



AMERICAN BENEFITS COUNCIL

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PROPOSED DOUBLE TAXATION OF RETIREMENT PLAN BENEFITS WOULD JEOPARDIZE RETIREMENT SECURITY

In an effort to address the looming fiscal cliff, many potential solutions are being discussed. Two proposals, however, in particular are being explored: (1) in the case of high-income individuals, limiting the tax benefits attributable to certain tax expenditures to 28%, and (2) capping the amount of deductions and exclusions from income that can be used at a specified dollar figure, such as \$25,000. *There are active discussions of subjecting contributions to retirement plans and IRAs to both of these proposals. Doing so would have a devastating effect on retirement security by generally making contributions subject to double taxation, thereby severely undermining incentives to adopt or maintain a plan.*

Our nation's primary challenge with respect to the private retirement system is increasing the level of coverage. As discussed further below, if small business owners are subject to double taxation on their retirement contributions, making retirement contributions will actually become *disadvantageous* in many circumstances, which could lead to the termination of many small business plans and a dramatic reduction in the formation of new plans. Similarly, large employers' commitment to retirement plans will be significantly undermined by double taxation.

As discussed at the end of this document, it is possible that exempting Roth contributions from the possible new rules could, to some extent, limit the harm to the retirement plan system. *However, at a minimum, we need a thorough set of Congressional hearings on the damage that could be done to the retirement plan system by these proposals.*

PROPOSALS INVOLVING DOUBLE TAXATION

28% proposal: The double taxation issue can best be illustrated by the proposal to cap the tax benefits attributable to certain "tax expenditures", including employee contributions to defined contribution plans and IRAs, at 28%.

Assume, for example, that an individual in the 35% Federal income tax bracket makes a \$1,000 contribution to a 401(k) plan. Under current law, the individual would save \$350 of current taxes (i.e., 35% of \$1,000). The premise of the 28% proposal is that the 35% tax benefit is inequitable because taxpayers in lower tax brackets receive a smaller tax benefit. Accordingly, under the 28% proposal, the individual in this example would pay \$70 of taxes on the \$1,000, thus saving only \$280 of taxes (i.e., 28% of \$1,000).

There is a fundamental flaw in applying the 28% proposal to retirement plan contributions. Unlike all the other tax expenditures to which the 28% proposal applies, retirement plan contributions are fully subject to tax when received by the individual. So by partially taxing contributions and then fully taxing distributions, retirement plan benefits would become subject to double taxation.

The above example illustrates the double taxation. The employee in the example would be required to pay a 7% tax on the \$1,000 contribution when it is made (i.e., \$70). Then when that \$1,000 is distributed, the employee would pay tax on it again at the employee's full marginal rate at that time (which could be 35% or higher).

This double tax regime would make contributing to a retirement plan disadvantageous in many circumstances, even compared to simply investing the contribution in non-tax advantaged investment products. Moreover, even in those circumstances where contributing may be advantageous, the complexity and uncertainty of the double tax regime will make many participants hesitant to move forward with retirement plan contributions.

If small business owners see little or no advantages in making retirement contributions – or even see disadvantages – huge numbers will shut down existing plans and new plan formation among small businesses will fall precipitously from its already low levels. In the case of large employers to the extent that retirement plan tax benefits are undermined or eliminated, retirement plans will become a far less useful tool to attract and retain key employees. This can certainly be expected to result in large companies devoting less dollars and attention to retirement plans, further undermining retirement security.

Cap on tax expenditures: As noted, there is active consideration of a proposal that would cap the amount of tax expenditures that an individual can use at a specified dollar amount, such as possibly \$25,000. Originally, this cap idea was to apply only to itemized deductions, such as mortgage interest and state and local income taxes. But recent discussions have reflected serious consideration of also subjecting other deductions and exclusions – including retirement plan contributions – to the cap.

We need to consider these types of proposals in the context of small business owners and large company decision-makers. It would actually be relatively normal for such individuals to have in excess of \$25,000 in deductions for, for example, mortgage interest and state and local income taxes. For such individuals, the above proposal would thus eliminate all current income tax advantage for retirement plan contributions.

If there is no current income tax advantage for retirement plan contributions, will the contributed amount be taxed again when distributed? This is distinctly possible, but we do not know at this point. If full double taxation applies, it would generally be quite disadvantageous to contribute to the plan. Even if there is no double taxation, eliminating all current income tax advantages to retirement plan contributions will make such contributions far less attractive.

Roth contributions: One potential answer to the concerns described above is for the limits on tax expenditures to be inapplicable to Roth contributions, which appears to be the case at least with respect to the 28% proposal and may well be the case regarding the dollar cap. Mathematically, this could raise revenue and still preserve incentives to make contributions and maintain a plan.

A critical question, however, is whether the exemption for Roth contributions would have the desired effect of preserving such incentives. We do not know, but here are some facts that could help begin what would be a very complicated public policy discussion. According to Towers Watson's 2012 U.S. Defined Contribution Sponsor Survey Report, (1) less than half of the employers surveyed offer a Roth contribution feature, and (2) almost 90% of those plan sponsors reported that fewer than 10% of their participants used the Roth feature. Interestingly, the data on high-paid employee usage was extremely similar to the data on usage by other employees.

CONCLUSION

All of the above highlights the fact that we need a full set of in-depth Congressional hearings before we move forward with any proposal that could jeopardize the entire private retirement system.