ADMINISTERING AUTOMATIC IRAS

PREPARED FOR AARP

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INTRODUCTION

In a paper prepared for AARP on May 9, 2007, we noted that the following issues and objectives can be identified with respect to the development of a workable Automatic IRA system: (1) an Automatic IRA system will be more efficient if the number of accounts established on behalf of any individual worker can be minimized; (2) flexibility for employers may reduce employer objections to the mandates imposed on them by Automatic IRAs, but may increase the complexity of the Automatic IRA system; (3) a workable Automatic IRA system will have adequate record keeping, reporting, and oversight; and (4) the power of inertia may work either for or against the administrability of an Automatic IRA system.

This paper continues the research on the administration of Automatic IRAs and articulates some specific additional goals for a workable Automatic IRA, discusses two possible models for central administration of Automatic IRAs, identifies some specific design considerations, and provides a detailed look at the duties and responsibilities of employers under an Automatic IRA system.

EXECUTIVE SUMMARY

Goals

- Four primary goals should drive the design and implementation of Automatic IRAs:
  - Keep account fees as low as possible;
  - Ensure portability of accounts when employees change jobs;
  - Establish only one account per individual, to the maximum extent possible; and;
  - Minimize the administrative burdens on small employers.

- These goals can be facilitated by using a central administration system that streamlines some of the administrative duties that might otherwise fall to employers or to the Automatic IRA service providers.

Central administration of Automatic IRAs

- The central administration function does not have to be provided directly by the Federal government, but could be outsourced to a public-private partnership or even contracted to a purely private entity. However, the Federal government will have some oversight responsibility in any event.

- There are two possible models that could be used – one in which the central administrator has primary responsibility for recordkeeping and reporting with respect to default Automatic IRAs and the other in which the central administrator has responsibility for recordkeeping and reporting for all Automatic IRAs.

Design considerations

- A single central administrator should be the primary record keeper and reporter for all Automatic IRA participants. In addition, the central administrator should maintain a TSP-like internet web site that can be accessed by participants for periodically updated information about their accounts.

- One way of facilitating the flow of information through the central administrator (and possibly to ease administrative burdens for employers) would be to have all money flow through the central administrator.

- The central administrator should hold Automatic IRA contributions for a period of time before transmitting them to the Automatic IRA service provider. The money could be invested in a safe investment option during this holding period. The holding period would ease the administrative burdens associated with errors that may be made and would also allow employees who failed to opt out a period of time to make an election not to participate without undue additional costs imposed on the system.

Employer responsibilities under Automatic IRA

- There are nine separate steps for employers to satisfy their initial responsibilities under Automatic IRAs. If the employer chooses to provide an Opt-Out arrangement and uses the default Automatic IRA service providers, some of the steps can be streamlined.

Costs of Automatic IRAs

- The overall costs of Automatic IRAs will depend heavily on both design of the system and on the operational models that are chosen to implement the program. The Federal Thrift Savings Plan had annual expenses of 0.03 percent of plan assets for 2006. However, it is unlikely that Automatic IRAs can achieve this level of expense for two reasons: (1) forfeitures under the TSP are used to offset plan costs, but these forfeitures will not occur with Automatic IRAs and (2) Federal agencies bear some of the TSP costs in their budgets and these costs are not reflected in the overall TSP costs.

- Depending upon the operational model selected, Automatic IRA contributions directed to the default Automatic IRA service providers will likely face lower overall costs due to scale economies.

I. Goals For a Workable Automatic IRA Program

Automatic IRAs are intended to increase participation in a retirement savings program by individuals who do not have access to an employer-provided retirement plan and who are unlikely to utilize existing incentives, such as IRAs, to save for retirement on their own. Thus, these individuals lack not only access to employer-based retirement savings, but also comprise a segment of the workforce that is demographically unlikely to save for retirement on their own. These individuals are likely to be lower paid, younger, and have higher job turnover than the average worker with access to employer-provided retirement savings.

The demographic profile of the likely Automatic IRA participant suggests that these workers will likely make relatively small Automatic IRA contributions resulting in small initial Automatic IRA account balances. In addition, these individuals may change jobs, leading to the possibility of Automatic IRA participation through multiple employers. Small individual account balances are more likely to be eroded by account fees than larger accounts. An employee earning $20,000 of compensation per year and making the 3 percent of compensation default contribution to an Automatic IRA will have contributions equal to $600 per year. At an 8 percent rate of return on the account balance, the employee will earn $48 on the contributions. Assuming an account fee of 2.0 percent of the account balance, the employee will have an account balance of $3,730 after five years. On the other hand, if the account fees are 1.0 percent of the account balance, then the employee's account balance will be $3,770 after five years.

Three particular features of an Automatic IRA program can help to increase account balances.

Keeps account fees as low as possible

A variety of factors will affect Automatic IRA account fees, including account design and enrollment, account management, reporting and recordkeeping, and customer services. The key point to consider is that account balances will be inversely proportional to the fees charged with respect to the accounts. Thus, the higher the fees imposed, the lower the ultimate account balances available for retirement income. An important goal in the design of Automatic IRAs is to reduce, to the maximum extent possible, the fees that are charged per account.

Ensure portability of accounts when employees change jobs

Because the likely Automatic IRA participant is likely to have higher job turnover than the average worker, an Automatic IRA program should build portability into the system so that Automatic IRA participants have an account that follows them when they change jobs.

One account per employee

The first two features lead to the conclusion that Automatic IRAs will be most effective if the program ensures that there will be one account established per employee. A single account per employee will result in lower overall administrative costs than multiple accounts and will facilitate the portability of accounts when an employee changes jobs.

Minimize administrative burdens on small employers

The inherent dilemma with Automatic IRAs is that success of the program hinges on the involvement of employers who have chosen not to offer a qualified retirement savings plan for their employees. These employers will generally be smaller, less stable businesses and increased costs and administrative burdens can be a major issue. Thus, an Automatic IRA program needs to be structured in a way that minimizes these costs and burdens.

Automatic IRAs require employers to withhold contributions from employee pay and transmit them to the appropriate place. This can be done either by using the existing payroll tax system for withholding and reporting of contributions or by creating a separate system that is used only for Automatic IRAs. Using the existing payroll tax system will impose fewer overall costs in implementing Automatic IRAs.

In any event, employers will have increased responsibilities for withholding, transmitting, and reporting employee contributions to Automatic IRAs and the goal of the system should be to minimize the costs associated with these responsibilities.

Furthermore, an Automatic IRA program that minimizes administrative burdens for small employers is likely to employ certain centralized administrative features that small employers might view as excessive governmental involvement.

II. Central Administrator Model

The goals of a workable Automatic IRA system articulated above can be facilitated by the use of a central administration system that streamlines some of the administrative duties that might otherwise fall to either employers or to the Automatic IRA service providers.[1] It is important to remember that this central administration function does not have to be performed by an agency of the Federal government, but could be outsourced to a public-private partnership or even a purely private for-profit entity.

Two possible workable models include: the TSP II model contained in the introduced Automatic IRA bills and the model below referred to as the central intermediary model. The flow of funds under these two models is reflected in Flow Charts 1 and 2, below.

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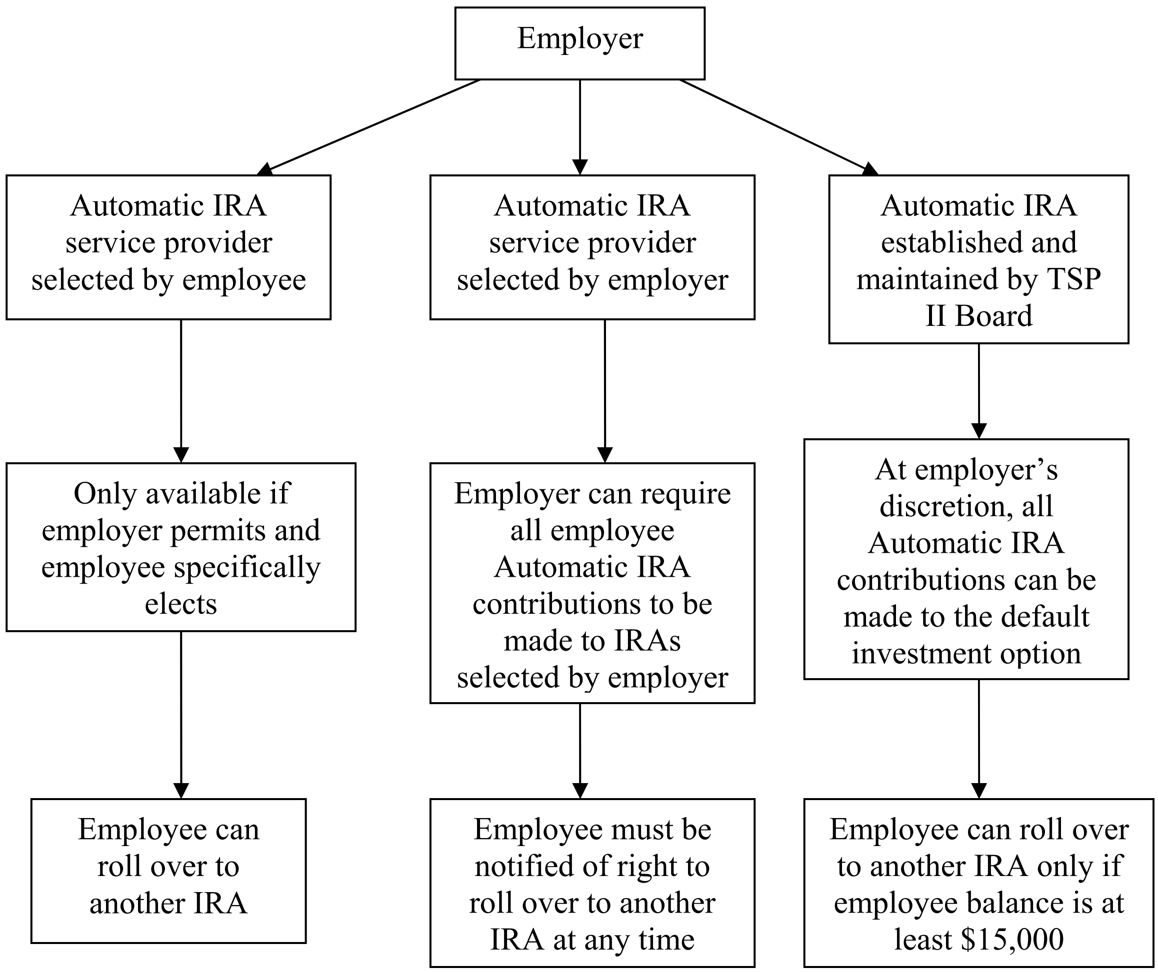
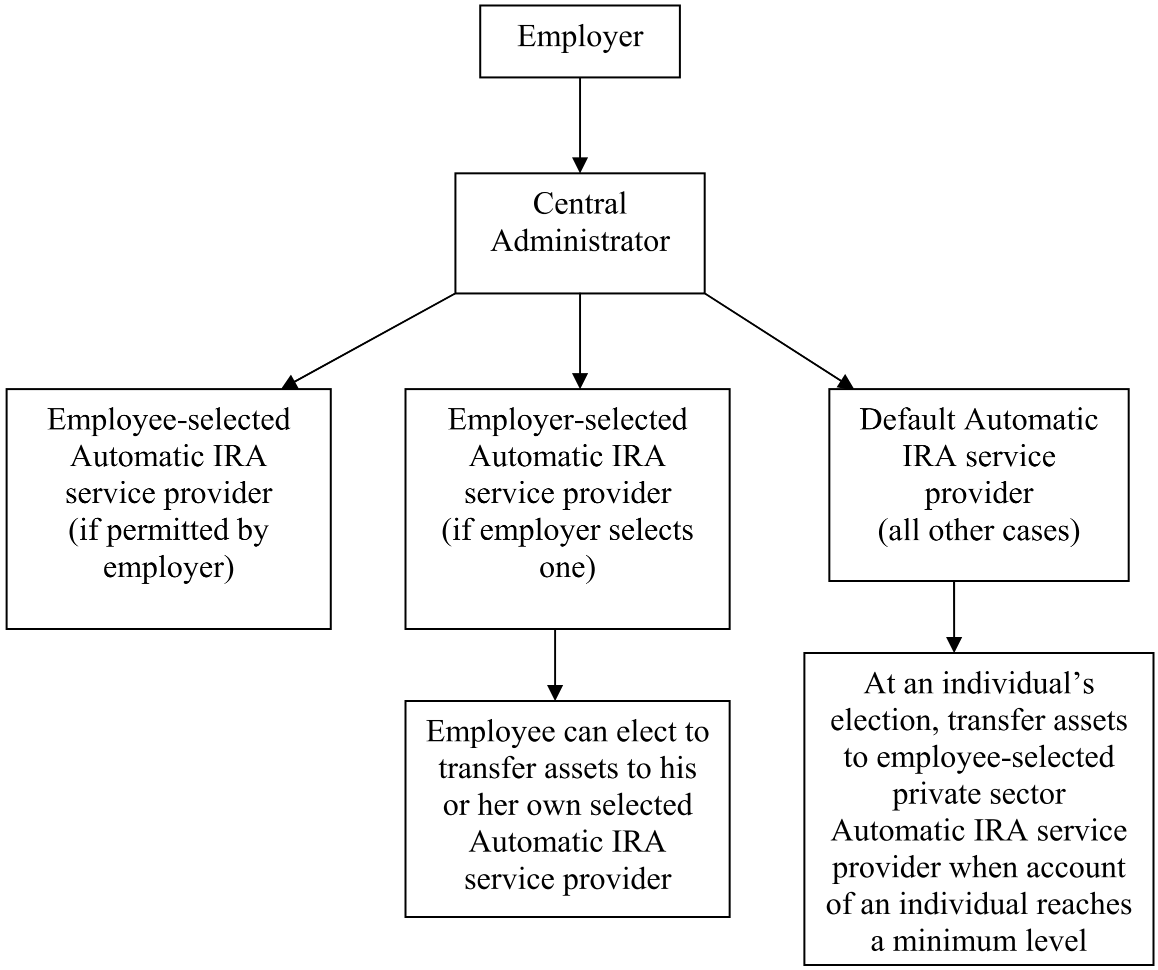
[1] Much of the debate about central administration that occurred in the context of discussion about Social Security individual account plans is relevant here. See, for example, United States General Accountability Office, *Implementation Issues for Individual Accounts*, GAO/HEHS-99-122, June 23, 2005.

Flow Chart 1 – TSP II Model



Flow Chart 2 – Central Intermediary Model



The primary difference in the two models relates to the flow of money and information. Under the TSP II model, if an individual employee selected his or her own Automatic IRA service provider or the employer selected an Automatic IRA service provider for all of its employees, then the employees' contributions are transmitted directly (through the employer's payroll deduction system) to the appropriate Automatic IRA service provider. Information with respect to these contributions would be reported on at least an annual basis directly to the participant by the Automatic IRA service provider.

On the other hand, if the employer uses the default Automatic IRA system, then employee contributions (i.e., those Automatic IRA contributions for which the employee either did not elect to opt out of the Automatic IRA program or did not select (or was not offered) his or her own Automatic IRA service provider) would be withheld and transmitted with the employer's payroll taxes. These contributions would go to the TSP II Board, which would establish Automatic IRA accounts for these default contributions.

Reporting with respect to these accounts would be done by the default Automatic IRA services providers.

Under the central intermediary model, the central administrator would provide reporting to all Automatic IRA participants, including those employees who selected their own Automatic IRA service provider and those whose employer selected an Automatic IRA service provider on their behalf.

This approach could provide several advantages. First, information with respect to Automatic IRAs of employees would be centralized and would help facilitate the one Automatic IRA per taxpayer goal. Second, the economies of scale that are provided by a single source for reporting and recordkeeping would be achieved for all Automatic IRA participants and presumably would help to keep costs reduced. Third, an internet web site could be established that would be available to all employees participating in Automatic IRAs. This approach would require the reporting of Automatic IRA contributions to the central administrator by employers through the payroll tax reporting system and the reporting of investment income to the central administrator by Automatic IRA service providers.

Under either model, the central administrator authority would be responsible for the following:

1) entering into contracts with default Automatic IRA service providers,
2) ensuring that the costs of investment management and administration are kept to a minimum,
3) considering the use of investments that involve passive management and that seek to replicate the performance of a portion of the market,
4) establishing procedures to minimize the administrative burdens on employers,
5) ensuring that only one Automatic IRA will be established per taxpayer,
6) developing a model notice for employees,
7) providing uniform forms for enrollment, and
8) establishing a web site or other electronic means for employers to obtain information on Automatic IRAs and to obtain required notices and forms.

Although not specifically articulated in the introduced bills, the central administrator should also be responsible for providing periodic reports to participants of the investment performance and fees for their accounts. Default Automatic IRA service providers would provide information directly to the central administrator, which would then generate reports for individual Automatic IRA participants. This type of system would enable the establishment of a TSP-like accessible website with periodically updated investment information for employees.

Automatic IRAs present a conundrum. A strong central administrative authority can make it easier for employers and service providers to comply with the Automatic IRA requirements. A strong central administrative authority can also help achieve the goals articulated above – a single Automatic IRA established per employee and low administrative fees. On the other hand, as the role of the central administrator increases, so may the employer objections to what they view as an intrusive governmental presence. Further, service providers may feel threatened that their ability to compete for Automatic IRA business will be diminished if there is too large a central administrator role.

Some of these objections might be muted if the central administrative authority is a private sector entity to which the responsibilities of Automatic IRA administration are contracted. However, there is clearly a need for government oversight of the Automatic IRA program that will require some Federal involvement.

III. DESIGN RECOMMENDATIONS

Based on the discussion and analysis above, certain design features for an Automatic IRA program are recommended. These design features are intended to help achieve the overall goals of Automatic IRAs – increased access to low-cost retirement savings for individuals who do not have access to an employer retirement plan.

These design features are also intended to overcome some of the challenges in addressing the needs of the target population when implementing the Automatic IRA system. Specifically, it is important to remember that Automatic IRA participants are likely to be lower earning employees who are younger and face greater job mobility.

The goal of minimizing costs of an Automatic IRA program leads to the suggestion that ideally, there should be one Automatic IRA account established per individual. The recordkeeping needed to achieve this goal strongly suggests the need for strong centralized administration of the Automatic IRA program.

1. The central administrator should be the primary record keeper and reporter for all Automatic IRA participants. In addition, the central administrator should maintain a participant-accessible web site to provide periodically updated information about Automatic IRA accounts.

Scale economies can be achieved by using a central administration function for Automatic IRAs. This function would be similar to the role that the TSP plays for Federal employees participating in the Federal Thrift Savings Plan.

Under this model, instead of reporting directly to Automatic IRA participants, Automatic IRA service providers would report information to the central administrator, which would maintain master records for all individuals participating in Automatic IRAs. The central administrator would have responsibility for reporting periodically to Automatic IRA participants. In order to keep costs low, only one paper report per year should be required.

However, the central administrator should maintain an internet web site that provides access to periodically updated information with respect to each Automatic IRA participant. This information would include contributions and investment earnings and would function similarly to the TSP web site for Federal employees.

2. In order to facilitate central administration of Automatic IRAs, all money should flow through the central administrator.

A system in which all Automatic IRA amounts withheld from employee pay is transmitted in the same manner provides a simpler system for employers. Thus, if all withheld amounts were transmitted to the central administrator and then transmitted to the Automatic IRA service provider, employers would have a single set of procedures with which to comply.

However, this approach might also cause some concerns and potential problems with stakeholders in the Automatic IRA program. For example, some employers may prefer to have the option of transmitting Automatic IRA contributions directly to an Automatic IRA service provider that the employer selects.

Under the Automatic IRA bills as introduced, only default contributions are transmitted through the TSP II Board (the central administrator). If an employee selects his or her own Automatic IRA service provider or the employer selects a service provider for all of its employees, the money is directly transmitted to the service provider.

During the first three months of New Zealand's KiwiSaver program (also an auto-enrollment retirement savings program), more than 213,000 people enrolled compared to 21,100 electing to opt out of enrollment. Of these 213,000 people, 102,000 had actively chosen a provider and went directly to the provider to enroll, 67,000 actively chose a provider and enrolled through their employer, and 44,000 did not make a decision and were automatically enrolled. The KiwiSaver data shows a much higher than estimated take-up rate. However, the New Zealand government is providing significant incentives, including a $1,000 kick-start contribution, to encourage enrollment.

3. Whether or not design feature 2 is adopted, the central administrator should hold funds for a period of time before transmitting them to the appropriate Automatic IRA service provider.

There should be a period of time (e.g., 30-90 days) after Automatic IRA contributions have been transmitted to the central administrator during which they are held by the administrator in a safe investment option. This would give the central administrator time to sort through issues that may arise. For example, employees who are automatically enrolled because they failed to opt out of enrollment may decide that they do not want to participate and, as soon as they realize that amounts have been withheld from their pay, they may submit a form to their employer to opt out of participation.

The central administrator may need to determine whether an employee already has an Automatic IRA and take steps to ensure that the employee's contributions are directed to that account (consistent with the goal of having one Automatic IRA account per individual).

New Zealand's KiwiSaver has a 90 day period for new employees when contributions are held before being transmitted to a KiwiSaver provider.

A relatively short period of time during which the Automatic IRA contributions are held in a pooled investment account would enable the central administrator to address these types of issues and this might lower the overall costs of administration that might otherwise be imposed.

IV. Employer Responsibilities

As a means of providing further depth to the understanding of how Automatic IRAs will impact small employers, outlined below are the steps that employers must take if Automatic IRAs are enacted.

Step One. Determine whether the employer is exempt from the Automatic IRA requirements

For a calendar year, the following employers would be exempt from offering Automatic IRAs to employees:

- Employers that did not have more than 10 employees earning at least $5,000 in compensation in the preceding calendar year

  Drafting issue – unlike the test for new employers (see next bullet), the bill does not specifically state that this determination is made on any day during the preceding year. Employers need to know when to apply this test (e.g., at the end of the year, on each day during the year, or at some other time)
- Employers that were not in existence at all times during the preceding two calendar years and did not have more than 100 employees earning at least $5,000 in compensation on any day during the preceding two calendar years
- Employers that are tax exempt and are a church or convention or association of churches

  Although this test technically does not exempt the employer from the Automatic IRA requirements, it is an effective exemption by exempting all employees of such an employer from the requirement that Automatic IRAs be offered
- Governmental employers

  Although this test technically does not exempt the employer from the Automatic IRA requirements, it is an effective exemption by exempting all employees of such an employer from the requirement that Automatic IRAs be offered

For purposes of determining the number of employees on any day during a year, the rules that apply to SIMPLE plans apply. Thus, all members of the same family are treated as one individual, and an employer includes any predecessor employer.

Issues – What happens if employer's status as exempt changes from year to year? For example, what if the employer has 15 employees in year one earning more than $5,000 in compensation and then has 9 employees in years two and three? It seems as if the rule should be that, once an employer is subject to the Automatic IRA requirements, *the employer does not subsequently become exempt. This would be too disruptive for employees. Alternatively, a rule could be applied that says that an employer must drop below the applicable employee threshold for a period of time (e.g., two years) before the employer is no longer required to continue offering Automatic IRAs.*

The determination of whether an employer has a specified number of employees on any day during a calendar year will be relatively straight forward in the case of very small employers, but could be more difficult to determine for new employers near the 100-employee cutoff.

The introduced bills incorporate a related employer aggregation rule for purposes of determining the number of employees of the employer. Thus, the employees of related corporations and partnerships or sole proprietorships under common control would be treated as employees of a single employer for purposes of the thresholds for Automatic IRAs.

Step Two. Determine whether employees (new or existing) are eligible to participate in an Automatic IRA.

Note: An employer is permitted to offer Automatic IRAs to all employees and skip this step.[2]

Under New Zealand's KiwiSaver program, only new employees of an employer after the effective date are required to be provided with an Opt-Out arrangement (see the discussion below about the difference between Opt-Out and Opt-In arrangements). Existing employees have the right to participate in an Opt-In arrangement under which the employee elects to participate in the KiwiSaver program. Under Automatic IRAs, all employees (whether new or existing) are required to be offered Automatic IRAs (unless they are not eligible or are otherwise excludable employees). For existing employees, participation on an Opt-Out basis in Automatic IRAs might result in inadvertent reductions in take-home pay as employees fail to make an election not to participate in an Automatic IRA. On the other hand, applying different rules to a new or existing employee increases complexity for employers.

An employee is eligible to participate in an Automatic IRA (1) if the employee was not eligible to participate in a qualified plan of the employer during the preceding calendar year, (2) it is reasonable to assume that the employee will not be eligible to participate in a qualified plan of the employer

[2] While employees who are eligible to participate in an employer's qualified plan are not precluded from participating in an Automatic IRA program of the same or a different employer, the employee is subject to the income phaseouts under section 219 for their contributions. In addition, any other IRA contributions made by an employee will also be taken into account.

during the current calendar year, and (3) if the employee is not an excludable employee.[3] If an employee has satisfied a qualified plan's eligibility requirements as of the last day of the preceding calendar year, the employee is treated as eligible to participate in the employer's qualified plan.

Excludable employees are defined as:

- Employees who are included in a collective bargaining unit and retirement benefits have been the subject of good faith bargaining;
- Employees who are nonresident aliens and who do not have any U.S. source earned income;
- Employees who have not attained age 18 before the beginning of the calendar year;
- Employees who have not completed at least three months of service with the employer;
- Employees who have not attained age 21 and completed at least one year of service with the employer in the case of an employer whose qualified plan generally excludes such employees from participation;
- Employees who are eligible to make salary reduction contributions under a section 403(b) annuity arrangement; and
- All employees if the employer maintains a SIMPLE arrangement.

Step Three. Determine whether to adopt an Opt-In or Opt-Out arrangement.

An employer must decide whether to adopt an Opt-In or Opt-Out arrangement. Under the Opt-In approach, an employee generally is required to make an explicit election either to participate or not to participate in an Automatic IRA. The employer is required to take all reasonable actions to secure an explicit election from an employee to whether the employee elects to participate. Under the Opt-Out approach, the employee is presumed to have elected to participate in an Automatic IRA unless the employee makes an explicit election to opt out of such coverage (see the further discussion below).

The primary difference between the Opt-In and Opt-Out approach is the level of effort required by an employer to secure elections from employees. With the Opt-In approach, an employer is required to use "all reasonable actions to solicit from all employees eligible to participate in the arrangement an explicit election to either participate or not to participate in the arrangement."[4]

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[3] An employer's plan will not be treated as a qualified plan for Automatic IRA eligibility purposes if the plan has been frozen as of the first day of the preceding calendar year or, in the case of a plan with discretionary contributions, there have been no contributions made to the plan for at least a two plan year period ending before the calendar year preceding the current year and it is not reasonable to assume that contributions will be made for the calendar year preceding the current year.

[4] S. 3952, proposed sec. 408B(b)(2)(F)(i).

The following two charts detail the steps that must be taken under either the Opt-In or Opt-Out approach to Automatic IRAs.

Figure 1 – OPT-IN ARRANGEMENT

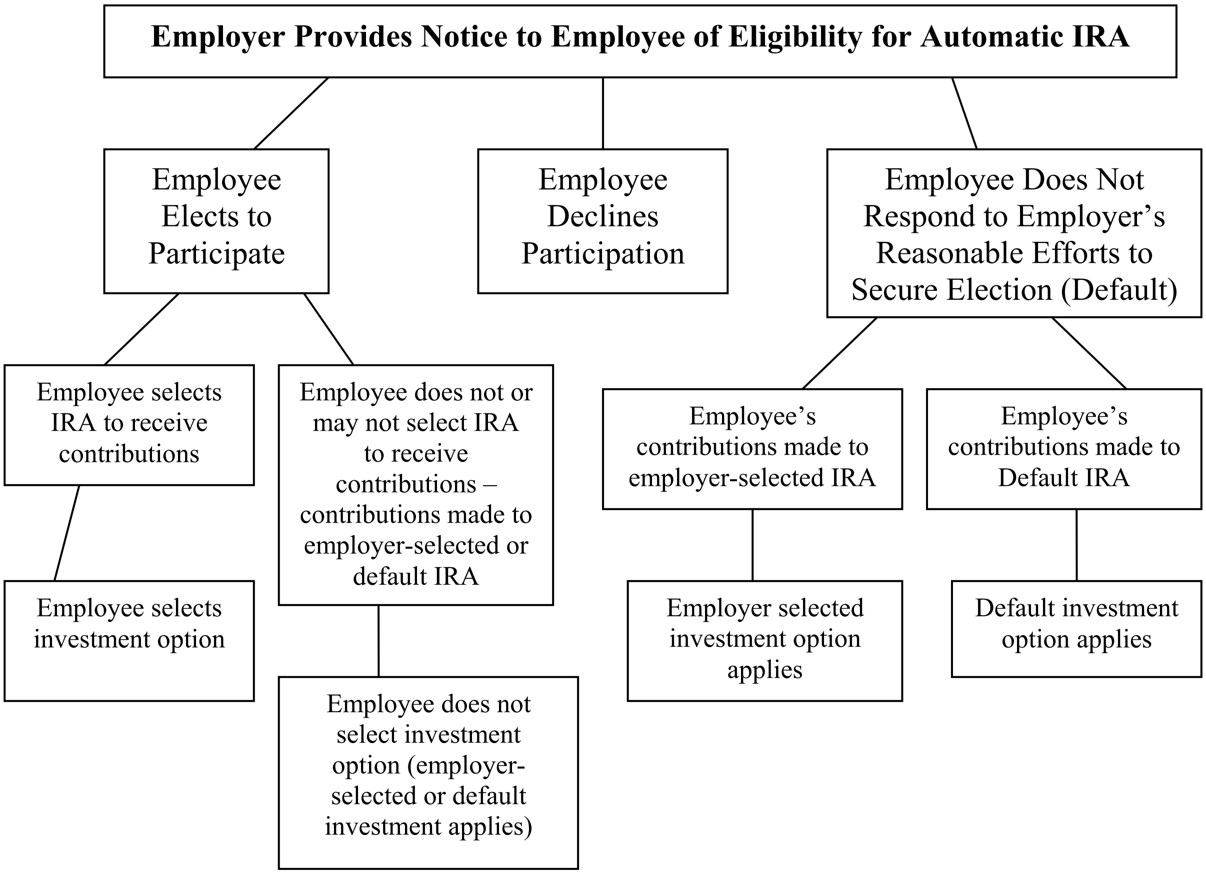
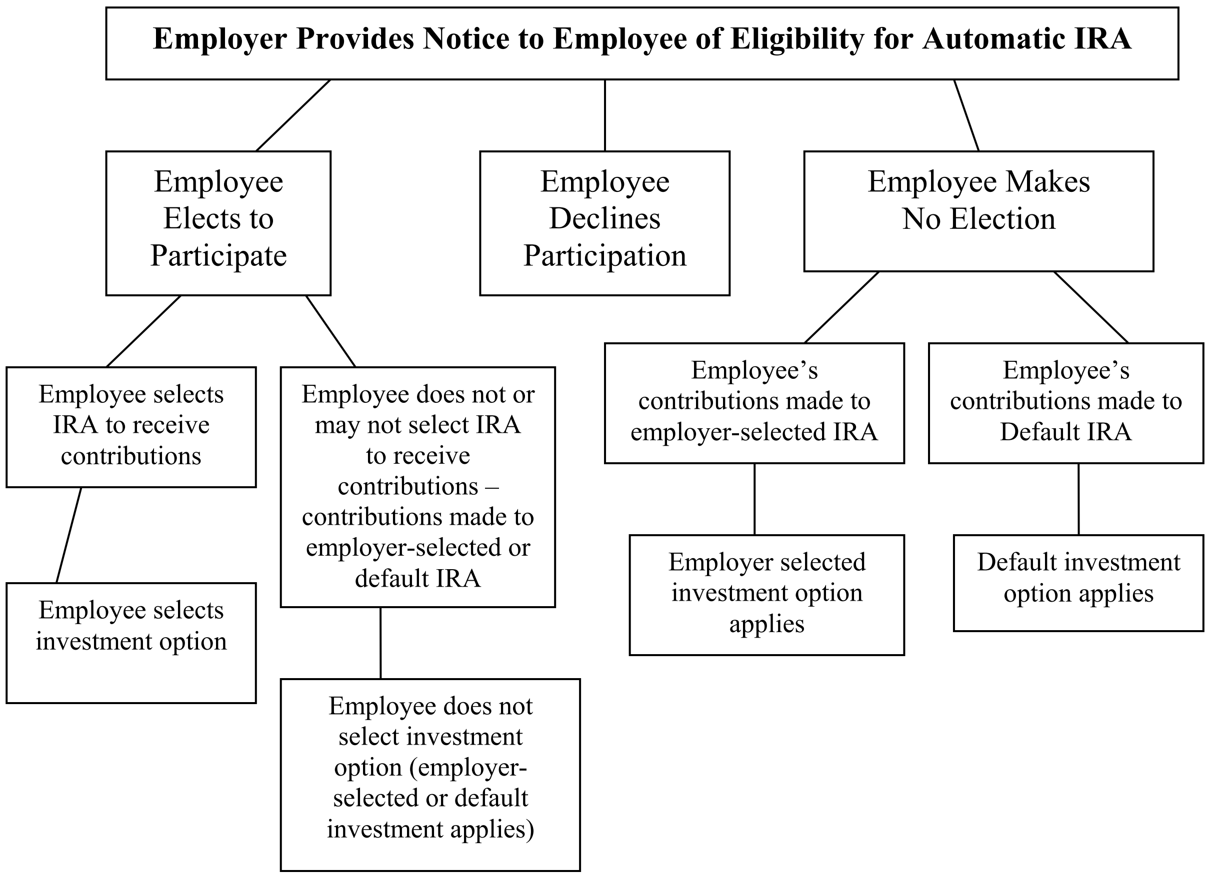


Figure 2 – OPT-OUT ARRANGEMENT



Step Four. Determine whether to select an Automatic IRA service provider (optional).

There are three ways in which employee contributions can be deposited – to an employee-selected Automatic IRA service provider (if permitted by the employer), to an employer-selected Automatic IRA service provider, or to a default Automatic IRA service provider identified by the central administrator.

Employers can choose to direct all employee contributions to an Automatic IRA service provider it selects. An employer might do this to utilize a financial institution with which the employer already has an established relationship. If the employer permits employees to designate their own Automatic IRA service provider, the employer could choose to deposit all other employee contributions to its designated Automatic IRA service provider.

Normally, employers would be concerned about selecting an Automatic IRA service provider that its employees are required to use because of potential fiduciary liability issues. However, fiduciary liabilities under ERISA are waived for anyone who otherwise would be a fiduciary as of the date that is seven days after notice has been given to an employee that an Automatic IRA has been established on behalf of the employee. This rule is similar to the rules that apply to SIMPLE retirement plans.

If an employer chooses to direct employee contributions to an Automatic IRA service provider selected by the employer, then all employees must also be notified in writing that they have the right to transfer their balances without cost or penalty to another Automatic IRA service provider.

The New Zealand KiwiSaver program operates in a similar manner. Employers pay employee contributions to New Zealand Inland Revenue, which directs them to the KiwiSaver scheme provider selected by an employee, by an employer, or to a default scheme provider.

If an employer opts to select an Automatic IRA service provider, then the employer will have the following additional responsibilities:

- Providing information to its employees concerning the investment options and performance under the Automatic IRA chosen by the employer,[5]
- Notifying employees of their right to transfer their Automatic IRA account balances to an Automatic IRA service provider of their choosing; and
- Notifying the central administrator if the employer changes Automatic IRA service providers or decides to no longer utilize their own Automatic IRA service provider.

Step Five. Provide notice to employees of the right to participate in Automatic IRAs.

The employer must provide notice to employees of their opportunity to participate in an Automatic IRA and the maximum amount that can be contributed to an IRA on an annual basis. If the Automatic IRA arrangement of the employer includes an automatic enrollment arrangement, then the notice must be a model notice developed by the Secretary of the Treasury, in consultation with the central administrator (TSP II Board).

The notice will permit employees to elect to participate in the Automatic IRA arrangement or to modify an election under an Automatic IRA arrangement, including

[5] The draft Automatic IRA legislation does not specifically require this information to be provided to employees, but it is logical to assume that employees will need to be provided this information in order to make an informed decision.

the amount of contributions made to an Automatic IRA and the way that Automatic IRA assets are invested.

This notice must be provided before the 60-day election period. The 60-day election period includes the 60-day period before the beginning of each calendar year and the 60-day period before the first day an employee is eligible to participate.

> *Employees can be excluded from participation if they have not been employed by an employer for at least three months. Thus, for new employees, the notice would be not required to be provided until an employee had been employed with the employer for one month. If an employer permits all employees to elect to participate in an Automatic IRA without regard to their length of service with the employer, then the notice would have to be provided when the employee is hired. As a practical matter, the employer can satisfy the notice requirement for new employees by including the notice in the paperwork provided to employees when they are hired.*

Step Six. If the employer does not have an Opt-Out arrangement, the employer must follow up with employees who do not respond to the notice.

If the Automatic IRA arrangement of the employer is an Opt-In arrangement, rather than an Opt-Out arrangement, then the employer is required to take all reasonable actions to solicit an explicit election from each employee to either participate or not to participate in the Automatic IRA arrangement.

> *If the employer adopts an Opt-Out arrangement, the employer is not required to take this additional step. There is a trade-off for employers. If they adopt an Opt-Out arrangement, the employer's responsibilities to secure employee elections are reduced; however, it is more likely under an Opt-Out arrangement that employees will be enrolled in an Automatic IRA in which they did not wish to participate and the employee may subsequently elect out of participation, increasing the burdens on the employer.*

Step Seven. Accept election forms from employees and begin withholding Automatic IRA contributions from the pay of electing employees.

The employer is required to process the election forms submitted by employees. Automatic IRA contributions are withheld from employee pay and transmitted to one of three Automatic IRA service providers – one selected by an employee (if the employer permits), one selected by the employer (if the employer elects to select one), or to the default Automatic IRA service provider. If employee contributions are transmitted to a default Automatic IRA service provider, they will be transmitted with the employer's payment of payroll taxes to the Federal government and then will be disbursed to the default Automatic IRA service provider.

> *Withholding and transmitting Automatic IRA contributions will be easier for employers who process their payroll electronically and for those who offer direct deposit options to their employees. According to a 2006 National Federation of Independent Business survey of small businesses, at least 50 percent of employers with at least 10 employees remit their payroll taxes electronically. In addition, 41.5 percent of employers with 10-19 employees and 54.5 percent of employers with 20-249 employees offer direct deposit of payroll checks. 52.5 percent of employers permit their employees to direct deposit amounts into more than one account. These statistics suggest that the physical processing of withheld amounts attributable to Automatic IRA contributions will not be particularly burdensome for small employers.*
>
> *Note: if the central intermediary model is adopted, then all employee contributions could be transmitted with an employer's payroll taxes.*

Under the introduced bills, if the employee is permitted to select his or her own Automatic IRA service provider, the employer is required to transmit the payments directly to the service provider.

> *The administrative burden associated with directing Automatic IRA contributions to service providers selected by employees will depend upon whether the employer uses direct deposit of payroll checks; if the employer does not use direct deposit, this will be a much more burdensome requirement for employers. On the other hand, it is unlikely that an employer would permit employees to select their own Automatic IRA service provider unless the employer uses direct deposit.*

If the employer has selected its own Automatic IRA service provider, then all employee contributions that are withheld will be directed to this single service provider unless the employer also permits employees to elect their own Automatic IRA service provider. In addition, if an employer selects its own Automatic IRA service provider, it is required to provide notice to employees that they have the right to transfer their account balance without cost or penalty to another Automatic IRA service provider.

> *Under New Zealand's KiwiSaver program, 80 percent of the enrollees during the first three months selected their own service provider, leaving only 20 percent using a default service provider.*

Employers might find this option appealing if they are able to negotiate a lower cost Automatic IRA option with a financial services provider with which they regularly do business.

Step Eight. Report on employee Automatic IRA contributions.

In the case of default Automatic IRA contributions, employers will be required to report with respect to Automatic IRA contributions withheld from employees' pay the following information: (1) the employee's name and taxpayer identification number, (2) the amount of Automatic IRA contributions, and (3) the investment options selected by the employee (or deemed to have been made by the employee if the employee failed to make an election) and the amount of the contribution allocated to each option. In the case of other Automatic IRA contributions, the result will depend upon whether the central administrator handles recordkeeping and reporting for all Automatic IRAs or only for default Automatic IRAs.

At the end of the year, the W-2 provided to employees should contain information concerning the aggregate amount of Automatic IRA contributions withheld from the employee's pay during the year. This will allow an employee to cross-check the reported employer information with the annual statement provided to the employee with respect to the Automatic IRA.

Step Nine. Demonstrate compliance with Automatic IRA requirements.

Employers must, within six months after the date of enactment, provide information demonstrating that the employer is in compliance with the Automatic IRA requirements or that the employer is not subject to such requirements. This reporting will also be required to be done no more frequently than annually thereafter and, under the introduced Automatic IRA legislation, can be done through the annual or quarterly employment tax return.

Ongoing – Employers will need to process elections from employees who wish to elect out of participation in an Automatic IRA arrangement.

Employees are entitled to terminate their participation in an Automatic IRA arrangement at any time. In many cases, it is likely that the power of inertia will tend to keep employees in Automatic IRA arrangements once they begin contributing. However, some employees will decide to stop contributing to an Automatic IRA and some employees will have a life crisis that will force them to stop contributing. This will be particularly true with the demographics of employees who are most likely to participate in Automatic IRAs.

New Zealand's KiwiSaver program allows employees to elect what is called a "contributions holiday." KiwiSaver members can take a break from participating in the KiwiSaver arrangement only after they have participated for 12 months. The contributions holiday can be a period from three months to five years. There is also a separate financial hardship contributions holiday. In order to request a contributions holiday, the member must submit a form to New Zealand's Inland Revenue for approval and Inland Revenue informs an employer to stop withholding contributions from an employee's pay.

APPENDIX A THE EFFECT OF DESIGN ISSUES ON ADMINISTRATIVE COSTS

Automatic IRAs present particular challenges that can greatly affect plan administrative costs. Because the average Automatic IRA participant is likely to be lower wage than the average person currently saving for retirement, initial account balances are likely to be quite small relative to a 401(k) plan or a regular IRA. An individual earning $20,000 per year and contributing the minimum 3 percent of pay to an Automatic IRA will have annual Automatic IRA contributions of $600.

The overall costs of Automatic IRAs will depend heavily both on the design considerations and on the operational models that is chosen to implement the program. Certain features may be developed to influence overall participation by employees while others may be developed to influence the way that Automatic IRAs are marketed or administered. One general rule applies – the cost of administering and processing the accounts will be lower with a more simplified and streamlined design.

The current design of Automatic IRAs leverages somewhat off the design of the Federal Thrift Savings (TSP) plan, which is the 401(k)-type plan for Federal employees. In 1988, the expenses of TSP averaged 0.40 percent of plan assets, meaning that the costs were approximately 40 cents per $100 of plan assets.[6] By 2006, these expenses had dropped to 0.03 percent of plan assets. There are a variety of reasons why the costs of Automatic IRAs will be higher. First, the expenses of the TSP are partially offset by forfeitures of contributions, which will not occur with Automatic IRAs. Second, the TSP is available only to Federal employees making recordkeeping and reporting issues much easier to address.

By contrast, for 401(k) plan participants holding money market funds at the end of 2005, their total expense ratio was 0.42 percent of assets.[7]

The following graphic provides some examples of potential sources of administrative costs for Automatic IRAs:

[6] TSP Expense Ratio. www.tsp.gov.

[7] Investment Company Institute. *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*. Vol 15, No. 7, November 2006.

Examples of Potential Sources of Costs of Automatic IRAs

Administrative Services:
Recordkeeping, including maintaining plan records, processing employee enrollment, processing participants' investment elections, contributions and distributions, and issuing account statements to participants
Transaction processing, including purchases and sales of participants' assets
Plan creation, conversion, termination, require administrative services
Fiduciary services, to provide the safe holding of plan assets

Participant-Focused Services
Participant communication, including employee meetings, call centers, voice-response systems, web access, and preparation of summary plan description and other participant materials
Participant education and advice, including online calculators and face-to-face investment advice
Investment management, typically offered through a variety of professionally managed investment options
Insurance and annuity services, including offering annuities as distribution options

Regulatory and Compliance Services
Consulting, including assistance in selecting the investment offered to participants
Accounting and audit services, including preparation of any annual reports
Legal advice, including advice regarding interpretation of plan requirements, compliance with regulatory requirements, and resolution of potential participant claims

Source: Investment Company Institute, The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, November 2006.

Under an employer-provided 401(k) plan, these costs are typically paid partially by the plan sponsor and partially by plan participants. In the case of Automatic IRAs, the goal is to minimize the costs borne by the employer to those costs directly associated with processing employee election forms and withholding. Thus, individual Automatic IRA contributors are likely to bear directly a higher percentage of the overall costs associated with the program.

On the other hand, economists generally believe that an employer's compensation costs will generally remain a fixed percentage of overall costs. Thus, if an employer has increased costs attributable to an item of compensation (such as the costs of complying with Automatic IRA requirements), then economists assume that these costs will be offset by reductions in other compensation costs. While this assumption may generally be true, most small employers do not have the flexibility to manage compensation costs in the same manner that larger employers can. Small employer may be unable to pass through the costs of Automatic IRAs fully to their employees.

As the design of Automatic IRAs is considered, the following cost drivers can be identified:

Cost increase –

- telephone assistance
- number of investment options
- allowing choice of Roth vs. traditional IRA
- automatic increases in contributions
- employee and employer selected Automatic IRA service providers

Cost decrease –

- pooling of assets vs. self-directed investments
- centralized recordkeeping and reporting
- reduced number of paper statements to account holders
- internet based participant account information

Automatic IRAs will have varying levels of costs, depending upon a variety of factors. In general, it can be expected that default Automatic IRA service providers may have lower costs than employee or employer selected Automatic IRA service providers due to scale economies. In addition, if a central administrator model is adopted and, at a minimum, all recordkeeping and reporting is done at the central administrator level, overall costs of Automatic IRAs will be lower.