



TAX INCENTIVES FOR 401(K) PLANS

BACKGROUND

As Congress considers changes to the tax incentives for 401(k) plans in a tax reform context or otherwise, we urge lawmakers and their staffs to take into account the points listed below. In short, the 401(k) system is used successfully by hundreds of thousands of employers and tens of millions of employees. We strongly caution against any fundamental changes to the tax incentives – such as removing the ability of employees to contribute on a pre-tax basis – without evidence that the change will not have adverse results. To modify the tax treatment enjoyed by tens of millions of Americans based on speculation about possible effects would be taking an enormous risk because the change could adversely affect many who most need the private retirement system.

TALKING POINTS

- 401(k) plans reach tens of millions of workers and provide an important source of retirement savings. Voluntary, employer-sponsored defined contribution plans, such as 401(k) plans, are a core element of our nation's retirement system. As of 2014, there are more than 640,000 private-sector defined contribution plans covering more than 94 million active and retired workers, with millions more covered by tax-exempt and governmental defined contribution plans. In addition, many employees own some kind of Individual Retirement Account often comprised of assets that have been "rolled over" from 401(k) plans.
- Promoting retirement savings must remain one of our nation's top policy priorities. Any changes made should preserve and build upon our existing and successful tax incentive structure so it works even more effectively to facilitate retirement plan coverage and savings for American families.
- Defined contribution plan savings is an important source of investment capital. With more than \$6.6 trillion in combined assets as of the third quarter of 2016, these plans represent ownership of a significant share of the total pool of stocks, bonds, and other investments, providing an important and ready source of American investment capital and a taxable stream of revenue that is far greater than the original contribution.

- Contributions to 401(k) plans are limited and rules promote fairness. Individual contributions to 401(k) plans are subject to coverage, participation and nondiscrimination rules to ensure they are fairly distributed among plan participants. By establishing voluntary 401(k) plans, employers bring millions of low and moderate-income earners and new retirement savings into a secure and efficient retirement system. Without these plans many of these savers would be dependent only on government programs.
- Pre-tax retirement savings incentives constitute a tax deferral, not a tax exemption. The amounts contributed and earnings on the contributions will be taxed to the individual when he or she receives a benefit payment at retirement. Alternatively, “Roth” contributions are taxed prior to contribution, but grow tax-free. Roth contributions result in a permanent tax exclusion of the earnings on the original contributions. Consequently, a mandatory change from pre-tax to Roth approach results in “savings” to the government only when the cost scoring is limited to the first 10 years after enactment instead of including the time period when distributions are made.
- The impact of changes to the structure of tax incentives needs further study. Roth contributions can result in the same tax consequences for retirement benefits as pre-tax contributions in limited circumstances but these situations are unlikely for most savers. Equivalency assumes (1) the worker’s income tax brackets are the same at the time of contribution and at the time of distribution, and (2) contributions to the Roth are net of taxes. For some individuals in a low tax bracket, Roth contributions are even advantageous. This is particularly true if the worker is ultimately in a higher tax bracket in retirement. The optimal approach for many individuals is a mix of pre-tax and Roth contributions.
- Commitment to savings may be undermined by changes in the law and fear of future changes. We do not know whether workers will be willing to save as much in the future if there is a shift to Roth. Such a shift would be a significant change in tax policy mid-stream for millions diligently preparing for retirement. Employee and employer decisions will be further complicated by the fact that the future tax incentive also depends on the law not changing for the next 40 years and even beyond, when many people who are counting on the tax-free distribution of earnings are in retirement and unable to earn additional income.
- Roth treatment reduces take-home pay and makes the same contribution more expensive. Roth treatment with no immediate tax deferral (but an eventual tax-free distribution) would reduce take-home pay if a worker who had been contributing on a pre-tax basis continues to contribute at the same level on a Roth basis.

- Obtaining matching contributions would likely become more expensive under shift to Roth. If employer matching contribution formulas are not altered to accommodate the shift to Roth contributions, it will become more expensive for workers to make the contributions necessary to receive the maximum matching contribution because those contributions will have to be made with after-tax money.
- Changes to retirement savings tax policy should focus exclusively on addressing coverage gaps and facilitating the ability of employers to maintain retirement plans rather than disrupting the gains made – and yet to be made – by the vast majority of plan participants. To address participation rates among part-time workers, lower-income individuals and employees at smaller firms, removing impediments to plan sponsorship should be the first step. Encouraging use of technology will help employers deliver cost efficient education and improved financial wellbeing. Changes to the fundamental structure of tax incentives should not be made without a full understanding of the impact of the change on the future retirement security of Americans.