AMERICAN BENEFITS COUNCIL

September 20, 2010

SUMMARY: THE BENEFITS OF EXISTING TAX INCENTIVES FOR RETIREMENT SAVINGS

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 private retirement savings system. It provides a strong incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that deliver meaningful benefits to Americans up and down the income scale.

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 radical and disruptive change that would pose unwarranted risks for individuals saving for retirement. It would very likely 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 whole.

These harmful effects for individuals, employers and the system as a whole should be avoided, and the proposals to change the current tax incentive structure to after-tax contributions and a capped tax credit should be 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.

ELEMENTS OF THE CURRENT TAX INCENTIVE STRUCTURE

- **Contributions Are Excludable, Allowing More Employee Savings.** 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. This pre-tax treatment allows individuals 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 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 (under which nearly 47 million tax filers have no federal income tax liability and the top quintile of filers bear almost 90% of the liability). 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. This critique also fails to recognize that 79% of the federal tax incentives for defined contribution plans are attributable to taxpayers with less than $150,000 of adjusted gross income.

- **Employer Contributions Are Exempt from Payroll Taxes, Taxes on Gains Are Deferred and Distributions Are Taxable.** 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 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. 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 won't 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 defined contribution plans and IRAs -- and the earnings on these contributions -- do not escape taxation but rather are taxed 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.
- **Saver's Credit Supplements Exclusion/Deduction.** The Saver's Credit, which provides a credit of up to $1,000 ($2,000 if married filing jointly) to low- and middle-income individuals who contribute to defined contribution 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.
- **Contributions Are Limited and Rules Ensure Fairness.** Congress has imposed maximum dollar limits on individual contributions to defined contribution plans and IRAs. In 2010, the maximum individual contributions are generally $5,000 to IRAs ($6,000 if 50 or older) and $16,500 to defined contribution plans ($22,000 if 50 or older). 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. In addition, a substantial statutory and regulatory regime requires employer plans to adhere to coverage, nondiscrimination and top-heavy rules to ensure that individuals at all income levels receive fair benefits.

BENEFITS OF THE EXISTING TAX STRUCTURE

- **Current Incentives Encourage Individual Savings.** The current pre-tax treatment of retirement savings is a powerful incentive for individuals. It is viewed by taxpayers as the core of our retirement savings regime, and, as noted above, allows them to save more on a paycheck-by-paycheck basis than would be the case with after-tax contributions. This financially efficient approach is particularly important for low- and middle-income families trying to make the most of scarce dollars. The payroll tax savings on employer contributions provides another significant advantage for modest-income households, as does the deferral on gains that spares families from annual tax bills on their accumulating savings.
- **The Public Strongly Supports Current Incentives.** Confirming the centrality of these incentives, in a recent survey 85% of households with a defined contribution account said that the immediate tax savings associated with contributions was a significant incentive to save. 88% of households (with or without a defined contribution account or IRA) opposed eliminating defined contribution and IRA tax advantages, and 72% opposed reducing these advantages. Even very modest-income households making less than $30,000 opposed elimination (75%) and reduction (62%) of these tax incentives.

- **Current Incentives Efficiently Produce Ultimate Retirement Benefits.** Repeated analyses have shown that, for every dollar of federal tax expenditure devoted to tax-preferred workplace retirement plans, four to five dollars in ultimate retirement benefits result. This extremely efficient catalyst produces a remarkable amount of benefits for workers and their families -- in 2008, private employer retirement plans paid out $462 billion in benefits.
- **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. A move to a capped tax credit that provides a reduced tax benefit could discourage plan sponsorship. If sponsorship declines and more employees are forced to save on their own, they 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).
- **Incentives Help Produce Investment Capital.** The tax incentives that encourage retirement savings help produce stable, long-term investment capital for our economy. Indeed, defined contribution plans and IRAs held approximately $4.1 trillion and $4.2 trillion in assets, respectively, as of year-end 2009. In total, defined contribution plans and IRAs hold nearly 20% of corporate equities. These trillions of dollars provide important investment capital, helping 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

- **It Would Reduce Plan Participation and IRA Usage.** Converting the deduction/exclusion for defined contribution and IRA savings into a capped tax credit would deter plan participation and IRA usage as it would undermine the core incentives that drive today's savings behavior. Such a system would often provide less tax savings than today's structure, particularly for middle-income families. Moving to this complex new regime would also create great confusion among individual savers, deterring savings and contributing 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.
- **It Would Deter Plan Sponsorship.** Current taxation of employee deferrals 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 and would undercut the current concerted effort to expand workplace retirement plan coverage.
- **It Would Impose Administrative Complexities and Costs.** A change to a capped tax credit would result in additional administrative complexity and would 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, imposition of a credit system could require the separate tracking of contributions and investment earnings, which is not typically done today. This is because earnings in an account might be subject to ultimate taxation upon withdrawal whereas underlying contribution amounts, which had been made on an after-tax basis, would not be. Tracking would also be required to ensure that a taxpayer's credit would be based only on contributions and not earnings. Third, 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.