illustrated by one of the case studies:

**Health Care Management Firm (80 Employees), Arlington, Virginia.** The regulation that has caused the most concern for this firm's 401(k) plan is discrimination testing. It takes the firm about 1/2 day each month to check to make sure the firm remains in compliance (i.e., that there are not too many highly compensated individuals). However, as yet they have not come close to failing to
meet this requirement.

**Age Discrimination in Employment Act (ADEA) Accruals Have Been a Problem for Some Plans.** ADEA accruals past normal retirement create a substantial unexpected unfunded liability to small plans that may cause plans to terminate. Even if they do not result in a funding problem, the ADEA accruals create a major administrative problem because many benefit formulas are geared toward retirement at 65. One actuary explained that she has encountered a particular problem with ADEA regulations:

One plan administered by this actuary had been very well funded with about $1.5 million in liability and $2.0 million in assets. ADEA increased the liability by close to $500,000, taking this company out of full funding. The actuary noted that while this particular company didn't terminate its plan, that most other companies faced with the same problem would have terminated.

SBA's analysis of the Current Population Survey has found that most workers aged 65 and older are employed by small businesses. For example, in 1979, 90 percent of all workers 65 years old and over were employed in small firms with fewer than 500 employees. By 1983, this percentage had dropped to less than 80 percent.\(^{50}\) Hence, because of the concentration of elderly workers in small businesses, problems associated with ADEA accruals past normal retirement age are most likely to impact small businesses.

**IRS User Fee Viewed as Too High for Some Small Firms.** Several actuaries indicated that the IRS user fee was too high, especially for firms with fewer than 25 employees. Currently, employers must pay the IRS $100 to apply for determination

\(^{50}\)In part, this may be because of the 1982 amendments to the Age Discrimination in Employment Act (ADEA), which require firms with 20 or more employees offering health insurance to also cover workers aged 65 to 69. The amendments also require that the employer plan now become the primary payer of health costs. Small Business Administration, *The State of Small Business: A Report of the President* (Washington, D.C., 1985), p. 275.
letters in master and prototype plans (i.e., this fee must accompany the submission of the Form 5307). Firms with fewer than 100 employees that establish individually-designed plans must pay a users fee of $450 (i.e., this fee must accompany the submission of Form 5300). This fee was increased from $400 earlier this year. IRS approval for plan amendments can range from $50 to $1000 for small employers. The IRS also charges $225 (increased from $200 earlier this year) for termination of plans with 100 or fewer employees.

In early 1990, it is expected that the IRS will again raise the user fees for applying for pension plans. According to the IRS Assistant Commissioner, at a meeting of the Employer Ad Hoc Committee in Baltimore, the IRS will raise the user fees for application Form 5300 (for individually-designed plans) and 5307 (for master or prototype plans) by as much as 50 percent. The user fee for the Form 5300 is expected to climb from $450 to a figure that "will well exceed" the $750 rate charged for plans with more than 100 participants. The user fee for submission of the Form 5307 is expected to increased from $100 to "maybe no more than" $150. This announcement was "the cause of numerous complaints from practitioners at the meeting."

The pension plan service providers interviewed for this study felt that the IRS user fees should be restructured so that the fee is based on the number of plan participants.

Rapid Vesting Schedule Viewed as both an Advantage and Disadvantage. Several actuaries stated that rapid vesting resulted in substantially higher administrative costs and was counterproductive to a retirement plan's objective of providing retirement benefits.

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They indicated that the very small benefits either get cashed out or cost more to maintain than they are worth.

The reaction to faster vesting provisions was mixed in firms. The owner-operator of one small firm (a building contractor) indicated that he was considering terminating the firm's money purchase plan because rapid vesting had encouraged some plan participants to quit the firm in order to collect their benefits. Another owner-operator (an automobile sales firm) indicated that his plan maintains very small and expensive accounts for precisely that reason. The expense is more than the accounts are worth, but without the accounts employees would leave to get the cash out of the plan. However, respondents in two other firms indicated that the more rapid vesting schedule are appropriate for today's generally more mobile workforce.
Chapter 5
Costs of Pension Plans to Small Businesses

This chapter begins with a discussion of the key components of the overall costs that a small business employer faces in providing a pension plan for employees. The chapter then presents the key findings from informal interviews of pension plan service providers, including actuaries, consultants, accountants, banks, and financial institutions, concerning the costs of setting up and administering small and intermediate\textsuperscript{52} size defined contribution and defined benefit pension plans in today's regulatory environment.

A. Key Components of Pension Plan Costs to Small Businesses

Any employer faces three sets of costs in establishing and administering a pension plan: initial set-up costs, annual maintenance or administrative costs, and costs associated with plan revisions (either to comply with changes in regulations or to modify the plan -- this chapter will deal only with the former).\textsuperscript{53}

As discussed in Chapter 3, to set up a tax-deductible pension plan the plan must first be designed, the plan documents prepared (and provided to all plan participants), a summary plan description and Form 5300 filed both with the IRS and the Department of Labor, and a $450 (in the case of plans with fewer than 100 participants) to $750 (in the

\textsuperscript{52}The term "intermediate" is used to describe a firm with 200 employees because it is in the mid-range of the SBA's definition of small businesses, which includes any firm with fewer than 500 employees.

\textsuperscript{53}In addition, firms also absorb costs when they terminate plans, including IRS user fees, legal costs and financial costs. These costs are not examined in this chapter.
case of plans with 100 or more plan participants) user fee paid to the IRS. The IRS must determine whether the plan is in compliance with IRS rules and regulations. Such set-up costs are fixed costs and tend to increase gradually as the size of the business increases for a given type of pension plan (e.g., defined benefit versus defined contribution). Most pension plan service providers contacted indicated the primary reasons why their charges increase with number of employees is that: (1) larger plans are more complex and tend to have more options, (2) larger employers tend to make pension plan decisions by committees and these committees are more likely to ask questions, and (3) plan reproduction and distribution costs are higher if more employees are involved. However, because these fixed costs do not vary greatly with plan size, the small employer faces a relative cost disadvantage compared to a larger employer because he must spread these costs over fewer employees.

As discussed in Chapter 3, annual administrative costs involve recordkeeping, testing for compliance with IRS rules and regulations, annual reporting and filing of the 5500 Series forms (containing information on characteristics and financial operations of the plan) with the IRS, and completing both internal and IRS audits of the plan. Such on-going costs may be thought of as the variable costs of maintaining a pension plan. The vast majority of pension plan service providers contacted indicated that for such administrative services they charged a fixed fee plus an additional amount for each plan participant (depending on the type of plan). Often times, the per participant charge was lower if the number of participants exceeded certain levels (e.g., first ten, next ten, next eighty, then remaining participants). With the combination of the fixed administrative

54 As noted in the previous chapter, the IRS user fee for master or prototype plans is $100.
fee and often times lower participant charges above certain threshold levels, the small employer once again tends to face a per-participant cost disadvantage versus a larger employer (although not as onerous as the set-up cost disadvantage) because he must spread these costs over fewer employees.

Since passage of ERISA, eleven federal legislative Acts have been implemented that affect small business pension plan provisions (see Chapter 2). Each piece of legislation has provided new and changing rules and regulations with which every employer-sponsored retirement plan must comply. These legislative changes have affected very broad areas of pension plan provisions including contributions, vesting, coverage, participation, benefits, discrimination, Social Security integration, PBGC premiums, and funding. So many new laws have been passed recently that the IRS has often missed its legislatively required dates for final rulemaking. This has made it impossible for all employers to keep up with the changes. Even the most experienced pension plan consultants have thrown up their hands saying they can hardly keep up with the changes. One pension plan service provider indicated: "We used to be in the business of pension plan administration; now we're in the business of Federal Government compliance." Such a dynamic legislative situation lends itself to a relatively new cost concept facing employers: namely variable fixed costs. Every time Congress passes a new law which dramatically affects a pension plan's provisions, the plan must be revised and resubmitted to the IRS, and recordkeeping and testing methods must be changed. For example, to comply with the new requirements under the Tax Reform Act of 1986, many service providers contacted indicated it was easier to completely redraft

55New requirements included vesting, coverage, participation, 415 limits on maximum benefits, SSA integration, highly compensated employee definition changes, etc.
the plan document rather than make patchwork changes. Again, for a given type of pension plan, revision costs to comply with legislative changes in a given year tend to increase more slowly with pension plan size and, hence, the small employer faces a distinct per-participant cost disadvantage.

B. Analysis of Pension Plan Costs

1. Methodology

In order to assess the relative fixed and variable costs of small and intermediate size employers, informal interviews of over 50 geographically-dispersed pension plan service providers throughout the U.S. were undertaken by Lewin/ICF in December 1989. In order to get a consistent and comparable response, service providers were asked to assume that two different employers came to them wishing to establish a new pension plan. One employer was assumed to own a small business with 25 employees and the other an intermediate size business with 200 employees.

The service providers were also asked to assume that each employer wishes to decide between establishing a relatively simple defined contribution plan (either a money purchase or profit sharing plan) or a relatively straightforward defined benefit plan. Service providers were first asked what would be the "full service" costs of setting up a plan tailored to the employer's specific needs (including plan design, document preparation and filing with the IRS) for both employers and both plan types exclusive of IRS user fees. To maintain a methodological consistency, "off-the-shelf" or prototype plans were not considered. As discussed below, a few respondents, particularly banks and brokerage houses, do sponsor such plans and offer them at low cost. Second, service providers were asked what would be the "full service"
administrative costs for administering each of the plans each year exclusive of any revisions and compliance costs related to legislative or regulatory changes. Service providers were told to assume that the employer would perform only a minimum of in-house administrative work, but that administration would exclude any asset management. Finally, in order to estimate the effects of legislative and regulatory changes on pension plan costs, the respondents were asked what were the "full service" costs to make plan revisions in order to comply with the regulatory changes under the Tax Reform Act of 1986 exclusive of IRS user fees.

2. Summary of Key Findings

a. Initial Set-Up Costs

Table 5-1 provides the results of the interviews of pension plan service providers relating to the cost of setting up small (25 participants) and intermediate (200 participants) size pension plans. Set-up costs vary to a large degree both within types of plans and across plans. Considering small defined contribution plans, costs vary between $875 and $5,000 (median of $1,500) versus $1,000 and $15,000 for intermediate size defined contribution plans (median of $3,000). For small size defined benefit plans, set-up costs vary between $1,000 and $7,500 (median of $2,125) versus $1,000 to $19,000 for intermediate size defined benefit plans (median of $4,700).

In examining defined contribution plans only, set-up costs increase from $2,018 on average per plan for a small plan to $4,278 on average for an intermediate size plan. In other words, average set-up costs only slightly more than double as the number of plan participants increases by 700 percent. This indicates a substantial per participant cost difference for small employers. This is reflected in the fact that the per participant costs
Table 5-1: Cost of Setting up Small and Intermediate Size Pension Plans

<table>
<thead>
<tr>
<th></th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25 Participants</td>
<td>200 Participants</td>
</tr>
<tr>
<td>Average Cost Per Plan$^a$/</td>
<td>$2,018$^b/</td>
<td>$4,278</td>
</tr>
<tr>
<td>Median</td>
<td>$1,500</td>
<td>$3,000</td>
</tr>
<tr>
<td>Range of Average Cost</td>
<td>$875$ to $1,000$ to $5,000$ to $15,000$</td>
<td>$1,000$ to $7,500$ to $19,000$</td>
</tr>
<tr>
<td>Standard Deviation of</td>
<td>$1,021$</td>
<td>$3,528</td>
</tr>
<tr>
<td>Average Cost Per</td>
<td>$81$</td>
<td>$21</td>
</tr>
<tr>
<td>Participant</td>
<td>38</td>
<td>46</td>
</tr>
</tbody>
</table>

\[a/\] Excludes "off-the-shelf" prototype plans provided by some of the respondents. Their set-up cost is significantly less than the employer-tailored plans presented here.

\[b/\] Responses for service providers who specialize in large and medium size pension plans were excluded because their response would impart a large upward bias to the result. The average cost per plan for seven such respondents for a small defined contribution plan is $10,250 and a small defined benefit plan is $17,535.


are $81 in the small plan versus $21 in the intermediate plan -- nearly a four-fold per participant cost disadvantage for small plans. It should be noted that these per participant cost disadvantages would be even more pronounced if we had examined businesses with plan participation significantly larger than 200.

When considering defined benefit plans, set-up costs are 37 percent to 43 percent higher in comparison to similar sized defined contribution plans because of their complexity and the need for actuarial consultation. Set-up costs increase from $2,755 on
average per plan for small defined benefit plans to $6,117 on average for an intermediate size defined benefit plan. This implies average costs of $110 per participant for small plans and $31 per participant for intermediate size plans -- nearly a three and one-half fold per participant cost disadvantage.

Prototype plans have traditionally been offered through insurance companies, banks, investment companies, and other financial institutions. Such vehicles allow an employer to establish a limited-flexibility pension plan at very low cost by "filling in the blanks" on a pre-written pension plan document. Four financial institutions offering prototype plans were contacted. These institutions only offered defined contribution plans at an average set-up cost of only $735, independent of the size of the plan.

With dramatic increases in pension plan costs in recent years, particularly related to frequent revisions and compliance costs, some traditional pension plan service providers (i.e., actuaries and pension plan consultants) are moving in the direction of providing prototype plans. IRS Revenue Procedure 89-13, issued in March 1989, allows service providers to offer prototype plans that are pre-approved by the IRS. IRS approval of defined contribution prototype plans submitted in 1989 (consistent with the new TRA'86 revisions) began in early 1990. One wholesaler of such prototype plans will offer documents to service providers at $400 for defined contribution plans and $450 for defined benefit plans once their prototype plan (consistent with TRA'86 provisions) is approved by the IRS. This firm expects that the market for prototype plans is going to expand dramatically in the future, particularly if Congress continues to change pension legislation and the IRS continues to issue new regulations. Three pension plan

57IRS approval for defined benefit prototype plans (consistent with TRA'86) has not yet been initiated, but is expected in the near future.
consultants contacted expect to provide prototype plans consistent with TRA’86 revisions (in addition to individually-designed plans) at an average cost of $815 for defined contribution plans and $1,250 for defined benefit plans.

Table 5-2: Annual Administrative Costs for Small and Intermediate Size Pension Plans

<table>
<thead>
<tr>
<th></th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25 Participants</td>
<td>200 Participants</td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,767</td>
<td>$4,997</td>
</tr>
<tr>
<td>Median</td>
<td>$1,500</td>
<td>$4,700</td>
</tr>
<tr>
<td>Range of Average Cost</td>
<td>$575 to $1,750</td>
<td>$2,000 to $12,800</td>
</tr>
<tr>
<td>Per Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard Deviation of</td>
<td>$947</td>
<td>$2,312</td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Participant</td>
<td>$71</td>
<td>$25</td>
</tr>
<tr>
<td>Cost as Percent of</td>
<td>4.2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Respondent Sample</td>
<td>36</td>
<td>45</td>
</tr>
<tr>
<td>Size</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


b. Annual Administrative Costs

Table 5-2 presents the results of interviews on annual administrative costs for small and intermediate size pension plans. As with pension plan set-up costs, annual administrative costs also vary greatly from a low of $575 for a small defined contribution plan to a high of $17,000 for an intermediate size defined benefit plan. However, for
both intermediate size defined contribution and defined benefit plans, the relative variation of annual administrative costs is lower than for set-up costs (standard deviations as a percent of average administrative costs range between 43 percent and 46 percent versus 80 percent and 82 percent) for average set-up costs.

In considering the responses for defined contribution plans in Table 5-2, average annual administrative costs per plan increase by 183 percent from $1,767 for small plans to $4,997 for intermediate plans; this is in contrast to a smaller 112 percent increase in costs for average plan set-up costs. The increase in administrative costs is greater in comparison to set-up costs because administrative charges are more closely linked to the number of plan participants. However, on a per participant basis, small plans are still faced with a significant per participant cost disadvantage of more than two and one-half times: the annual cost per participant is $71 for small plans and $25 for intermediate plans. In perspective, this $71 per participant charge for small plans represents about four percent of annual average total employer and employee defined contribution pension plan contributions of $1,683 in 1987.

Average annual administrative costs per plan are 192 percent higher for intermediate size defined benefit plans at $7,747 versus $2,651 for small plans. This translates into per participant costs of $106 for small plans and $39 for intermediate plans. For small defined benefit plans, this annual administrative cost represents 12 percent of average annual total employer and employee defined benefit pension plan contributions of $880 in 1987.

Average annual administrative costs for the four financial institutions offering prototype defined contribution plans were substantially lower, at $538 for small plans and $1,667 for intermediate plans, in comparison to average administrative costs of plans.
offered by pension plan consultants. The three pension plan consultants providing prototype plans indicated that, whereas there were substantial savings in the costs of setting up such plans, there was no difference in annual administrative costs for a prototype plan versus an individually-designed plan.

c. Additional Administrative Costs to Revise Plans to Comply with the Tax Reform Act of 1986

Small employers face significant additional per participant administrative costs in order to keep up and comply with the plethora of changing laws and regulations affecting private pension plans. For small employers, the additional administrative costs of complying with the Tax Reform Act of 1986 represent on average more than 50 percent of annual administrative charges and more than 50 percent of pension plan set-up costs for both defined contribution and defined benefit plans (Tables 5-3).

Administrative costs for defined contribution plans to comply with the Tax Reform Act of 1986 average $1,060 for small plans and $1,755 for intermediate size plans. On a per participant basis, costs are about four and one-half times higher for the small employer ($42 per participant) versus the intermediate size employer ($9 per participant). In relative terms, the compliance costs for defined benefit plans are similar to defined contribution plans: on a per participant basis, costs are about four and one-half times higher for the small employer ($59 per participant) versus the intermediate size employer ($13 per participant).

When compliance costs and annual administrative costs are combined and compared to annual employer and employee contributions for small pension plans the results are quite dramatic: these costs represent nearly 7 percent of annual contributions.

58Figures for these four financial institutions are not shown on the chart.
Table 5-3: Costs to Revise Plans to Comply with the Tax Reform Act of 1986

<table>
<thead>
<tr>
<th></th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25 Participants</td>
<td>200 Participants</td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,060</td>
<td>$1,755</td>
</tr>
<tr>
<td>Median</td>
<td>$1,000</td>
<td>$1,250</td>
</tr>
<tr>
<td>Range of Average Cost</td>
<td>$0 to $2,750</td>
<td>$0 to $7,000</td>
</tr>
<tr>
<td>Per Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard Deviation of</td>
<td>$538</td>
<td>$1,395</td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per</td>
<td>$42</td>
<td>$9</td>
</tr>
<tr>
<td>Participant</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost as Percent of</td>
<td>2.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Respondent Sample Size</td>
<td>36</td>
<td>43</td>
</tr>
</tbody>
</table>


for defined contribution plans and nearly 19 percent of annual contributions for defined benefit plans.

Average annual compliance costs for the four financial institutions offering prototype defined contribution plans were substantially lower in comparison to average compliance costs of plans offered by pension plan consultants at $317 for small plans and $450 for intermediate plans. The three pension plan consultants providing prototype plans indicated that the cost of revision for compliance was exactly the same cost as setting up a new prototype plan at $900 on average for defined contribution plans and $1,200 on average for a defined benefit plan.
Table 5-4: Summary of Pension Plan Set-up and Administrative Costs for Small And Intermediate Size Pension Plans

<table>
<thead>
<tr>
<th></th>
<th>Defined Contribution Plans</th>
<th>Defined Benefit Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25 Participants</td>
<td>200 Participants</td>
</tr>
<tr>
<td><strong>Set Up Costs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$2,018</td>
<td>$4,278</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$81</td>
<td>$21</td>
</tr>
<tr>
<td><strong>Annual Administrative Cost</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,767</td>
<td>$4,997</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$71</td>
<td>$25</td>
</tr>
<tr>
<td><strong>Revisions and Compliance Cost</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,060</td>
<td>$1,755</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$42</td>
<td>$9</td>
</tr>
</tbody>
</table>


Finally, Table 5-4 provides a summary of the data presented in this chapter on costs of plan formation and administrative.
Chapter 6
Implications and Conclusion

Small employers lag substantially behind large employers in offering pension benefits to their employees. If pension coverage in the United States is to expand, much of the growth must come through expanded coverage in small firms because most large firms already have plans. However, this study (and others before it) has pointed to a variety of barriers that small firms face in establishing and maintaining pension benefits for their employees.

This chapter focuses on two major questions: (1) Are there ways to reduce the burden and costs of administering pension plans in small firms? and (2) Would a reduction in administrative burden and cost lead to an increase in pension coverage in small businesses? A series of alternatives is presented. These alternatives are based upon our interviews with pension plan service providers, small businesses and other experts in the field of pension plan policy. The alternatives are primarily intended to reduce the burden and/or costs of administering plans in small businesses. It is likely that some of these alternatives would also expand the level of coverage of pension benefits in small businesses. However, expansion of coverage does not come without costs. Many of the recent legislative and regulatory changes that Congress enacted were implemented to address perceived abuses and/or to reduce the federal budget deficit. Attempting to change these laws for the sake of increasing pension coverage must be done carefully, with political and economic tradeoffs fully considered.

This study has documented four major types of administrative problems that small firms have encountered:
Need to Constantly Modify Plans: Many small businesses complain about the frequent shifts in regulations and the resulting need to make almost constant revisions to plans. As discussed in earlier chapters of this report, small plan sponsors often have a difficult time understanding that the changes in regulations and modifying plans -- particularly defined benefit plans -- can be costly.

High Costs of Setting-Up and Administering Plans: Some of the reluctance of small businesses to form plans appears to be associated with the generally higher per participant costs of administering small versus large plans. The preceding chapter has shown that small firms face substantially higher per participant costs not only for setting up plans, but also for on-going administration.

Complicated Laws and Regulations that Reduce the Benefit of Providing Pension Benefits for Employees: A frequent complaint from small businesses and pension plan service providers is that the pension plan laws and regulations are excessively complicated. In addition, many of the recent changes in regulations are costly to comply with and have reduced some of the incentives for owners to offer retirement benefit plans.

Lack of Simple, Low-Cost Plan Options: Some small firms complain that there is a lack of simplified pension plan options. This may, in part, be a function of a lack of knowledge on the part of small firms about the many options that are currently available (e.g., a wide range of prototype plans).

The section that follows discusses the advantages and disadvantages of a series of possible alternatives that are intended to address each of the four problems discussed above.

A. Reduce the Need to Constantly Modify Plans

A frequent complaint that was heard from pension plan service providers and most employers (small and large alike) concerned the frequent changes in pension plan regulations over the past decade. Nearly all of the small firms indicated that (a) they generally did not understand the changes, (b) they were very concerned over the uncertainty that these changes created for their firm, (c) they felt it was unfair to apply new regulations to plans that were initiated under a different set of rules, and (d) the
costs of modifying plans could be quite substantial. The message from most small employers was clear that there had been enough changes in regulations over the past few years and that there was a need for a moratorium on changes. For example, the owner of one small firm stated that he'd had enough "bull" and it was time that Congress "slowed the rate of change and simplified pension plan administration." Another owner-operator of a small firm argued that "Congress shouldn't keep nibbling away year after year."

This sentiment from small firms concerning the need for slowing the pace of regulatory change was echoed by both large employers and pension plan service providers. Some pension plan service providers even indicated that they were having problems keeping up with and understanding the many complicated changes in recent years. Some service providers indicated that they dedicated two or three full-time staff simply to keep up with changing laws and regulations.

**Alternative #1: Slow the Pace of Regulatory Changes**

Several recommendations for slowing the pace of regulatory change emerged in our discussion with small firms and pension service plan providers. First, some have suggested that regulatory changes should apply to only new plan formations; existing plans should be "grandfathered" (i.e., exempted) from new provisions. The argument made here is that firms make decisions concerning their pension benefits under a given set of rules and circumstances, and that it is unfair to change these rules mid-stream. On the other hand, many regulatory changes have been made to stop perceived abuses and their effectiveness would be limited if established plans were exempted.

Alternatively, firms with plans already in existence might be given a longer period
to comply with new regulations -- perhaps five years -- while new plans might be required to meet the new regulations at the time of formation. While this would provide existing plans with a longer period in which to bring their plans into compliance (and an ability to bundle changes that occur over a five year period), small firms would still be faced with the expense of eventually making the required revisions.

Some have suggested a moratorium on rule changes for a period of at least five years so that firms can catch up to the current rules.

A final recommendation is that firms be required to update plans to comply with new laws only once every five years. This would enable firms to make a single revision to their plan document, rather than the repeated, costly and time-consuming changes firms have been required to make during the past decade. The date of compliance for plans could be based on the date of plan formation. This would ensure that 20 percent of plans had to comply each year. This change could require that plans only comply with final IRS regulations. It could also be linked to plans only filing with the IRS and DOL once every five years to further reduce administrative burden.

Alternative #2: Mandate that the IRS and other Regulators Publish New Regulatory Requirements Prior to the Effective Date of New Laws

A major complaint of both small firms and pension plan providers is that due to frequent changes in regulation over the past few years, the IRS has not always been able to publish new regulations before the effective date of the law. For example, a benefits manager at one of the large firms interviewed noted that some of the rule changes for TRA'86 were not even issued by the time that the rules were to go into effect. This sentiment was echoed by the many plan service providers that we talked with, who
complained that even as experts they often did not know the specific requirements of new regulations until after the date the regulations went into effect. The recommendation of service providers on this point was straightforward: The IRS should be required to issue final rules and regulations well before the effective date of the change in the law. The effective date of laws should be sufficiently deferred after the date of law passage so that IRS and other regulators have adequate time to write well-considered and easily understood regulations.

B. Reduce the Cost of Plan Establishment and Administration

This study, like others before it, has found that small plans are administratively more costly (on a per participant basis) than larger plans. This is primarily due to economies of scale that are achieved in spreading (fixed) costs across a larger group of plan participants. If the costs (and complexity) of plan formation and on-going administration could be reduced for small firms, then it is likely that more small firms would be encouraged to establish and keep plans. There are several possible alternatives that would reduce plan establishment and on-going costs.

Alternative #3: Provide a Tax Credit toward Plan Administration

Andrews has suggested that a tax credit or a "negative income tax" for small employers would reduce administrative costs, thereby encouraging plan formation. A tax credit, for example, might enable plans with fewer than 100 participants to credit (against

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59 Andrews, p. 155
taxes) up to some specified amount (e.g., $1,000) per year of administrative costs. While such a credit would be likely to have some impact upon willingness to offer a plan, there would be some additional administrative costs for the firm in using the credit and such a credit would reduce tax revenue for the federal government.

**Alternative #4: Reduce IRS User Fee Schedule**

Several of the pension plan service providers suggested that the IRS user fee schedule for pension plans was too high. As discussed in Chapter 4, small employers must pay an IRS user fee of $450 to establish an individually-designed plan and $100 for a master or prototype plan. This cost is expected to increase by as much as 50 percent in early 1990. The IRS also charges $225 for termination of plans with 100 or fewer employees. The user fee, in addition to the cost of designing a plan (which can range for a small firm from about $300 for a prototype plan to an average of $2,755 for an individually-designed defined benefit plan), can be a barrier to establishing plans, particularly for smaller firms that typically have lower cash reserves.

Most of those interviewed have not suggested that the user fee be eliminated. Rather, it is recommended that the fee be based on the number of participants that are in the plan. An alternative would be for the fee to be waived for plans with fewer than 100 employees. It should be realized that such user fees were implemented specifically for deficit reduction and relaxing such fees, while reducing costs of setting up and administering plans for small businesses, would reduce revenue collected by the government from such fees.

Such a tax credit, however, would not help those small firms which did not have taxable income.
Alternative #5: Reduce PBGC Premiums for Fully Funded Plans

OBRA’89 identified a paradox that Congress, on the one hand, restricts plans that are overfunded and, on the other hand, requires them to pay excess PBGC premiums because they are underfunded. Although some pension plan service providers argue that fully funded plans should pay no premium, others argue that they should because they may become underfunded sometime in the future. Although this is not a major cost factor, the inconsistency is a major irritant to some plan sponsors. On the one hand, plans have their funding schedules penalized because they are overfunded. On the other hand, they must pay substantially higher PBGC premiums than in years past presumably because the plan poses some funding risk (i.e., is underfunded). Initially, premiums were $0.50 per employee, now they are a minimum of $16.50 per employee and additional employees are counted in the calculation, including employees who have terminated and may never receive any benefit from the plan. Hence, for plans that are fully funded, the PBGC premium could be reduced to reflect the risk that the plan faces currently (and in the future) of terminating with an unfunded liability that must be covered by the PBGC.

Another major irritant to small plan sponsors regarding PBGC premiums is that premiums must be paid on former employees who have small deferred vested benefits. Employers should have the option of buying fully insured deferred annuities on these former employees and no longer having to pay PBGC premiums. PBGC premiums and the administrative expense of keeping track of these employees may, in fact, be more costly to the firm than the monetary value of the benefit. In other words, the cost of administration is greater than the dollars paid out in benefits.
Alternative #6: Reduce Filing Requirements

The administrative costs of filing reporting forms could be reduced if plans were required to file only once every five years. Although small firms only file the Form 5500-C every three years (and the simplified Form 5500-R in the intervening years), this burden could be further reduced by allowing consolidated filings every five years. This change would be particularly appropriate if firms were required to amend their pension plan for regulatory changes only once every five years, as discussed above.

C. Simplify Pension Plan Regulations and Increase Advantages of Offering Pension Benefits for Small Firms

Some of the reluctance of small firms to establish plans in recent years is directly related to regulatory changes that have (a) increased the complexity or cost of plan administration or (b) reduced the benefit (to the firm or key individuals within the firm) of providing pension benefit for employees. Some regulations -- such as more rapid vesting requirements and top-heavy rules -- have made it generally less advantageous for the owner-operators of small firms to establish pension plans. Other regulatory actions have made certain types of plans less attractive to small businesses. For example, the OBRA'87 full funding limit has substantially disrupted the funding of small defined benefit plans, contributing to many terminations and making such plans generally less attractive to firms that do not already have plans.

At the same time, it is important to acknowledge that many of the changes in regulations were intended to reduce abuses and expand coverage of workers by the private pension system. For example, top-heavy requirements and nondiscrimination rules were established so that the lower paid employees would receive a fair share of...
contributions to and benefits from retirement plans. Other changes in regulations were made in large part as a response to the need to cut the federal deficit (e.g., changes to limit the maximum cash compensation subject to tax-deferred benefit and the IRS user fees). It is important to weigh future changes in regulation against both revenue needs of the government and the potential for abuse by employers.

Several alternatives for reducing the complexity or increasing the incentives of offering pension benefits to employees are discussed below.

**Alternative #7: Modify the OBRA'87 Full Funding Limitation**

The OBRA'87 full funding limitation was identified as a major factor in the rapid decline in establishments and the escalation of terminations of defined benefit plans in small firms. The full funding limitation, which narrows the range of funding choices, can have a substantial impact upon the amount that small firms must contribute to the plan during a given year. For example, during a profitable year the firm may be prevented from contributing to the plan even though the employer has sufficient cash reserves available for this purpose; then later, during an unprofitable year, the firm may be required to make a greater than expected contribution. The full funding limitation was identified as a major factor in the unwillingness of small firms to establish defined benefit plans and the high rate of termination among these plans in recent years. In addition, the actuarial calculations resulting from the full funding limit are quite complex, leading to additional administrative costs for plans.

There are several ways in which it would be possible to reduce the adverse impact of the full funding limitation. First, the limit could be based on the interest rates used
by the PBGC for plan terminations.\(^{61}\)

Second, the OBRA’87 limit could be raised. OBRA’87 stipulated that plan contributions in excess of 150 percent of the current liabilities were no longer a tax deductible expense and were subject to a 10 percent excise tax penalty. As noted earlier, this 150 percent limitation has kept some plan sponsors (of fully funded plans) from making contributions during profitable years. The added margins and lower interest assumptions needed by small plans could be recognized by using a 200 percent limit for small plans.

Third, funding after a plan comes out of full funding could be simplified by letting the same rules be followed as for the old full funding limit.\(^{62}\)

Fourth, funding flexibility could be preserved by maintaining the old credit balance plus interest or by increasing the old credit balance by waived contributions and interest at the plan’s funding rate. The maximum allowable contribution could have added to it some recognition of contributions prevented during the period that a plan has been under the full funding limit. For example, it could be the amount calculated without regard to the waived contributions, plus the greater of (1) the largest annual waived contribution (increased by interest under the plan’s funding assumption) or (2) 10 percent of the accumulated value of all waived contributions.

\(^{61}\)If a plan terminates it must show that it has sufficient assets to cover liabilities. This calculation is based on annuity tables published by the PBGC. These tables, in turn, have been calculated based on a variable interest rate. For example, the applicable rate for January 1, 1989 was 7.75 percent for immediate annuities, plus a variable rate for the deferral period, which was 7 percent for the first seven years, 5.75 percent for the next eight years, and 4 percent thereafter. This is a measure by the PBGC of the current market value of annuity liabilities.

\(^{62}\)The old full funding limit generally included consideration of the prior bases to be fully amortized and calculation of the normal cost by the plan’s funding method.
Alternative #8: Simplify or Eliminate Top-Heavy Requirements for Small Plans

Top-heavy rules, which are discussed in detail under TEFRA in Chapter 2, were instituted by Congress to ensure that the employees receive benefits from their employer pension plans and that the plans are not simply tax shelters for the owners and managers. Under these rules, plans must apply special standards (e.g., stricter limits on allowable benefits for key employees and larger minimum benefits for all employees), if more than 60 percent of accumulated benefits are earmarked for key employees.

Three changes could be made to simplify top-heavy rules reducing the burden on top-heavy plans, but not changing the spirit of the law: (1) delete the top-heavy vesting schedule now that TRA’86 has essentially required all plans to have a schedule that is almost as demanding, (2) clear up the administrative burden placed on career average defined benefit plans by permitting the use of the career average definition of compensation for top-heavy accruals in career average plans, and (3) reduce the excessive impact of top-heavy rules on modest plans where the increase from the plan formula to top-heavy accruals is far greater than a plan that may already accrue at a rate of 2 percent of pay per year (the top-heavy minimum). Other changes could be made to lessen the severity of the top-heavy definition.

Some pension plan service providers question the need for special top-heavy vesting requirements given the faster vesting requirements under TRA’86. They view this requirement (applied to top-heavy plans) as an unnecessary administrative burden to plans. However, a recently published GAO study found that TEFRA’s top-heavy

vesting rules did make a difference for many plan participants, but that the effect on retirement income was small:

...Many more participants, men and women alike, would have had smaller or no vested benefits if TEFRA's top-heavy vesting rules had been repealed and replaced with TRA's vesting rules in the 55,000 top-heavy plans in our study population. However, the effect of this change in vesting status on participants’ retirement income would likely have been small and would only have occurred if these participants left their jobs before becoming fully vested. This is because these participants probably would have been vested in a relatively small pension benefit at that point in their careers.

For plan sponsors, the cost to administer these small benefits is often larger than the dollar value of the benefits. Given the relatively low dollar benefit to plan participants and the administrative costs of the top-heavy vesting requirement, one option, then, would be to eliminate this vesting requirement for top-heavy plans.

Two other changes in the special provisions applied to top-heavy plans might be considered:

- In order to address the fact that a modest plan (i.e., a plan whose formula generates a relatively low percentage of benefit to compensation) is more adversely impacted by top-heavy rules than a rich (more generous) plan, the two percent top-heavy annual accrual rate could be reduced so that the modified top-heavy accrual rate would not exceed 1/35th of the benefit percentage accrued for a participant with 35 years of service under the normal benefit formula.

- The top-heavy accruals on career average plans could be changed to accrue on a career average basis, rather than on a final average basis. This would vastly simplify administration of this type of plan, which requires two different kinds of recordkeeping if it is top-heavy.

In order to reduce the impact of the top-heavy requirement on small firms, the stringency of the definition of key employees could be modified. The current definition tends to penalize small firms because they typically have a higher ratio of stockholders to employees. The current definition of key employees is as follows: (a) officers (revised in 1984 to exclude those earning less than 1.5 times the dollar limit on contribution in
defined contribution plans -- currently $30,000); (b) the 10 employees with the largest ownership share in the company (having at least a one-half of one-percent ownership interest and earning more than $30,000 a year); (c) those with more than a five percent interest in the company; or (d) those with more than a one percent ownership interest in the firm who receive cash compensation in excess of $150,000. The stringency of this definition might be relaxed -- for example, instead of "10 employees" (in (b) above) the number might be reduced to five employees; instead of the "those with more than a five percent interest in the company" (in (c) above), the limit might be raised to 15 percent. In addition, the maximum number of employees to be included as key employees might be capped at a specified percentage of all employees -- perhaps 15 percent.

There is one drawback to reducing the stringency of the top-heavy definition. Top-heavy requirements were enacted to reduce perceived abuses within the retirement system -- i.e., to ensure that a disproportionate share of benefits did not go to a small group of owners and management personnel. The effect of reducing the stringency of the requirement might be to increase the concentration of benefits to a smaller group of employees. This concentration of benefits runs counter to the basic intent of legislation over the past decade.

Care must be taken in changing the basic definition of top-heavy so that the calculations do not become even more complicated and employers (who are just now coming to understand the existing definition) would need to become familiar with yet another new definition.

Alternative #9: Modify Section 415 Limits on Plan Contributions and Benefits
To limit the tax deduction in qualified plans on benefits for highly-compensated
employees, Section 415 of the Internal Revenue Code imposes limits on the amount of benefit that defined benefit plans can provide and on the amount of annual additions that can be made to defined contribution plans during a year. Pension plan service providers and small businesses complain that these limits are too low and complicated. They may, in some instances, discourage employers from offering qualified plans in the first place. In fact, for existing plans many service providers indicated that one of the most important reasons for plan termination was the fact that the Section 415 limits have been continually reduced, thus eliminating benefits for key employees.

The current defined benefit dollar limit was changed under TRA'86 to be related to an individual's Social Security retirement age. Thus, all employees born after 1954 have their dollar limit reduced for retirement prior to age 67. The age is different for those born before 1955. This new requirement is quite complex and not consistent with other requirements of the law mandating a normal retirement age of 65.64 Hence, consideration should be given to reverting back to prior law, under which the dollar limit reduction began for retirement prior to age 65.

In addition, the compensation considered for benefit calculations could be increased from its current limit of $200,000. Increasing the limit would increase the incentive for owner-operators (earning in excess of $200,000) to establish plans.

The drawback of these changes would be that more highly-compensated employees could receive higher benefits through defined benefit plans. These benefits

64This limit generated such a low maximum benefit at age 55, that a special exemption had to be written into the law for airline pilots. It might be asked: Why should individuals in small businesses be treated less generously than airline pilots? Further, certain government employees retiring at ages prior to 65 also are treated more generously than individuals in small businesses.
are tax-deferred, so there would be a resulting loss of tax revenue for the federal government.

**Alternative #10: Modify Social Security Integration Rules**

Congress has gradually tightened up the ability of firms to integrate pension benefits with Social Security (i.e., to offset pension benefits for employer-provided Social Security benefits). This has meant that firms have been less able to make higher contributions to plans for those employees whose salaries have exceeded the Social Security taxable wage base ($51,300 in 1990). These higher paid employees generally include the owner-operators and managers that make decisions about whether to form plans. Several pension plans service providers noted that the tightening of Social Security integration rules has adversely affected defined benefit plan formation and increased plan terminations.

One option would be to eliminate the 35-year limit on the three-quarter percent integrated portion of benefits in defined benefit plans, as specified in Section 401(l)(4) of the Internal Revenue Code. A similar limit has not been set on the number of years that an employer must pay Social Security taxes on an employee. Such a change would simplify the rules governing integration. At a minimum, this limit could be removed for career average pension plans. These plans already suffer from having a reduced

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65A career average pension bases benefits on each year’s compensation, thus having the effect of creating a benefit that is based on the average pay over a participant’s full career. A final average, or high average, pension plan bases benefits on a participant’s three to five years of highest average compensation. For example, a career average plan may give one percent of each year’s compensation to a participant who enters at age 30 and retires at age 65, this is equivalent to 35 percent of his average compensation over his full career. The same participant covered by a final average plan would receive 35 percent of his five highest years of compensation. With a five percent annual pay increase, the second formula would
percentage (.75 percent) for the excess benefit. Prior law permitted career average plans to have a higher excess percentage than final average plans. The recordkeeping necessary to keep track of the 35-year limit is substantially more complicated for career average plans.

The regulations on the reduction of excess benefits for early retirement could be simplified. For example, age 65 could be used as a reference point, rather than the variable age prescribed by Social Security law. In most instances, regulations require a normal retirement age of not greater than 65. It is not clear why the integration rules should use a different age.

Alternative #11: Modify OBRA'86 Age Discrimination in Employment Act (ADEA) Accruals

Several pension plan service providers have noted that ADEA accruals past normal retirement age have created a substantial unexpected unfunded liability for some small defined benefit plans. Many defined benefit plans gear their benefit formula toward a certain benefit percentage at age 65 and do not lend themselves to an accrual past normal retirement age. Further, benefits for employees older than age 65 may be substantially more expensive than those for younger employees. Employers could be permitted to either actuarially increase benefits or add five percent of compensation to the lump sum value of benefits. The benefit purchased by the five percent of pay could be added to the previously accrued benefit. The amount purchased by the five percent of pay could be calculated based on PBGC equivalence assumptions (see description above under full funding limitation recommendation).

give more than two and a half times as much benefit as the first formula.
D. Increase Knowledge of Small Businesses About Pension Plans and Expand the Availability of Simplified Plan Options

It is important to acknowledge that important steps have already been taken in recent years to simplify some aspects of pension plan establishment and administration. For example, the rapid expansion of prototype plans has substantially reduced the costs and complexity of setting up plans for small businesses. However, many small businesses are unaware of the many choices that are available at a relatively low cost. Hence, there is a need for added emphasis on disseminating information to small firms about the many choices that are available in establishing plans. Because of the constant formation of new small businesses, it is important that information about pension plan alternatives be regularly disseminated to the small business community. In addition, there is still much more that could be done to enhance and simplify the plan offerings that are available to small firms.

Alternative #12: Conduct Joint DOL/SBA Outreach to Inform Small Employers About Pension Plan Options

DOL and the SBA could expand outreach efforts to inform small employers about the many pension plan options available. While many small businesses are aware of some of the advantages of establishing qualified pension plans, they often lack specific knowledge about the many options that are available and the steps that they should go through in setting up plans. DOL and SBA could expand their efforts in providing information to small businesses about various options. This information could be provided directly to small employers and/or through pension plan service providers. An excellent example of this type of joint outreach effort is DOL and SBA's recent
publication entitled "Simplified Employee Pensions: What Small Businesses Need to Know." The Pension and Welfare Benefits Administration, of the Department of Labor, has also recently published an informational pamphlet which is a guide to ERISA as amended by the Retirement Equity Act of 1984 and TRA'86, entitled "What You Should Know About the Pension Law."

There are a variety of methods that could be used. The simplest would involve the development of a pamphlet that would serve as a guide to establishing qualified retirement plans in small businesses. This type of guide could be part of SBA's Directory of Business Development Publications. Such a guide should identify: (1) reasons for setting up plans (e.g., tax advantages, enhanced ability to compete for and retain employees, etc.), (2) types of plans that are available and the specific advantages/disadvantages of each plan type for small businesses, (3) specific steps that firms must undertake to establish plans, (4) what small businesses can expect to pay for setting up various types of plans, (5) advantages and disadvantages of using prototype versus individually-designed plans, and (6) additional sources of information and assistance that can be used by small businesses to set up plans. Such a guide could be disseminated directly to small businesses (i.e., through a direct mailing), through pension plan service providers, or be made available upon request through SBA, DOL, PBGC

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66SBA currently offers a publication to small employers through this directory which describes employee benefits as one part of the total compensation package and discusses proper management of benefits. This publication, entitled "Managing Employee Benefits," Publication Number PM 3, is an example of the types of "how to" publications that can be of assistance to small businesses.
SBA also might consider developing a video cassette that provides similar information as the pamphlet discussed above.

**Alternative #13: Increase Flexibility and Encourage Use of SEPs**

The Revenue Act of 1978 established simplified employee pensions, which were intended to be used by small employers as a low-cost method for starting a retirement plan. Many small employers are eligible to set up so-called "model" SEPs and can do so by simply completing the IRS Form 5305. Despite the ease and low-cost of such plans, many small firms who do not currently offer pension benefits have not established SEPs.

Several factors might explain the reluctance of small firms to establish SEPs. Most important are some of the restrictions that are imposed on these plans, which limit the eligibility of small firms or reduce the benefit to key employees of the firm. The cumulative effect of such restrictions limit the applicability and benefits of such plans.

The establishment of these plans by small businesses may also have been affected by the widespread availability of prototypes for both defined benefit and defined contribution plans. Prototype plans, as discussed in Chapter 3, substantially simplify the process (and cost) of setting up and administering plans. Small employers may feel that SEPs are only marginally easier to establish and administer than prototype plans, which provide the small firm with wider choices (and fewer restrictions) in tailoring plans to

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67 The IRS, DOL and PBGC have jointly issued a pamphlet entitled "Filing Requirements for Employee Benefit Plans" (Publication 1048), which details the reporting requirements for businesses with retirement plans. The guide discussed in this option could supplement this existing pamphlet and be available through the IRS upon request.

68 See Chapter 3 for a discussion of the specific limits on SEPs.
the specific needs of the employer and employees.

Some have suggested that efforts could be made by the federal government to increase the utility of SEPs to small businesses. Several changes appear to be needed. First, to make SEPs more appealing to small businesses, some of the restrictions on such plans could be reduced. An EBRI/AARP focus group session found that many small employers did not favor the stringent SEP participation requirements and vesting schedules.69 For example, immediate vesting requirements reduce the ability of small firms to use pension benefits as a method for retaining employees. By providing employers with some flexibility in limiting participation in SEPs and allowing for vesting over three (or possibly five) years, employers may be more encouraged to establish such plans.

Second, as proposed in the Pension Portability Act of 1987 (H.R. 1961, H.R. 1962 and S. 944), reporting and disclosure for SEPs could be further streamlined. However, without improving incentives for small firms to set up SEPs (by easing participation and vesting standards), simplification of reporting and disclosure is unlikely to increase the use of SEPs by small firms.70

Third, as proposed in the Retiree Health Benefits and Pension Preservation Act of 1989 (H.R. 1866) all businesses that do not offer a pension plan could be required to establish SEPs at the request of any employee.

Finally, there is a need to better inform small businesses about the availability and advantages of such plans. Increasing the knowledge of small businesses about SEPs


70Andrews, p. 139.
(and other low-cost methods for providing pension benefits for employees) could be done through direct contact with employers or through pension plan service providers. SBA/DOL's recent publication on SEPs is an important step in the direction of better informing small businesses about SEPs.

Alternative #14: Establish a Voluntary Federal Retirement Plan for Smaller Firms

The federal government could create a voluntary national retirement plan for small businesses that do not elect to set up a plan on their own. This proposal, which was suggested by an owner-operator in one of our case studies, has been recommended by a number of pension experts.

Such a plan might operate much like Social Security currently does, with the employer making additional deductions from those employees that choose to join the plan. A federal agency (perhaps within the Social Security Administration) could establish an independent trustee group that would manage and invest the fund. By establishing such a plan, small businesses would (in effect) join a single large plan, able to take advantage of economies of scale in administering such plans. Further, much of the reporting and disclosure requirements faced by private pension plans would be eliminated for these small firms. The costs of setting up plans and future revisions could be reduced or even eliminated for small firms.

There are several probable effects of such a proposal. First, there would be additional costs to the federal government. Such a proposal may also have a detrimental effect upon the willingness of small employers to form employer-sponsored plans and may cause some (perhaps many) small plan sponsors to terminate their plans. If plans
were terminated by employers in response to a national retirement program, the net result for some employees might be a reduction in overall benefit levels and decreased in choices available to employees.

A step beyond a voluntary national system would be to mandate that all employers provide pension benefits for their regular employees. Such proposals have been made in the past. For example, in 1981 the President's Commission on Pension Policy recommended that a "minimum universal pension system" be established for all employees over the age of 25 with one year of service and 1,000 hours of employment with the employer. The minimum contribution level was set at 3 percent of payroll and vesting was immediate.

Under such a proposal all employers would be required to provide pension coverage for their employees to supplement Social Security. Because small employers are much less likely to have a retirement plan than large employers, mandating provision of pension coverage would have a disproportionate impact on small employers. The key advantage to a mandatory system would be that all (or a large number of) workers would be provided for and receive the tax advantages of pension contributions.

However, there are several major drawbacks, which may be particularly felt by small firms. Some of the key problems include the following:

...Unlike tax expenditures, mandating does not work in conjunction with market forces. Consequently, firms have to offer pension coverage even if the costs of providing a plan outweigh the advantages. Employers unable to raise their prices or pass on their pension expense to their employees would be forced to reduce other expenditures, change their method of production, lower their profit, or go out of business.71

Some have argued that the cost of mandatory pension benefits would eventually be

passed on to the employee in the form of lower wages. It is likely that there would be some effect on unemployment, with some workers losing jobs because firms are forced to go out of business or lay off workers whose wages cannot be lowered (e.g., those at the minimum wage). It would also reduce the flexibility of employers to compensate employees with either increased wages or other benefits. Finally, in the long run, a mandatory retirement system may place the American small businesses at a competitive disadvantage in the world market place. These disadvantages argue strongly against such a mandatory approach.

E. Conclusions

The alternatives discussed in the preceding sections were intended to overcome some of the major problems that small businesses have had with forming or administering retirement plans. These alternatives focussed principally on reducing the burden and costs of offering pension benefits in small firms which, in turn, may lead to expansion in the pension plan coverage in small firms. The question that remains is whether, in fact, such changes would lead to increased coverage of workers in small businesses.

The alternatives presented in this chapter, while not certain to increase the level of coverage in small firms, are intended to specifically address some of the key reasons that small firms do not offer retirement benefits. Some of the reasons for not offering pension benefits -- and the corresponding options that are intended to address the specific problem -- include the following:

- **Confusion and/or lack of knowledge about pension plans:** Small businesses, which generally do not have an in-house employee benefits manager and may not be able to afford expert assistance from an employee
benefits specialist, often lack the knowledge that is necessary to establish a plan. This problem is further exacerbated by the frequent and complicated changes in regulations. The following alternatives are intended to address this problem:

- **Alternative #1**: Slow the Pace of Regulatory Change
- **Alternative #2**: Mandate that the IRS and other Regulators Publish New Regulatory Requirements Prior to the Effective Date of New Laws
- **Alternative #12**: Conduct Joint DOL/SBA Outreach to Inform Small Employers About Pension Plan Options

**Limits on benefits to owners and key employees:** Recent changes in regulations have reduced some of the benefits to owners and key employees of offering pension benefits to rank and file employees. The following alternatives are intended to address this problem:

- **Alternative #7**: Modify the OBRA'87 Full Funding Limitation
- **Alternative #8**: Simplify or Eliminate Top-Heavy Requirements for Small Plans
- **Alternative #9**: Modify Section 415 Limits on Plan Contributions and Benefits
- **Alternative #10**: Modify Social Security Integration Rules
- **Alternative #11**: Modify OBRA'86 Age Discrimination in Employment Act (ADEA) Accruals

**High Cost of Administering Plans:** The per participant costs of plan establishment and administration are typically much higher for small plans than larger plans. Recent changes in regulations have increased the costs of plan administration by increasing reporting requirements and necessitating that plans be amended. Some small firms do not have sufficient cash reserves to establish or maintain a plan. The following alternatives are intended to address this problem:

- **Alternative #3**: Provide a Tax Credit toward Plan Administration
- **Alternative #4**: Reduce IRS User Fee Schedule
- **Alternative #5**: Reduce PBGC Premiums for Fully Funded Plans
- **Alternative #6**: Reduce Filing Requirements
Inadequacy of Current Plan Options: Some small firms may find that existing plans -- particularly low cost prototype plans and SEPS -- do not have sufficient flexibility to meet the specific needs of the firm or its employees. While this problem may be a function of small firms not being fully aware of all the options that are available, it may also reflect the need for continued development of pension plan alternatives to meet the needs of small firms. The following alternatives are intended to address this problem:

- Alternative #12: Conduct Joint DOL/SBA Outreach to Inform Small Employers About Pension Plan Options
- Alternative #13: Increase Flexibility and Encourage Use of SEPs
- Alternative #14: Establish a Voluntary Federal Retirement Plan for Smaller Firms

Unpredictability: Given the recent past, many small businesses are concerned about the likelihood that regulations governing pension plans will change in the near future. They fear that some unforeseen liability or added administrative cost will be added to the plan in the future. The following alternative is intended to address this problem:

- Alternative #1: Slow the Pace of Regulatory Change

Given the variety of factors that go into the decision of whether to offer pension benefits, it is not certain that any of the alternatives discussed above would substantially change the level of coverage in small businesses. However, given the slow growth in plan formations in recent years and the acceleration in the rate of plan terminations, it is unlikely that in the absence of some change in pension plan regulations that there will be a major increase in the level of pension plan coverage in small firms.
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