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RETIREMENT SAVINGS ISSUES NEED TO BE CONSIDERED IF CAPITAL ASSETS ARE INDEXED FOR TAX PURPOSES

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There have recently been discussions that Treasury Department might issue guidance under which the cost basis of capital assets would be indexed for inflation. We recognize that this raises a number of questions on which there are sharply different views. We express no opinion on any of those questions.

This paper is intended to address a single concern: if Treasury were to pursue this indexing issue, it is critical that retirement savings issues be taken into account and addressed. If retirement savings issues are not addressed, the result could be adverse for retirement security, as discussed below. At the end of this paper, we provide a brief summary of possible ways to address the retirement issues.

Indexing the basis of capital assets would reduce the incentive to contribute to a retirement savings arrangement, assuming that indexing does not apply to retirement assets. The attached chart shows that if the basis of capital assets is indexed for inflation, in many cases, the advantages of contributing to a retirement plan or IRA (as compared to investing in a capital asset) would be substantially reduced. The attached analysis compares (1) a taxable account that invests in a capital asset to which an indexing rule applies and (2) a qualified retirement plan or IRA account that invests in the same asset with pre-tax contributions but no indexing. Roth arrangements are also illustrated.

The chart shows that indexing capital assets in taxable accounts but not in retirement accounts would, based on the specific facts assumed, reduce the relative incentive for saving through a retirement account by 38%. Depending on the extent to which the assumed facts are changed, the reduction could be higher or lower in any

particular situation. If it would be helpful, additional modeling could be provided with different assumptions.¹ But the attached chart illustrates the core point: indexing the basis of capital assets can materially decrease the relative value of contributing to a retirement plan.

It is true that any reduction in the taxation of income reduces the relative value of contributing to a retirement plan. The key point here, however, is that the principle underlying the indexing of the basis of capital assets also applies to retirement savings, as discussed below. So it is inappropriate to reduce the value of contributing to a retirement plan based on an economic theory that applies equally to retirement savings.

EFFECT ON PLAN AND IRA CONTRIBUTIONS AND PLAN CREATION OR RETENTION

As discussed above, if capital assets are indexed and no type of indexing is applied to retirement plan or IRA assets, the tax incentive to contribute to a plan or IRA would generally be substantially reduced in many situations, generally aside from situations where a meaningful matching contribution or tax credit, such as the Saver's Credit, is available.

The next question is what effect this would have on the maintenance and vitality of private retirement plans. We are certainly not suggesting that there would be no more private retirement plans if the basis of capital assets were indexed. But we are suggesting that the effect on the private retirement system would be adverse.

If the tax incentive to contribute to a plan or IRA is substantially reduced, such contributions could very well fall materially because of various reasons not to contribute. Such reasons include the fact that in many situations retirement assets cannot be readily accessed (at least without a penalty). Also, for small business owners who face the decision of whether to set up a plan or continue to maintain a plan, there are material administrative costs in addition to the cost of contributions on behalf of employees (who may not value such contributions 100¢ on the dollar). In light of the hesitation of many small business owners to maintain a plan today, substantially reducing the tax incentive to do so would likely have an adverse effect on retirement coverage.

In the case of larger employers, for many of their employees, the advantages of contributing to the plan above the level where matching contributions or tax credits are available would be substantially reduced. It is, however, unclear the extent to which this would affect their contribution level, especially in light of the ease of payroll deduction. But this would be an issue that bears further review.

¹ For example, if we assume that asset appreciation does not exceed the rate of inflation, then qualified plans would not have any advantage over direct investment in capital assets.

The effect of indexing on the formation and maintenance of defined benefit plans is less clear and is not addressed by the attached analysis. There would certainly be fewer small business defined benefit plans because the tax advantage of such plans to the small business owners would be substantially reduced. Since defined benefit plans are in substantial decline among large employers, reducing the tax advantages of such plans cannot be helpful overall.

In the short term, defined benefit plans could get a boost through higher stock prices if indexing helps the stock market.² But it is not clear if that would simply lead to more plan terminations by employers that suddenly have plans that are sufficiently well funded to be terminated. Also, for the many plans heavily invested in corporate bonds, the short-term effect might be adverse. If capital assets are indexed, but corporate bond interest payments remain taxable (when held by a taxable entity),³ it seems as though that would have an adverse effect on bond values. This could hurt those plans heavily invested in bonds.

TAX POLICY CONSISTENCY REQUIRES THAT SOME TYPE OF INDEXING ALSO APPLY TO RETIREMENT SAVINGS

The theory underlying the indexation of capital assets is that taxpayers should not be taxed on illusory gains that are simply the result of inflation and not an actual increase in value. There is clearly a logic to this analysis, but the logic is by no means limited to capital assets held outside a plan.⁴

- **Argument for indexing retirement savings:** Assume that an IRA purchases a single capital asset for \$1,000. Over time, the asset appreciates to \$1,500, with \$200 of the \$500 of appreciation being attributable to inflation. Under the theory supporting the indexing of capital assets, the \$200 of appreciation attributable to inflation should be treated as basis and not be taxed, so that a distribution to the IRA owner should generate only \$1,300 of taxable income, not \$1,500.
- **Argument against indexing retirement savings:** There is a contrary argument, as follows. In the case of pre-tax contributions, distributions from retirement arrangements are effectively deferred wages because the employee was not taxed on the wages when earned. Accordingly, the distributions should be taxed as

² This would also be true for defined contribution plans, but this boost would not affect interest in making future contributions.

³ If capital assets are indexed, it would not make sense to tax interest payments up to the level of inflation. But that may be beyond the scope of the project being undertaken by the Treasury Department.

⁴ The logic has broad applications to, for example, interest payments and receipts, dividends, and annuity payments. A discussion of these other applications is beyond the scope of this paper.

deferred wages at ordinary income rates without taking into account how the assets were invested in the plan. Since the assets were never held by the employee, any favorable tax treatment of capital assets (or other assets) should not inure to the benefit of the employee. This contrary argument is arguably consistent with current law, as evidenced by the fact that appreciation in a capital asset held by a plan is taxed on distribution at ordinary income rates, with nothing taxed at capital gains rates.⁵

Roth amounts are taxed as ordinary income when contributed and not taxed on distribution. This is consistent with taxing the distribution of pre-tax amounts as ordinary income upon distribution.

RECOMMENDED RESOLUTION OF THE COMPETING ARGUMENTS, IN FAVOR OF MODIFYING THE TREATMENT OF RETIREMENT ARRANGEMENTS

As noted at the outset of this paper, we express no opinion on the question of whether the basis of capital assets should be indexed. We are only addressing the retirement issues that arise if such indexing is adopted. In that context, the following arguments militate strongly in favor of modifying the tax treatment of plans, if the basis of capital assets is generally indexed.

- **Retirement policy:** Unless indexing applies to retirement assets, the effect on retirement savings and retirement security will be adverse, as discussed above.
- **Tax policy:** The treatment of retirement distributions as deferred wages is a throwback to the days when the retirement plan landscape was dominated by traditional defined benefit plans. The view of retirement distributions as deferred wages may have been appropriate in the context of such defined benefit plans. In the 401(k) plan and IRA world (and the cash balance plan world), however, distributions are a combination of deferred wages and real investment return. For example, if an employee invests well and earns 10% returns over an extended period of time, it does not make sense to characterize that as wholly deferred wages.
 - **Overdue change:** In effect, the point is that the treatment of all plan returns as ordinary income is out of date and needs re-examination in the new 401(k) and account-based world. To avoid disadvantaging defined benefit plans, the results of such a re-examination should apply to those plans too. The possibility of indexing the basis of capital assets accelerates the need to revisit this issue and modify the rule, because if indexing takes

⁵ There is an exception from this “no capital gains” rule for net unrealized appreciation in employer securities held by the plan and distributed to an employee.

effect and the retirement taxing regime is not revisited and revised, the effects on retirement security would be adverse.

PROPOSAL

- **Theoretically consistent approach:** If the basis of capital assets were to be indexed, the theoretically consistent adjustment in the case of retirement savings would be for the indexing rule to flow through to the assets held by retirement plans and IRAs. For example, if the indexing rule is limited to the basis of capital assets, then capital assets held by retirement arrangements would be indexed. If the indexing rule applies to interest or dividend income, then that rule also would flow through to retirement arrangements.
 - **Example:** Assume the same facts as above: an employee has an account in a plan that invests \$1,000 in a capital asset, which appreciates to \$1,500, with \$200 of the appreciation attributable to inflation. The employee then sells the asset within the plan and invests the \$1,500 in another asset. The \$200 of appreciation would be treated as basis, as would any appreciation in the second asset attributable to inflation.
 - **Note:** This is a theoretically consistent approach but does not address all outstanding issues. For example, this would not have any effect on Roth amounts, since they are not taxed on distribution. Second, it would treat different retirement investments differently, but that is simply a function of the fact that the underlying indexing rule does the same thing.
- **Simpler approach needed:** In the context of retirement plans, the theoretically consistent regime described above, which requires tracking of capital assets and reporting basis, would be extremely difficult to administer. Accordingly, we recommend consideration of simpler approaches that are structured to avoid disadvantaging retirement savings without creating complexity.
 - **Example:** Many different approaches might be considered to avoid disadvantaging retirement savings. Here is one example: The government could provide for a slightly lower maximum tax rate on distributions from retirement plans, such as a taxpayer's applicable marginal rate minus five percentage points. Reducing the marginal tax rate by a flat number of percentage points would produce a progressive result by disproportionately benefiting lower bracket taxpayers.
 - **Roth:** To maintain the current-law parallel tax treatment of Roth amounts and pre-tax amounts, this approach would also require that Roth *contributions* be taxed at the same lower marginal rate.

- **Additional note:** Assuming that the indexing concept is limited to the basis of capital assets (and not applied to, for example, interest or dividends), the approach illustrated above (reducing the tax rate on distributions) would not be theoretically consistent with that concept because it would apply without regard to the type of income generated within a retirement account (capital gains, interest, dividends, etc.). But, as a practical matter, it may produce a workable solution for retirement plans, which would have extreme difficulty administering the theoretically consistent approach.
- **Issues of authority:** We recognize that the less complicated approaches may be difficult to achieve without legislation. But if capital assets are indexed and no adjustment is made to eliminate the adverse effect on retirement savings, retirement security is likely to be unjustifiably undermined. Accordingly, we urge the government to take retirement savings issues into account in whatever way is workable as it considers indexing issues.

Analysis: Adjusting Cost Basis of Assets for Inflation

Inputs:

Initial investment	Gross annual rate of return	Duration (years)	Compounding (per year)	Ordinary Income Tax Rate	Cap Gains Tax Rate	Inflation Rate
\$10,000	7.00%	10	1	24.0%	20%	3%

Current Law: No Basis Adjustment for Inflation			
Account Type	Taxable Account	Qualified (Traditional)	Qualified (Roth)
Starting value	\$10,000	\$13,158	\$10,000
Ending value (pre-tax)	\$19,672	\$25,884	\$19,672
Original basis	\$10,000	\$0	\$10,000
Basis step-up	\$0	\$0	\$0
Adjusted basis	\$10,000	\$0	\$10,000
Taxable amount (a)	\$9,672	\$25,884	\$0
Tax (b)	\$1,934	\$6,212	\$0
a minus b	\$7,737	\$19,672	\$0
Ending value (after-tax)	\$17,737	\$19,672	\$19,672
Relative incentive for saving through qualified account		\$1,934 10.9%	\$1,934 10.9%

Adjust Basis for Inflation: Taxable Account ONLY			
Account Type	Taxable Account	Qualified (Traditional)	Qualified (Roth)
Starting value	\$10,000	\$13,158	\$10,000
Ending value (pre-tax)	\$19,672	\$25,884	\$19,672
Original basis	\$10,000	\$0	\$10,000
Basis step-up	\$3,439	\$0	\$0
Adjusted basis	\$13,439	\$0	\$10,000
Taxable amount (a)	\$6,232	\$25,884	\$0
Tax (b)	\$1,246	\$6,212	\$0
a minus b	\$4,986	\$19,672	\$0
Ending value (after-tax)	\$18,425	\$19,672	\$19,672
Relative incentive for saving through qualified account		\$1,246 6.8%	\$1,246 6.8%
Change in incentive for qualified accounts		-38.0%	-38.0%

Adjust Basis for Inflation: ALL Accounts			
Account Type	Taxable Account	Qualified (Traditional)	Qualified (Roth)
Starting value	\$10,000	\$13,158	\$10,000
Ending value (pre-tax)	\$19,672	\$25,884	\$19,672
Original basis	\$10,000	\$0	\$10,000
Basis step-up	\$3,439	\$4,525	\$3,439
Adjusted basis	\$13,439	\$4,525	\$13,439
Taxable amount (a)	\$6,232	\$21,358	\$0
Tax (b)	\$1,246	\$5,126	\$0
a minus b	\$4,986	\$16,232	\$0
Ending value (after-tax)	\$18,425	\$20,758	\$19,672
Relative incentive for saving through qualified account		\$2,333 12.7%	\$1,246 6.8%
Change in incentive for qualified accounts		16.1%	-38.0%

Assumptions and notes:

- 1 All the accounts invest in the same capital asset.
- 2 The illustrated asset pays no dividends, so the gross annual rate of return is attributable solely to appreciation in market value.
- 3 At the end of the assumed duration, the account is liquidated for cash, thereby triggering taxation (except for the Roth account).
- 4 Investment return and basis step-up calculations reflect the same assumed duration and compounding frequency.
- 5 Some numerical discrepancies may exist in the figures above due to rounding.