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STATE-FACILITATED RETIREMENT PLANS

Is defaulting to a state-facilitated plan your best option?

While the world of retirement plans is complex, there is good news for employers searching for ways to help employees save. Today, there are more options than ever, including state-facilitated retirement plans. But before defaulting into the plan created and administered by your state, it's smart to know the options and select one that works best for your organization and employees. In this paper, we compare two alternatives — state-facilitated and employer-sponsored retirement plans — for employers to consider as they make this important decision.

BACKGROUND

Traditionally in the United States, whether or not to provide retirement benefits has been a decision made by employers. The value of a voluntary, employer-sponsored system to provide retirement benefits beyond those from Social Security is apparent. Employers, for their part, recognize the value of retirement plans in attracting and retaining talent, and have readily adopted such plans for the mutual benefit of their businesses and their employees.

According to the Investment Company Institute (ICI), more than 710,000 401(k) plans held $7.4 trillion in assets as of December 31, 2023 for the benefit of about 70 million active participants, former employees, and retirees. Of the $13.6 trillion held in individual retirement accounts on that date, the ICI says roughly half is comprised of rollovers from employer-sponsored plans.[1] If we include other types of common retirement plans such as 403(b) plans, these numbers are even higher.

The U.S. government provides significant incentives to encourage employer sponsorship of retirement plans. These include targeted tax incentives for both sponsoring employers and participating employees, and robust fiduciary standards that protect employee savings. Further, employees are protected by extensive disclosure obligations that provide transparency of plan benefits and fees, as mandated by federal law under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code.

The SECURE Act of 2019 and the SECURE 2.0 Act of 2022 also impacted qualified retirement plans, providing incentives, reducing administrative complications, and clarifying rules in a number of areas. Of particular interest to employers without a retirement plan are SECURE Act provisions allowing unrelated employers to join a pooled plan. Pooled plans offer significant benefits to employers and their employees, many of which may have previously been out of reach, thus leveling the playing field for smaller employers.

[1] "401(k) Resource Center," Investment Company Institute, as of December 31, 2023

BUT THERE'S A PROBLEM

Despite incentives and growing employee demand, many employers do not offer a retirement plan, leaving a significant percentage of U.S. employees without access to workplace retirement benefits. This may have to do with the perceived cost or complexity in administering these programs.

43%

of workers at private-sector businesses with fewer than 100 employees have no access to a workplace retirement plan.[2]

Only half

of employers with fewer than 100 employees offer a retirement plan.[3]

In this context, state-facilitated retirement programs are emerging to close the retirement savings gap, particularly for low- to moderate-income wage earners in small and midsized businesses with no retirement plan at work.

[2] "Employee Benefits in the United States - March 2023," United States Bureau of Labor Statistics, September 2023

[3] "Stepping Into the Future: Employers, Workers, and the Multigenerational Workforce," nonprofit Transamerica Institute, May 2023

STATE-FACILITATED PROGRAMS EMERGE

The goal of state-administered retirement programs is to increase retirement savings for individuals who do not have access to employer plans. Typically, they are structured as automatic Roth individual retirement accounts (IRAs), although a few have a different design. When an employee is enrolled in the program, their contributions are made by payroll deduction on an after-tax basis.

The default employee contribution rate — the percentage of an employee's pay deducted when an employee is automatically enrolled in the plan and does not take affirmative steps to choose their own contribution rate — is typically set between 3% and 5%. Employees may opt out at any time. Employees earning more than the limit set for IRA contributions may be unable to contribute.[4] Many programs also have an auto-escalation feature which gradually increases the employee's contribution rate over a specified number of years.

Participating employees can withdraw their contributions from Roth IRAs without tax consequences at any point. However, investment earnings withdrawn prior to age 59½ from accounts that are not in the plan for at least five years are included in taxable income and are also subject to a 10% tax penalty. Employees who change employers or move out of state can keep the same IRA or transfer savings to a different IRA.

Small employers (as defined by each state) may be exempt from the mandates, as are organizations that already offer an employer-sponsored plan such as a 401(k) or 403(b). Some state programs also allow self-employed workers and those who do not work for a participating employer to self-enroll in the state plan.

CONSIDER THE OPTIONS

Employers considering whether to offer a retirement plan should weigh the differences between a state-facilitated and an employer-sponsored plan. Employers without a current plan (either employer-sponsored or state-facilitated) may face stiff state penalties for failing to adopt a plan. Before defaulting into a state-facilitated program, employers should consider their options. The worst of all possible options is to incur a state-imposed financial penalty for failing to take any action.

[4]For example, a single filer with income of $161,000 or higher in 2024 or a married/joint filer with income of $240,000 or higher

STATE-FACILITATED PLANS LIMIT WORKERS' SAVINGS

For small employers whose workforce is made up of mostly low- to moderate-wage workers, state-facilitated plans may provide a good alternative. Employees in state-facilitated programs are subject to lower contribution limits than employees in employer-sponsored plans. This limitation may be of less concern for small employers with low-wage workers whose resources available to save for retirement are limited.

Higher-wage employees in state-mandated plans may be disadvantaged, however, because they may be restricted from contributing at the same rate as employees in employer-sponsored plans. While state-mandated programs are a step in the right direction for employers with no current plan, the opportunity to accumulate a retirement nest egg may be insufficient for these higher-wage employees under state programs. Some reasons:

- IRA contributions are limited to $7,000 per year ($8,000 for those age 50 and older) for 2024, compared to $23,000 ($30,500 for those age 50 and older) allowed in a 401(k) plan.
- The combined employer and employee contribution limit in a 401(k) or similar plan is $69,000 ($76,500 for those age 50 and older) for 2024.
- Employers are generally prohibited from contributing on behalf of employees through state-mandated programs.
- People with income over a certain threshold (single filers with income of $161,000 and married/joint filers with income over $240,000 or higher in 2024) cannot contribute to Roth IRAs, and may need to opt out of a state-facilitated program.

The lack of flexibility in state-facilitated programs could result in the loss of significant retirement savings opportunities for the higher-wage worker.

EMPLOYER-SPONSORED PLANS PROVIDE FLEXIBILITY

For employers with workers on the lower end of the pay scale, critics of state-facilitated plans have pointed out that the one-size-fits-all design of state-sponsored auto-enrollment plans may be a problem for cash-strapped workers.

As noted, employer contributions to state-facilitated programs are generally prohibited. Organizations with an employer-sponsored plan can include profit sharing and/or employer matching contributions in their plan's design, providing benefits for both employers and employees. Employer contributions are effective tools to attract and retain talent, and they provide a current tax deduction for the organization. Employees, of course, benefit from the additional tax-deferred contributions on their behalf. For employers with higher-wage employees, the ability to contribute to the plan is an especially valuable benefit, helping foster employee loyalty. Unlike state-facilitated plans, employer contributions to an employer-sponsored plan can be subject to a vesting schedule so that only longer-service workers earn a nonforfeitable interest in those contributions. A vesting period may help employers retain their most valued employees.

EMPLOYER-SPONSORED PLANS PROTECT WORKERS

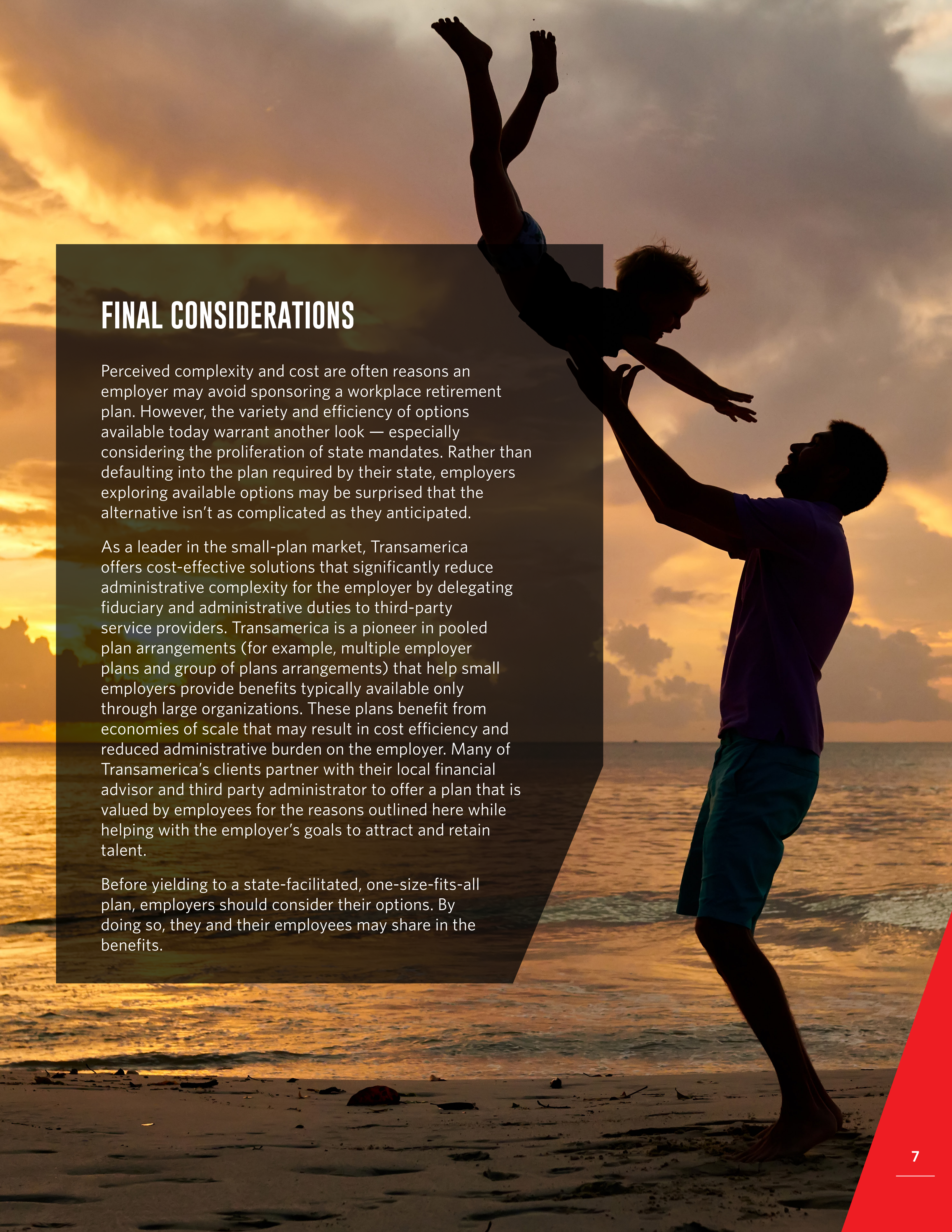
One of the hallmarks of employer-sponsored plans is the high level of worker protection required by ERISA. State programs are not subject to ERISA's robust worker protection and may, therefore, lack adequate measures to ensure participants' contributions are made timely, that fees are reasonable, and investment choices are prudent. ERISA requires payroll contributions from an employer-sponsored plan to be invested in the plan without delay (generally within a few days) from the time contributions are withheld from payroll. This ensures contributions receive market returns as soon as possible. Because state-facilitated plans are not subject to ERISA, they may not have the same strict timing requirements, although some states may have stronger protections than others.

COMPLICATIONS FOR MULTI-STATE EMPLOYERS

Another hallmark of ERISA is the pre-emption of state law for employer-sponsored plans, which allows employers to avoid the administrative quagmire of adhering to a patchwork of inconsistent state rules. Multi-state employers that opt for state-facilitated programs in multiple states may be required to participate in several programs. This would likely add administrative burden on employers by requiring them to monitor employee eligibility for different state programs based on residence or office location.

EMPLOYEE EDUCATION AND INCENTIVES

Perks that tend to come with employer-sponsored retirement plans — such as matching contributions and financial well-being education — may encourage employees to save more. State-facilitated plans may lack the robust retirement education opportunities that employers offer, commonly in partnership with their recordkeeper, third party administrator, and financial advisor.



FINAL CONSIDERATIONS

Perceived complexity and cost are often reasons an employer may avoid sponsoring a workplace retirement plan. However, the variety and efficiency of options available today warrant another look — especially considering the proliferation of state mandates. Rather than defaulting into the plan required by their state, employers exploring available options may be surprised that the alternative isn't as complicated as they anticipated.

As a leader in the small-plan market, Transamerica offers cost-effective solutions that significantly reduce administrative complexity for the employer by delegating fiduciary and administrative duties to third-party service providers. Transamerica is a pioneer in pooled plan arrangements (for example, multiple employer plans and group of plans arrangements) that help small employers provide benefits typically available only through large organizations. These plans benefit from economies of scale that may result in cost efficiency and reduced administrative burden on the employer. Many of Transamerica's clients partner with their local financial advisor and third party administrator to offer a plan that is valued by employees for the reasons outlined here while helping with the employer's goals to attract and retain talent.

Before yielding to a state-facilitated, one-size-fits-all plan, employers should consider their options. By doing so, they and their employees may share in the benefits.

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Before adopting any plan sponsors should carefully consider all of the benefits, risks, and costs associated with a plan. Information regarding retirement plans is general and is not intended as legal or tax advice. Retirement plans are complex, and the federal and state laws or regulations on which they are based vary for each type of plan and are subject to change. In addition, some products, investment vehicles, and services may not be available or appropriate in all workplace retirement plans. Plan sponsors and plan administrators may wish to seek the advice of legal counsel or a tax professional to address their specific situations.

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