AMERICAN BENEFITS COUNCIL

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Defined Contribution Plans & IRAs: Existing Tax Incentives Effectively and Efficiently Increase Retirement Savings

Proposals to repeal current tax incentives and replace with a credit are dangerous

The U.S. retirement savings system encourages individuals to save for retirement by providing income tax exclusions or deductions for contributions to employer-sponsored defined contribution (DC) plans and IRAs, up to certain limits. This tax incentive structure is a pillar of our successful private retirement savings system. It provides a strong incentive for workers at all income levels to save for retirement and encourages employers to sponsor plans that deliver critical benefits to Americans at all incomes.

Today's retirement policies are working, enabling Americans – with support from their employers – to accumulate savings and generate retirement income. Private-sector DC plans cover more than 70 million active and retired workers, with many millions more participating in 403(b), 457, and the federal Thrift Savings Plan – types of DC plans maintained in connection with employment by tax-exempt and governmental employers. Overall, about 100 million active and retired workers (and their spouses) currently have retirement savings through employment-based retirement plans and IRAs. Congress has adopted rules that encourage employers to voluntarily offer these plans, encourage employees' participation, promote prudent investing, allow operation at reasonable cost, and safeguard participant interests through strict fiduciary obligations.

Some have argued that the current tax incentive system is not the optimal structure, finding fault with a retirement savings tax exclusion that provides a tax benefit proportional to an individual's income tax bracket. They have proposed replacing it with after-tax contributions paired with a tax credit (capped at a dollar or percentage level). As detailed below, the critique of the current structure is misplaced, and the new proposed tax regime would represent a disruptive change posing unwarranted risks for individuals saving for retirement. It very likely would lead to a decline in savings levels and reduced plan sponsorship by employers, both of which would have detrimental effects for the retirement prospects of American families and for our economy as a whole.

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Proposals to change the current tax incentive structure to after-tax contributions with a tax credit should be rejected. The harm to the retirement security of current and future Americans could be irreparable. That is a gamble we cannot afford to take, especially now with the Baby Boom generation reaching retirement age. Policymakers should instead seek to build upon our existing and successful tax incentive structure so that it works even more effectively to facilitate retirement plan coverage and savings by American families.

CRITICAL ELEMENTS OF THE CURRENT TAX INCENTIVE STRUCTURE

- ***Contributions to Workplace Retirement Plans and IRAs are Not Subject to Current Taxation, Encouraging More Savings.*** Contributions to workplace DC plans – both those made by employees and those made by employers – are generally excluded from the employees' taxable income. Similarly, for eligible taxpayers, contributions to traditional Individual Retirement Accounts (IRAs) are tax-deductible in many instances. This pre-tax treatment allows individuals to save more from each paycheck today than would be the case with after-tax contributions. For a worker in the 25% income tax bracket, for example, a $40 weekly contribution into a 401(k) plan will only reduce take home pay by $30, making saving into the plan an efficient economic proposition.

  While it is true that pre-tax treatment provides a greater percentage tax benefit to those in higher tax brackets, this is nothing more than the logical extension of our progressive income tax structure. This critique also fails to recognize that 79% of the federal tax incentives for DC plans are attributable to taxpayers with less than $150,000 of adjusted gross income. The fact that income tax benefits for retirement savings flow to those who pay income tax is an insufficient basis to condemn the current structure, especially since those in higher tax brackets today will also likely be in higher tax brackets when they begin to receive retirement benefits, resulting in more revenues back to the government.

- ***Contributions Are Limited and Rules Promote Fairness.*** Congress has imposed maximum dollar limits on individual contributions to DC plans and IRAs. These limits act to constrain the tax-preferred savings of upper-income savers while allowing robust tax-preferred savings by low- and middle-income households. Critically, the levels retain enough of a personal incentive for business owners and decision-makers to set up and maintain plans benefiting their workforce. The maximum any employee can contribute to a DC plan in 2012 is $17,000 ($22,500 if 50 or older), and employer contributions are subject to a variety of limits. However, for owners and higher-paid employees, those maximum contribution levels can only be reached if the plan satisfies tough non-discrimination rules that ensure participation and contributions for rank-and-file workers. Contributions to IRAs are generally subject to much lower limits (in 2012, $5,000 generally or $6,000 for those age 50 or older) and eligibility to deduct those IRA contributions fully is not generally

available to individuals with income above $58,000 and couples with income above $92,000.

- ***Saver's Credit Supplements Exclusion/Deduction.*** The Saver's Credit, which provides an additional tax credit of up to $1,000 ($2,000 if married and filing jointly) to low- and middle-income individuals who contribute to DC plans and IRAs, provides a more robust savings tax incentive for eligible individuals than would be provided by the exclusion or deduction alone. Between availability of the underlying income tax exclusion/deduction for contributions, payroll tax savings on employer contributions and the supplemental Saver's Credit, eligible individuals are provided with a very significant tax incentive to contribute to retirement accounts, one that far exceeds mere proportionality to their income tax bracket.

- ***Employer Contributions Are Also Exempt from Payroll Taxes.*** Employer contributions to plans are not regarded as "wages," and so neither employers nor employees owe payroll taxes on these amounts. These payroll tax savings are most significant for low- and moderate-income employees earning amounts below the Social Security wage base ($110,100 in 2012), since payments in cash rather than into the plan would be fully subject to payroll taxes.

- ***Taxes on Gains Are Deferred and Distributions Are Taxable.*** Another significant benefit is the deferral of tax on investment gains inside retirement accounts. This deferral is critical in incenting savings as workers know they will not have to divert income year-by-year to pay tax on their retirement savings. Indeed, for the many individuals who save for retirement over a significant period, gains can ultimately outstrip underlying contributions, making this deferral extremely valuable. It is also critical to remember that pre-tax contributions made to DC plans and IRAs – and the earnings on these contributions – do not escape taxation but rather are almost always taxed at ordinary income tax rates when withdrawn. Thus, the federal tax incentives devoted to spur savings are not lost but are reclaimed as additional tax revenue when individuals make withdrawals.

CURRENT TAX INCENTIVES ARE THE FOUNDATION OF OUR SUCCESSFUL RETIREMENT SAVINGS SYSTEM

- ***Current Incentives Efficiently Produce Retirement Income.*** Analyses have shown that, for every dollar of federal tax expenditure devoted to tax-preferred workplace retirement plans, four to five dollars in retirement benefits result. This extremely efficient catalyst produces a remarkable amount of benefits for workers and their families – in 2010, employer-sponsored retirement plans paid out $836 billion in benefits, substantially more than the $577 billion in retirement benefits paid by Social Security in the same year.

- ***Incentives Encourage Sponsorship of Employer Plans.*** The employer-sponsored retirement system is premised on its voluntary nature. As such, tax incentives for contributions by employees (including key business decision-makers) are important in encouraging plan sponsorship, especially by small businesses. Changes that reduce tax benefits, such as a conversion to a pure tax credit approach, could discourage plan sponsorship. In fact, in a 2011 study by Harris Interactive, nearly all plan sponsors (92%) said the ongoing tax deferral for employees is important in their decision to offer a DC/401(k) plan. And nearly two-thirds (65%) said that if the ability for employees to deduct any amount of the 401(k) contribution from taxable income were eliminated, their desire to continue offering the plan would decrease. If employer sponsorship declines and more employees are forced to save on their own, they would save less and would not receive the many protections and benefits associated with employer-sponsored plans (from ERISA protection to fiduciary oversight – especially of investments and fees – to employer contributions).

- ***The Public Strongly Supports Current Incentives.*** Recent surveys found that 83% of households with a DC account said that the immediate tax savings associated with contributions was a significant incentive to save. Almost half of DC account-owning households state that they probably would not be saving for retirement at all if it were not for their DC plans. 85% of households (with or without a DC account or IRA) opposed eliminating DC tax advantages, and 83% opposed reducing these advantages. Even very modest-income households making less than $30,000 opposed elimination (79%) and reduction (73%) of these tax incentives.

- ***Incentives Help Produce Investment Capital.*** The tax incentives that encourage retirement savings help produce stable, long-term investment capital for our economy. At the start of 2012, retirement plans held approximately $17.9 trillion in assets, with almost $10 trillion held in DC plans and IRAs. These trillions of dollars provide important investment capital that will help companies grow, add jobs, and raise wages. Given the weak economy, it would be unwise to reduce savings incentives, thereby limiting much-needed investment capital.

THE DETRIMENTAL EFFECTS OF REPLACING PRE-TAX TREATMENT WITH A TAX CREDIT SYSTEM

- ***A Tax Credit Approach Would Substantially Reduce Plan Participation and IRA Contributions.*** Converting the deduction/exclusion for DC and IRA savings into a tax credit would discourage plan participation and IRA utilization as it would undermine the core incentives that drive today's savings behavior. Such an approach would often prove less attractive than today's structure, particularly for middle-income families. Moving to this complex new regime would also create great confusion among individual savers, which would likely deter savings and contribute to inertia. This would be extremely counterproductive at a time when all

have agreed that the way to foster savings is to keep things simple. Reducing and impeding the incentives to save in plans and IRAs in this way would be particularly detrimental as such savings typically represent a significant share of families' total financial assets.

- ***A Tax Credit Approach Would Reduce Plan Sponsorship.*** Current taxation of employee deferrals would deter plan sponsorship as key business decision-makers would see a reduced tax benefit for themselves and their workers from offering a plan. When a typical small business owner evaluates the significant legal responsibilities, risks, and costs of plan sponsorship, it is often the promise of meaningful tax benefits that is the deciding factor in choosing to maintain a retirement plan. If tax benefits to decision-makers are substantially diminished (as in most tax credit proposals), businesses that would have considered plan sponsorship will no longer do so and existing plan sponsors will have to reevaluate whether they should eliminate matching contributions or even continue to offer retirement plans altogether. All employees will suffer.

- ***A Tax Credit Approach Would Diminish the Incentive to Make Employer Contributions.*** Even those employers who might continue to maintain plans under a tax credit regime would likely cut most other employer contributions to retirement plans, like profit-sharing contributions. The reason is simple. Under a tax credit proposal, if an employer were to contribute $1,000 to each employee's retirement account, the individual would then receive a $180 tax credit. The $1,180 in the employee's account would be locked in. In many cases, the employee could not access the $1,000 employer contribution, and in others the money would only be available if the employee incurred substantial taxes and penalties. The problem is that all employees would immediately owe income tax on the $1,000 employer contribution, even though many would not have the money to pay the tax. Many employers will not want to put employees in a situation where the employee is forced to pay income tax today on wages they never saw, in order to get a modest government tax credit.

- ***A Tax Credit Approach Would Erode Overall Retirement Readiness.*** A March 2012 study by the nonpartisan, independent Employee Benefit Research Institute (EBRI) confirms that one tax credit proposal (with a maximum 18% tax credit replacing existing exclusions and deductions) would reduce retirement security for workers at all income levels, not just high-income workers. Specifically, the study revealed that some employers would decide to no longer offer a plan to their workers and some participants would decrease their contributions. The combined effect of these changes would result in reduced savings balances at retirement between 6% and 22% for workers currently age 26-35, with the greatest reductions for those in the lowest income quartile. Lowest-income participants in small business plans would see retirement savings reductions as high as 40%.

- ***A Tax Credit Approach Would Impose Administrative Complexities and Costs.*** A move to a tax credit would result in additional administrative complexity and would very likely raise compliance costs and fee levels. First, a tax credit system would necessitate a complex recapture regime to prevent individuals from making short-term contributions merely to collect the tax credit. Second, to the extent that the amount of the tax credit is restricted by a taxpayer's income level, new burdens would be imposed on sponsors and service providers to track participants' household income levels. Such tracking is not currently done and would be both practically difficult and extremely sensitive from a privacy perspective.

WE MUST DO MORE TO INCREASE RETIREMENT SAVINGS, BUT POLICY SHOULD BUILD ON EXISTING SYSTEM, NOT UNDERMINE IT

- ***Changes in Retirement Policy Should Build on Existing System, Not Undermine It***. Promoting retirement savings must remain one of our nation's top policy priorities. But any changes that are made should build upon our existing and successful tax incentive structure so that it works even more effectively to facilitate retirement plan coverage and savings by American families.