American Benefits Council

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The Benefits of Existing Tax Incentives for Retirement Savings

Introduction and Summary

The U.S. retirement savings system successfully encourages individuals to save for retirement by providing tax incentives, typically income tax exclusions or deductions, for contributions to employer-sponsored defined contribution plans and IRAs, up to certain limits. This tax incentive structure is a pillar of our successful employment-based defined contribution plan system and indeed of our private retirement savings system as a whole. It provides a strong incentive for individual taxpayers at all income levels to save for retirement and successfully encourages employers to sponsor retirement plans that deliver meaningful benefits and important protections to Americans up and down the income scale.

Some, however, have recently argued that the current tax incentive system is not the optimal structure, suggesting that after-tax contributions paired with a tax credit, capped at a dollar amount or on a percentage basis, would work better than the current system of exclusions and deductions.[1] This profound shift in the tax rules would be a radical and disruptive change to one of the foundations of the current successful system and would harm individuals saving for retirement. As discussed in detail below, eliminating the current tax incentives and replacing them with after-tax contributions and a capped tax credit would lead to a decline in individual savings levels as well as reduced employer sponsorship of (and contributions to) workplace retirement plans.

[1] *See, e.g.*, Teresa Ghilarducci, *Guaranteed Retirement Accounts: Toward Retirement Income Security* (Economic Policy Institute, Briefing Paper No. 204, Nov. 2007) (proposing repeal of the current law exclusion/deduction for retirement savings and replacement with a universal refundable tax credit capped at $600 per person per year); William G. Gale, Jonathan Gruber & Peter R. Orszag, *Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households* (The Hamilton Project, The Brookings Institute, Discussion Paper 2006-02, Apr. 2006) (proposing replacement of the current law exclusion/deduction for retirement savings with a 30% governmental matching contribution (essentially a refundable tax credit placed directly into retirement accounts) on defined contribution plan contributions up to $20,000 per person and IRA contributions up to $5,000 per person).

Such results would have significant and detrimental effects on the retirement prospects of American families and would shrink an important pool of investment capital that is critical for the success and growth of our economy. Such a change in the tax structure could also create tax inequities among workforces covered by different types of retirement plans and deter plan sponsors from selecting the retirement plan design that would best serve their employees' needs. Administrative burdens for stakeholders in the retirement system would also result, prompting a likely increase in the fees imposed on individual savers.

Highlighting the fundamental flaws with a tax credit approach, as this paper does, should not be regarded as a statement that improvements to the current tax incentive structure and current retirement system cannot be made. Indeed, the American Benefits Council has set forth a comprehensive set of recommendations to make such improvements so that our savings tax incentives work even better and so that even more Americans are covered by workplace retirement plans and IRAs.[2]

The Council is likewise supportive of a number of proposals from the Obama Administration and retirement policy leaders in Congress that are designed to strengthen rather than undermine the current system of tax incentives.[3] However, while we work to improve the current system and expand retirement plan coverage, we must not eliminate one of the central foundations – the tax treatment of savings – upon which today's successful system is built. The harmful effects of such a change, for individuals, employers and the system as a whole, are simply too pervasive and must be avoided.

The discussion below is divided into three sections. The first section reviews the primary elements of the current retirement savings tax structure. The second section sets forth the numerous benefits produced by the current tax structure both for individual savers and for our economy. The third section describes the detrimental effects of repealing the current tax incentive structure and replacing it with after-tax contributions and a capped tax credit.

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[2] Expanding retirement plan coverage to those without access to workplace savings vehicles is often cited as a prime rationale by those who want to change and reallocate the current tax incentives for retirement savings. The Council's coverage expansion recommendations are contained in its "Multi-Plank Coverage Agenda" (July 13, 2009).

[3] The Council supports the expansion of the small business tax credit for retirement plan start-up expenses, which was included in the Obama Administration's Fiscal Year 2011 budget proposal to Congress. The Council likewise has supported expansion of the Saver's Credit, which has been proposed in various forms by the Obama Administration and a number of Members of Congress, including Representative Earl Pomeroy (D-ND) in H.R. 1961. We have also been supportive of steps to make SIMPLE 401(k)s and SIMPLE IRAs more attractive, a centerpiece of legislation from Representatives Ron Kind (D-WI) and Dave Reichert (R-WA) (H.R. 4742).

I. Elements of the Current Tax Incentive Structure

Contributions to Workplace Retirement Plans and IRAs Are Excludable from Tax. The core of the current retirement savings tax incentive structure is the availability of an exclusion or deduction for contributions to defined contribution plans and IRAs, subject to certain dollar limits. Contributions to workplace defined contribution plans, both those made by employees and those made by employers, are generally excludable from employees' taxable incomes, and contributions to traditional Individual Retirement Accounts (IRAs) are tax-deductible in many instances.[4]

In certain circumstances, a comparable tax benefit is provided for individual contributions to "Roth" vehicles (Roth 401(k)s, Roth 403(b)s and Roth IRAs) under which contributions are made on an after-tax basis but qualifying distributions are tax-free.[5] While not the common perception, contributing to one of these Roth accounts, with its back-end tax incentives, can be particularly advantageous for low- to middle-income taxpayers in certain circumstances.[6]

In addition, employer contributions to plans are not regarded as "wages," and so neither employers nor employees owe payroll taxes (Social Security, Medicare, unemployment) on these amounts. Social Security and Medicare taxes are owed, however, on employees' own contributions.

The tax benefit for pre-tax defined contribution plan contributions occurs at the time amounts are contributed. These amounts are not included in taxable income and therefore not subject to income tax withholding (and payroll tax withholding in the case of employer contributions). This pre-tax treatment of contributions occurs automatically in these plans; employees need not take affirmative steps to claim the tax

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[4] Eligibility to make tax-deductible IRA contributions depends on several factors, notably access to employer-sponsored retirement plans and income level.

[5] Participants in 401(k) and 403(b) plans may make employee contributions to Roth accounts if the employer's plan so permits. In addition, taxpayers below certain income thresholds are also eligible to contribute to Roth IRAs. For taxpayers whose income levels and income tax rates remain consistent throughout their working and retirement years, the net income from a pre-tax contribution to a traditional account and an after-tax contribution to a Roth account is the same (presuming the same investment returns). *See, e.g.*, Terry Bechtel & Mark Schaub, *The Roth Versus the Traditional IRA: An Annual Decision*, NAT'L PUB. ACCT., July 2003, at 40 (demonstrating that "the Roth IRA has no advantage over the Traditional IRA if the investor's marginal tax bracket is the same during both the contribution years and the retirement years (for an equal before-tax contribution)").

[6] *See, e.g.*, Michael Ahern, John Ameriks, Joel Dickson, Robert Nestor & Stephen Utkus, *Tax Diversification and the Roth 401(k)*, at 11-13 (Vanguard Center for Retirement Research, Vol. 18, Oct. 2005) (noting that lower-income workers who anticipate being in higher tax brackets in the future and certain low-income workers eligible for income-related tax credits may benefit from making Roth contributions rather than pre-tax contributions).

benefit. The tax deduction for pre-tax IRA contributions is taken on the individual's annual tax return, which is generally filed by April 15th of the following year.[7]

The tax benefit provided by an exclusion or deduction is proportional to the taxpayer's income tax bracket (and does not provide an income tax benefit to those with no income tax liability). For example, a taxpayer in the 33% tax bracket saves 33 cents in tax for every excludable/deductible dollar saved and a taxpayer in the 15% tax bracket saves 15 cents in tax for every excludable/deductible dollar saved. It is this rather unremarkable fact that generates much of the criticism of the existing tax incentive structure for retirement savings. Critics argue that existing incentives unduly benefit those in upper-income tax brackets and insufficiently help those in lower-income tax brackets. Yet the distribution of these tax benefits is nothing more than the logical extension of providing an income tax exclusion/deduction under our progressive income tax structure (under which nearly 47 million tax filers have no federal income tax liability[8] and the top quintile of taxpayers by income bear 87.5% of the liability[9]). The fact that income tax benefits for retirement savings flow to those who pay income tax seems an insufficient basis to condemn the current structure. It undoubtedly fails to recognize the many benefits for workers of all income levels from the current tax exclusion/deduction and also fails to take into account the supplemental retirement savings tax credit (the "Saver's Credit") discussed below.

This line of criticism also ignores the payroll tax savings that workers of all income levels enjoy in connection with employer contributions to defined contribution plans. As noted above, employer contributions are not subject to payroll tax, meaning that workers save 15.3 cents in payroll tax for every dollar employers contribute.[10] These payroll tax savings are of most value to modest-income employees earning amounts below the Social Security wage base ($106,800 in 2010) since payments in cash rather than into the plan would be fully subject to payroll taxes. For employees earning amounts above the wage base, the payroll tax saving is much less as only Medicare taxes would be applied to wage payments made in lieu of plan contributions. Clearly, income tax benefits are not the only tax savings associated with retirement plan contributions, especially for modest-income workers.

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[7] Taxpayers are allowed to make IRA contributions up until April 15th and have these contributions count as contributions for the prior year.

[8] In 2007, it is estimated that roughly 46.6 million tax returns had a zero or negative (*i.e.*, the taxpayer received a refund in excess of taxes owed) tax liability. *See* Gerald Prante, *Summary of Latest Federal Individual Income Tax Data* (The Tax Foundation, Fiscal Fact No. 183, July 30, 2009). Roughly 121 million Americans were not included in the federal income tax system in 2006 because they did not file a tax return and/or did not have federal income tax liability. *See* Scott A. Hodge, *Number of Americans Paying Zero Federal Income Tax Grows to 43.4 Million* (The Tax Foundation, Fiscal Fact No. 54, Mar. 30, 2006).

[9] It is estimated that the top cash-income quintile will bear 87.5% of the 2010 federal individual income tax liability while only earning 54.4% of total income. RACHEL M. JOHNSON & JEFFREY ROHALY, URBAN-BROOKINGS TAX POLICY CENTER, THE DISTRIBUTION OF FEDERAL TAXES, 2009-12 (Aug. 2009).

[10] This represents 12.4% in combined employer and employee obligation for Social Security taxes and 2.9% in combined employer and employee obligation for Medicare taxes.

While there is clearly a link between an individual's income tax bracket and his or her retirement savings tax benefit, it is important to note that a significant share of the federal tax incentives provided for defined contribution plans (so-called "tax expenditures") nonetheless are used by low- and middle-income participants and retirees. Fully 65% of these tax benefits for defined contribution plans are attributable to taxpayers with less than $100,000 of adjusted gross income (AGI), 79% are attributable to taxpayers with less than $150,000 of AGI, and 89% are attributable to taxpayers with less than $200,000 of AGI.[11] Devotion of significant tax incentives to households making up to $100,000 (and above) is certainly appropriate as these families often struggle to set aside assets for retirement. Indeed, the Obama Administration has recently recommended expanding the Saver's Credit (which supplements the underlying exclusion/deduction for retirement savings) for households making up to $85,000 per year.[12]

Private Plans Work Together with Social Security. It is also important to recall that employer-sponsored retirement plans are designed to work together with Social Security to provide meaningful income replacement upon retirement. Under Social Security, lower-income individuals benefit from a higher "replacement rate" of pre-retirement earnings than do middle- and upper-income individuals.[13] Tax-preferred employer retirement plans, which deliver meaningful benefits to many middle-income families, help to equalize retirement income and replacement rates across income groups. In this context, it is logical and appropriate that middle-income taxpayers derive somewhat more benefit from employer defined contribution plans and IRAs because they derive less benefit from Social Security. When the two systems are evaluated as a whole, they produce a fair distribution of retirement benefits across all income groups.

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[11] AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES, ESTIMATED BENEFITS OF TAX EXPENDITURE ESTIMATES FOR DEFINED CONTRIBUTION PLAN PARTICIPANTS AND RETIREES WITH ACCOUNT BALANCES (Aug. 2009) (analyzing IRS data), *available at* http://www.asppa.org/document-vault/pdfs/mediaroom/LTENYT082509.aspx.

[12] This recommendation was made by the Administration's Middle Class Task Force and is also contained in the Administration's Fiscal Year 2011 budget proposal to Congress. Office of the Press Secretary, Executive Office of the President, Fact Sheet: Supporting Middle Class Families (Jan. 25, 2010), *available at* http://www.whitehouse.gov/sites/default/files/Fact_Sheet-Middle_Class_Task_Force.pdf; DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 19-20 (2010).

[13] The Social Security benefit formula was designed to be a progressive formula; in other words, it was designed so that monthly benefits replace a higher proportion of preretirement earnings for people with lower earnings compared to those with higher earnings. Patricia P. Martin & David A. Weaver, Social Security Administration, *Social Security: A Program and Policy History*, 66:1 SOCIAL SECURITY BULLETIN, Sept. 2005, at 1. *See also* Andrew G. Biggs, Mark Sarney, & Christopher R. Tamborini, *A Progressivity Index for Social Security* (Social Security Administration, Issue Paper No. 2009-01, Jan. 2009).

It also bears noting that those with significant balances in their defined contribution plans and IRAs typically pay additional income tax on their Social Security benefits. Since withdrawals from plans and IRAs are generally taxable, they are often the additional income source that causes an individual's Social Security benefits to become taxable. And as a retiree's income increases, the percentage of Social Security benefits subject to tax increases. Thus, those who have benefited significantly from the initial tax incentives for retirement savings will not only pay income tax on these amounts under our progressive income tax system but will also pay additional income tax on their Social Security benefits under our progressive system of Social Security benefit taxation.

Taxes on Gains Are Deferred. Another significant tax benefit in the retirement savings system for many individuals is the deferral of tax on investment gains inside retirement accounts. As amounts grow inside a retirement account, earnings accumulate on a tax-deferred basis and taxes are not due until the amounts are withdrawn.[14] This is of significant assistance to the many individuals who find themselves in a higher tax bracket during their working years and a lower tax bracket during retirement. For the many individuals who save for retirement over a significant period, gains can ultimately outstrip underlying contributions – often by a substantial amount – making this tax treatment extremely valuable.[15]

The Saver's Credit Supplements the Exclusion/Deduction. Another element of the current retirement savings tax incentive structure is the Saver's Credit, a non-refundable tax credit that supplements (rather than replaces) the exclusion/deduction for certain taxpayers. The Saver's Credit provides a credit of up to $1,000 ($2,000 if married filing jointly) to low- and middle-income individuals who contribute amounts to workplace defined contribution plans and IRAs.[16] It was designed to provide a more robust savings tax incentive for eligible individuals (who are in lower tax brackets) 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 certain contributions and the supplemental Saver's Credit, eligible individuals are provided with a significant tax incentive to contribute to retirement accounts, one that far exceeds mere proportionality to the individual's income tax bracket.

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[14] As noted above, amounts in Roth accounts (including accumulated gains) are not subject to tax when withdrawn.

[15] *See, e.g.*, Sarah Holden, Jack VanDerhei, & Luis Alonso, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008* (Investment Company Institute, Perspective Vol. 15, No. 2 / Employee Benefit Research Institution, Issue Brief No. 335, Oct. 2009) (in addressing older participants' account balances, stating that "[i]nvestment returns, rather than annual contributions, generally account for most of the change in accounts with larger balances").

[16] In 2010, the Saver's Credit is available to married individuals filing separately and single individuals with incomes up to $27,750; heads of household with incomes up to $41,625; and married couples filing jointly with incomes up to $55,500. These income thresholds are adjusted annually to keep pace with inflation.

Congress enacted the Saver's Credit in the Economic Growth and Tax Relief Reconciliation Act of 2001 with strong bipartisan support. Taxpayer utilization of the Saver's Credit has been significant and has increased modestly over time.[17] The Saver's Credit was initially scheduled to expire at the end of 2006, but Congress made it permanent in the Pension Protection Act of 2006. Because permanent tax benefits tend to be utilized more than temporary tax benefits, it can be expected that the permanency of the Saver's Credit will contribute to its increased use by taxpayers.[18] Moreover, the Obama Administration has made expansion of the Saver's Credit to reach more low- and middle-income households a centerpiece of its retirement agenda.[19] Such expansion would enhance the tax benefits for these households and spur a greater amount of savings without producing the serious harms of a capped tax credit approach.

Contributions Are Subject to Dollar Limits. As noted above, Congress has imposed maximum dollar limitations on individual contributions to defined contribution plans and IRAs.[20] In 2010, individuals can contribute a maximum of $5,000 per year to a tax-deductible or Roth IRA (increased to $6,000 for individuals who are at least age 50) and a maximum of $16,500 per year to tax-excludable defined contribution plans (increased to $22,000 for individuals who are at least age 50).[21] This per-employee maximum on plan contributions acts as a meaningful cap on upper-income savers but does not unduly constrain the savings levels of moderate-income savers. To illustrate, for someone with $200,000 in income, the $16,500 limit translates into a cap of 8.25% of income that can be saved into a defined contribution plan. For someone making $75,000, the dollar limit imposes a saving cap of 22% of income, and for someone making $50,000 the limit imposes a cap of 33% of income. Thus, the dollar limits allow robust tax-preferred savings by low- and middle-income households but substantially constrain the tax-preferred savings of upper-income households.

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[17] In 2007, approximately 5.86 million taxpayers claimed the Saver's Credit, up from approximately 5.31 million in 2002, the first year in which the Saver's Credit was available. *See* Justin Bryan, Internal Revenue Service, *Individual Income Tax Returns, 2007*, *in* STATISTICS OF INCOME BULLETIN (Fall 2009), *available at* http://www.irs.gov/pub/irs-soi/09fallbulindincomeret.pdf; Michael Parisi & Scott Hollenbeck, Internal Revenue Service, *Individual Income Tax Returns, 2002*, *in* STATISTICS OF INCOME BULLETIN (Fall 2004), *available at* http://www.irs.gov/pub/irs-soi/02indtr.pdf.

[18] *See* THE RETIREMENT SECURITY PROJECT, SPLIT REFUND AND SAVER'S CREDIT: TWO BETTER WAYS TO SAVE FOR RETIREMENT 2 (noting that, "[b]ecause temporary tax benefits are generally not as fully utilized by taxpayers and preparers as permanent ones, we expect that, over time, more taxpayers will now take advantage of the Saver's Credit").

[19] *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 19-20 (2010).

[20] Employer contributions to defined benefit and defined contribution plans are tax-deductible but are likewise subject to dollar limitations.

[21] Employers may make additional excludable contributions to defined contribution plans above the $16,500 level subject to an annual cap of $49,000 on combined employer and employee contributions to a defined contribution plan in 2010. Individuals contributing to a SIMPLE plan may exclude contributions up to $11,500 ($14,000 for individuals who are at least age 50).

Rules Exist to Promote Fairness of Employer Retirement Plans. Beyond these dollar limits, a substantial statutory and regulatory regime has been developed with the goal of ensuring fairness in retirement plan benefit delivery to employees up and down the income scale. The rules Congress has established to promote fairness in workplace retirement plans include coverage rules to ensure that a fair cross-section of employees (including sufficient numbers of non-highly compensated workers) is covered by the employer plan, nondiscrimination rules to make certain that benefits are being provided to non-highly compensated employees at a rate that is not dissimilar to the rate for highly compensated workers, and top-heavy rules to require minimum contributions for non-highly compensated employees where the plan delivers significant benefits to top employees.[22] These rules complement the dollar limits on contributions to help ensure that higher-, middle-, and lower-income taxpayers receive fair benefits from employer-sponsored retirement plans.

Distributions from Defined Contribution Plans and IRAs Are Subject to Tax. It is also important to remember that pre-tax contributions made to defined contribution plans and IRAs – and the earnings on these contributions – do not escape taxation. Amounts withdrawn from plans and IRAs are subject to taxation at income tax rates (rather than the lower capital gains rates applied to many forms of savings outside of plans and IRAs). This means that income taxation has merely been deferred, not avoided, and that tax is collected at a higher rate (income vs. capital gains) than might otherwise have been the case. Indeed, the federal tax revenue collected on retirement account distributions is very substantial.[23] In other words, the federal tax incentives we devote

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[22] The specific nondiscrimination rules applicable to defined contribution plans are detailed and mathematical. Voluntary pre-tax and Roth after-tax contributions to such plans must satisfy the Actual Deferral Percentage test ("ADP test"). The ADP test compares the elective contributions made by highly compensated employees and non-highly compensated employees. Each eligible employee's elective contributions are expressed as a percentage of his or her compensation. The numbers are then averaged for (i) all eligible highly compensated employees, and (ii) all other eligible employees (each resulting in a number, an "average ADP"). The ADP test is satisfied if (i) the average ADP for the eligible highly compensated employees for a plan year is no greater than 125% of the average ADP for all other eligible employees in the preceding plan year, or (ii) the average ADP for the eligible highly compensated employees for a plan year does not exceed the average ADP for the other eligible employees in the preceding plan year by more than 2% <u>and</u> the average ADP for the eligible highly compensated employees for a plan year is not more than twice the average ADP for all other eligible employees in the preceding plan year. Treas. Reg. § 1.401(k)-2.
Employer matching contributions and employee after-tax contributions (other than Roth contributions) must satisfy the Actual Contribution Percentage test ("ACP test"). The ACP test compares the employee and matching contributions made by highly compensated employees and non-highly compensated employees. Each eligible employee's elective and matching contributions are expressed as a percentage of his or her compensation, and the resulting numbers are averaged for (i) all eligible highly compensated employees, and (ii) all other eligible employees (each resulting in a number, an "average ACP"). The ACP test utilizes the same percentage testing criteria as the ADP test. Treas. Reg. § 1.401(m)-2.

[23] For the 2007 taxable year, the amount of taxable pensions and annuities reported on individual income tax returns was $490.5 billion, and the amount of taxable distributions from IRAs was $148 billion. *See* Justin Bryan, Internal Revenue Service, *Individual Income Tax Returns, 2007*, *in* STATISTICS OF INCOME BULLETIN 7, fig.B (Fall 2009), *available at* http://www.irs.gov/pub/irs-soi/09fallbulindincomeret.pdf.

to spur savings are not lost but are reclaimed as additional tax revenue when individuals make withdrawals in retirement. In addition to being subject to income taxation, withdrawals from defined contribution plans and IRAs that are made prior to retirement are generally subject to an additional 10% penalty tax. This penalty is designed to encourage individuals to retain the savings in workplace plans and IRAs for retirement.

II. Benefits of the Existing Tax Structure

Current Incentives Encourage Savings and Are Popular with Taxpayers. The pre-tax treatment of retirement savings encourages individuals to save for retirement, allowing workers to save more from each paycheck than would be the case with after-tax contributions. For a worker in the 25% income tax bracket, for example, a $20 deferral into a 401(k) plan will only reduce take home pay by $15, making saving into the plan a particularly efficient economic proposition, particularly for low- and middle-income families trying to make the most of scarce dollars. The tax deferral on earnings is also critical in incenting savings as workers know they won't have to divert income year-by-year to pay tax on their retirement savings. Recent surveys confirm that the current tax exclusion/deduction structure plays a large role in encouraging households to save for retirement. 85% of households with a defined contribution account said that the immediate tax savings for plan contributions was a significant incentive to contribute.[24] Also, 88% of surveyed households (without regard to whether they owned a defined contribution plan or IRA account) were against *eliminating* the tax advantages of defined contribution plans and IRAs[25] and 72% were against *reducing* such advantages.[26] Strong opposition to changing the tax incentives for defined contribution plans and IRAs existed even among households that did not have a defined contribution account or IRA (76% opposed elimination and 62% opposed reduction) and among households making less than $30,000 (75% opposed elimination and 62% opposed reduction).[27]

Current Incentives Efficiently Produce Ultimate Retirement Benefits. One of the most important advantages of the current retirement savings tax incentive structure is that it efficiently produces ultimate retirement benefits for American families. Repeated analyses have shown that for every dollar of tax expenditure devoted to tax-preferred workplace retirement plans, these plans deliver between four and five dollars in ultimate retirement benefits to plan participants.[28] This multiplier effect produces a

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[24] SARAH HOLDEN, JOHN SABELHAUS & BRIAN REID, INVESTMENT COMPANY INSTITUTE, ENDURING CONFIDENCE IN THE 401(K) SYSTEM: INVESTOR ATTITUDES AND ACTIONS (Jan. 2010).
[25] *Id.*
[26] BRIAN REID & SARAH HOLDEN, INVESTMENT COMPANY INSTITUTE, RETIREMENT SAVING IN WAKE OF FINANCIAL MARKET VOLATILITY (Dec. 2008).
[27] *Id.*
[28] *See, e.g.,* AMERICAN BENEFITS COUNCIL, MYTHS AND FACTS ABOUT THE SAVINGS PROVISIONS OF H.R. 1776 (July 2003) ("Benefits paid by employer-sponsored pensions are 4.5 times as large as the foregone federal tax collections attributed to them." (analyzing Department of Commerce and Office of Management and Budget data)); ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, BENEFITS BARGAIN: WHY WE

remarkable amount of benefits for retirees, with the Department of Commerce reporting that in 2008 private employer-sponsored retirement plans paid out $462 billion in benefits to employees and their families.[29]

Incentives Spur Creation and Maintenance of Valuable Employer Retirement Plans. The employer-sponsored retirement system is premised on its voluntary nature. Employers can choose to provide retirement plans to their workers but they are not required to do so. In this context, the tax incentives for plan contributions that are available to employees generally, and to key business decision-makers specifically, can play an important role in encouraging plan sponsorship and maintenance. This is particularly the case for small businesses.[30] If a business decision-maker can realize meaningful tax benefits for herself and her employees through sponsorship of a workplace retirement plan, she may be more willing to take on the significant legal responsibilities and business costs inherent in plan sponsorship. If the tax benefit is reduced (for example, through conversion of the exclusion to a capped tax credit), then some businesses that would have considered plan sponsorship may no longer do so and some existing plan sponsors may stop offering retirement plans. These outcomes would be extremely counterproductive for employees.

Why would this be so counterproductive? As plan sponsors, employers must adhere to strict fiduciary obligations established by Congress to protect the interests of plan participants. ERISA imposes, among other things, duties of prudence and loyalty upon plan fiduciaries, and requires that plan fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and for the "exclusive purpose" of providing participants and beneficiaries with benefits and defraying reasonable administrative expenses.[31] These exceedingly demanding fiduciary obligations (which are enforced through both civil and criminal penalties) offer investor protections not typically associated with savings vehicles individuals might use outside the workplace.

Beyond rigorous fiduciary oversight, employer plan sponsorship offers a number of important advantages and protections to individual workers that would be lost if plan creation is impaired. Employers facilitate savings through payroll deduction (and increasingly through automatic enrollment), they typically provide matching contributions, profit-sharing contributions or both, they select high-quality, reasonably-priced investment offerings and monitor these offerings on an ongoing basis, they use

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SHOULD NOT TAX EMPLOYEE BENEFITS 23 (May 1990) ("The data suggest that in the pension area, the benefits paid by the plan are 4.6 times the foregone federal tax collections attributed to them.").

[29] BUREAU OF ECONOMIC ANALYSIS, 89:9 SURVEY OF CURRENT BUSINESS tbl.6.11D (Sept. 2009).

[30] *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, THE 2003 SMALL EMPLOYER RETIREMENT SURVEY (SERS) SUMMARY OF FINDINGS 3 (June 3, 2003) ("Substantial minorities of new [small business] sponsors say that *major* reasons they offer a plan are <u>tax advantages for employees</u>, the availability of a plan that could really be customized for the needs of their business, demand from employees, and <u>so key executives can save for retirement on a tax-preferred basis</u>." (italics in original, underlining added)).

[31] ERISA § 404. Internal Revenue Code § 401(a) also requires that a qualified trust be organized for the exclusive benefit of employees and their beneficiaries.

their bargaining power to reduce both investment and administrative fees, they provide education about retirement saving, investing and planning, and they increasingly provide access to professional investment advice.[32] These numerous advantages for workers would be lost as employers institute fewer plans (or even drop plans) in response to a capped tax credit regime.

Some of the critics of the current system would instead create a regime in which all employers must offer a plan. Meaningful tax incentives for key business decision-makers do not have the same relevance, of course, under a regime that mandates that all employers must offer retirement programs. The proposals for such mandates differ notably, but they nevertheless raise a significant number of concerns, including the imposition of new expenses on employers, increased costs associated with each hired worker, and reduced retirement plan choice for both sponsors and participants. In any event, tax incentives will continue to play an important role. For example, if the mandate is simply to make a retirement savings program available to employees (with no mandated employee contributions), the tax treatment of employee contributions will certainly continue to be relevant to whether employees participate. In addition, some such mandates, such as the Obama Administration proposal for automatic IRAs that has recently been introduced in the House and Senate,[33] apply only to employers that do not offer retirement plans. In this context, tax incentives will continue to be critical to encourage business owners to offer more robust employer-sponsored plans with their many advantages for employees. The Obama Administration itself has recognized the importance of tax incentives for plan sponsorship by including in its 2011 budget a proposal to double the tax credit provided to small employers that initiate qualified workplace retirement plans.[34]

Incentives Help Produce Important Source of Investment Capital. The tax incentives that spur savings in defined contribution plans and IRAs and allow the earnings in these accounts to grow tax-free help to produce a critical source of stable, long-term investment capital for our economy as a whole. These assets have an economic impact that extends well beyond the retirement security of the individual workers who save in these plans. Indeed, retirement plans held approximately $16 trillion in assets as of year-end 2009.[35] Amounts in defined contribution plans accounted for approximately

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[32] For a fuller discussion of the many advantages for employees that result from employer sponsorship of defined contribution plans, *see* AMERICAN BENEFITS COUNCIL, DEFINED CONTRIBUTION PLANS: A SUCCESSFUL CORNERSTONE OF OUR NATION'S RETIREMENT SYSTEM 2 (Feb. 2009), *available at* http://www.americanbenefitscouncil.org/documents/dc_success_paper021709.pdf.
[33] *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 16-18 (2010) and The Automatic IRA Act of 2010 (S. 3760/H.R. 6099).
[34] *Id.*
[35] Peter Brady, Sarah Holden & Erin Short, *The U.S. Retirement Market, 2009* (Investment Company Institute, Fundamentals Vol. 19 No. 3, May 2010).

$4.1 trillion of this total, and amounts in IRAs represented approximately $4.2 trillion.[36] In total, defined contribution plans and IRAs hold nearly 20% of corporate equities.[37]

These trillions of dollars in assets, representing ownership of a significant share of the total pool of stocks and bonds, provide an important and ready source of investment capital for American businesses. This capital permits greater production of goods and services and makes possible additional productivity-enhancing investments. These investments thereby help companies grow, expand their payrolls and raise employee wages. Thus, reducing the tax incentives for retirement savings would not only deter individuals from saving but would reduce this pool of investment capital. Given that retiring baby-boomers will already be moving from a contribution posture to a withdrawal posture with respect to their retirement savings, thereby drawing down this pool of capital, now is not the time to reduce the tax incentives that lead younger generations to save. Moreover, in light of the continuing weakness in the U.S. economy and the critical need for resources to facilitate business expansion and job growth, jeopardizing continued additions to this pool of capital through reduced tax incentives would be unwise.

III. The Detrimental Effects of Moving to a Tax Credit System

It Would Reduce Plan Participation and IRA Usage. As discussed above, converting today's deduction/exclusion for defined contribution and IRA savings into a tax credit would deter plan participation and IRA usage as it would undermine the core incentives that drive today's savings behavior. Under most tax credit proposals, the amount of the credit would be capped (on either a dollar or percentage basis) and would provide less tax savings for many families than today's exclusion/deduction. This will likely deter savings into defined contribution plans and IRAs, particularly by the middle-income families who could be affected by the cap. Indeed, as noted above, taxpayers of all income levels indicate in surveys that the current tax treatment is a significant incentive to save and that they oppose elimination or reduction of this incentive. Reducing the incentive to save in plans and IRAs would be particularly detrimental as such savings typically represent a significant share of families' total financial assets.[38]

A change to a system of after-tax contributions and capped tax credits would also likely create great confusion among individual savers. Enormous educational efforts would be required to explain the complex new system and how it differs from the current

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[36] *Id*.

[37] *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL RESERVE STATISTICAL RELEASE Z.1, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (Dec. 11, 2008).

[38] Craig Copeland, *Individual Account Retirement Plans: An Analysis of the 2007 Survey of Consumer Finances, With Market Adjustments to June 2009* (Employee Benefit Research Institute Issue Brief, No. 333 at 14, Aug. 2009).

regime. This complexity and confusion would be extremely counterproductive at a time when policymakers, consumer groups, employers and service providers have all agreed that the way to foster savings and successful investing is to keep things simple. Complex, confusing rules too often lead to inaction, and we must not create new reasons for inaction in the retirement savings arena. Given the many challenges American families confront in saving adequate resources for retirement, policymakers should avoid undermining one of the key incentives to do so and adding additional complexity to the system.

It Would Deter Plan Sponsorship. As noted above, current taxation of employee deferrals into defined contribution plans would likely deter plan sponsorship as key business decision-makers see a reduced tax benefit for themselves and their workers from offering a plan. Given the many advantages and protections employer plans offer to employees, this decrease in employer-sponsored plans would be extremely detrimental for workers. Indeed, changing the tax structure in a way that will deter plan sponsorship will undercut the current concerted effort to expand retirement plan coverage to more working Americans.

It Would Deter Employer Contributions. Certain proposals to replace the income tax exclusion for defined contribution plan contributions with a tax credit also suggest that employer contributions to these plans (matching contributions, profit-sharing contributions), which the vast majority of plan sponsors make,[39] should likewise be subject to current tax. Making these contributions taxable would undoubtedly deter employers from providing them, and would be extremely unpopular with workers. Indeed, the income (and potential payroll) tax withholding for these taxable employer contribution amounts would reduce employee take home pay and could make it more difficult for families to make ends meet. If employer contributions are to be taxed and withholding imposed, employees may well prefer to receive such amounts in the form of additional wages, which are not subject to the restrictions on access applicable to retirement plans. This substitution of wages for employer contributions to plans would undoubtedly reduce savings levels and impair employees' retirement readiness.

It Would Create Artificial Distinctions Among Plan Designs. Proposals to change the tax incentive structure for defined contribution plans and IRAs do not typically recommend any change to the tax incentives provided for defined benefit plan accruals and contributions. While defined benefit plans are valuable retirement vehicles for many workers and employers, this divergent treatment would create artificial distinctions and could have a number of counterproductive effects. First, it would treat workforces covered by different plans inequitably. Workers covered by defined contribution plans would wonder why their contributions (and possibly those made by their employer) were being taxed while the benefit accruals of workers covered by defined benefit plans were not. Second, this divergent tax treatment could

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[39] *See* DEFINED CONTRIBUTION PLANS: A SUCCESSFUL CORNERSTONE OF OUR NATION'S RETIREMENT SYSTEM, *supra* note 26.

inappropriately affect employer plan design decisions. Presumably, such decisions should be guided by what design will best deliver benefits to a particular workforce and by what design is most consistent with an employer's business objectives. It seems unwise to substitute the tax treatment of employee contributions and accruals as a driving factor behind plan design, but that is what the tax credit proposals would do. Moreover, resulting changes in plan offerings would generate unnecessary operational and compliance costs, which will reduce employer resources available for actual benefits.

It Would Impose Administrative Complexities and Costs. Replacement of the current exclusion/deduction with a capped tax credit would also result in additional administrative complexity for our retirement savings system. This added complexity would affect individual taxpayers, employer plan sponsors, retirement plan and IRA service providers and the Internal Revenue Service (IRS).

First, a tax credit system would necessitate a complex recapture regime to ensure fairness in tax policies, prevent gaming and deter early withdrawals from retirement accounts. This is because an individual could contribute the amount needed to obtain the tax credit and then withdraw the contribution soon thereafter. Under a credit regime, the initial contribution would have been made with after-tax dollars so there would be no tax consequence to withdrawing the contribution once the credit had been collected (other than taxation of any modest gains earned since the contribution was made). Even when no gaming is involved, a tax credit regime would allow contributions to retirement accounts to be easily withdrawn and spent for non-retirement purposes – clearly a counterproductive result. The government would need a mechanism to recover tax credits awarded in these situations where there is no real long-term retirement savings being produced.[40] Creation and administration of this recapture regime would impose significant burdens on the IRS.

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 defined contribution plan participants, sponsors and service providers, who today need not track the income level of plan participants. Plan sponsor involvement in determinations of employee household income levels would be both extremely difficult and extremely sensitive. In terms of difficulty, employers do not typically possess the information needed to determine household income (spousal income, non-wage income, etc.). In terms of sensitivity, employers are very reluctant to become involved in these personal financial matters that have no bearing on the employment relationship. Employees are likewise reluctant to share this personal information with their employers.

[40] No such recapture regime is needed under the current exclusion/deduction system because contributions to plans and IRAs are generally made on a pre-tax basis and the tax benefit is automatically forfeited when amounts are withdrawn and taxed.

These administrative complexities would raise compliance costs for plan sponsors and for defined contribution plan and IRA service providers. These higher compliance costs would ultimately result in higher fees being imposed on individuals saving for retirement. With policymakers understandably focused on ensuring the reasonableness of fee levels in retirement vehicles, adopting a tax credit regime that will unnecessarily raise compliance costs and fee levels seems counterproductive.

Conclusion

The current tax incentive system for retirement savings, which provides an exclusion/deduction for individual contributions to defined contribution plans and IRAs, deferred taxation of contributions and gains until withdrawal, a supplemental Saver's Credit for low- to moderate-income taxpayers and dollar limits and non-discrimination rules for tax-preferred savings, has proven successful at spurring both individual savings and the sponsorship of workplace retirement plans. The current incentives are delivered equitably to those who pay income tax and efficiently produce ultimate retirement benefits that are well-distributed across income groups. Taxpayers themselves tell us that the current tax incentives encourage them to save and that they oppose changes to these incentives. And we know that the retirement savings that have resulted from these incentives are an important source of investment capital for our economy.

Eliminating the current tax incentives and replacing them with after-tax contributions and a capped tax credit would very likely lead to a decline in savings levels and reduced plan sponsorship, both of which would have detrimental effects for the retirement prospects of American families and for our economy as whole. Such a change in the tax structure could also create tax inequities among workforces covered by different types of plans and inappropriately affect plan sponsors' plan design determinations. Administrative burdens for all stakeholders in the retirement system, and a corresponding increase in fees imposed on savers, would also likely result. These harmful effects for individuals, employers and the system as a whole should be avoided and the tax credit proposals rejected. 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.