AMERICAN RETIREMENT ASSOCIATION

Working for America's Retirement

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On behalf of the

American Retirement Association

Senate Finance Committee Hearing on

Corporate Integration

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The American Retirement Association ("ARA") thanks Chairman Hatch, Ranking Member Wyden, and the other members of the Senate Finance Committee for the opportunity to testify regarding the impact of corporate integration on small business qualified retirement plans.

The ARA is an organization of more than 20,000 members nationwide who provide consulting and administrative services to retirement plans that cover millions of American workers and retirees. ARA members are a diverse group of retirement plan professionals of all disciplines, including: financial advisers, consultants, administrators, actuaries, accountants, and attorneys. The ARA is the coordinating entity for its four underlying affiliate organizations, the American Society of Pension Professionals and Actuaries ("ASPPA"), the National Association of Plan Advisors ("NAPA"), the National Tax-deferred Savings Association ("NTSA") and the ASPPA College of Pension Actuaries ("ACOPA"). ARA members are diverse but united in a common dedication to America's private retirement system.

A workplace retirement plan is the single most important factor that determines whether or not workers accumulate significant savings for retirement. Data from the Employee Benefits Research Institute shows that workers earning between $30,000 and $50,000 per year are *fifteen times* more likely to save at work that to go out and set up an IRA to save on their own. Because moderate income earners almost exclusively save at work through plans like the 401(k) – the most widely known section of the tax code – it is not surprising that Internal Revenue Service data shows that nearly 80% of participants in 401(k) and other profit sharing plans make less than $100,000 per year, and 43% of participants in these plans make less than $50,000 per year. Simply stated, saving at work, works. That is why it is so critical that businesses, especially small businesses, be encouraged to maintain workplace retirement plans.

The tax incentives for employer-sponsored plans in place today do an efficient and effective job in allowing Americans across the income spectrum to build a secure retirement. These incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Nondiscrimination rules combined with compensation and contribution limits assure that non-highly compensated employees also benefit from these programs. Proposals such as corporate integration that would reduce the incentives for small business owners to save for themselves through a qualified retirement plan will discourage the establishment and maintenance of these retirement plans, and so reduce the availability of workplace retirement savings.

Background

What are the current tax incentives?

Employer contributions made to qualified retirement plans are deductible to the employer when made. Income tax on investment earnings on those contributions is deferred until amounts are distributed from the plan. When a distribution is made to a plan participant, all amounts are subject to ordinary income tax. Employer contributions made on a participant's behalf are not subject to FICA. In addition, individuals with adjusted gross income ("AGI") of less than $30,750, and married couples with AGI of less than $61,500, may qualify for a Saver's Credit ranging from 10% to 50% of the first $2,000 the individual contributes to an IRA or employer-sponsored defined contribution plan.

Limits are placed on contributions to defined contribution plans, and on benefits payable from defined benefit plans:

- Certain defined contribution plans permit employees to contribute on their own behalf by electing to have a certain dollar amount or percentage of compensation withheld from pay and deposited to the plan. These "elective deferrals" are excludable from income for income tax purposes, but FICA is paid on the amounts by both the employer and the employee. For 2016, the maximum elective deferral to a 401(k) or similar plan is $18,000. Employees age 50 or over can also make a "catch-up contribution" of up to $6,000. Elective deferrals to a SIMPLE plan are limited to $12,500, plus a $3,000 catch-up contribution for those age 50 or over.

- If the employer also contributes to a defined contribution plan (such as a 401(k) plan), the maximum contribution for any employee is $53,000. This limit includes any elective deferrals other than catch-up contributions. This means a participant that is age 50 or over, and who makes the full $6,000 catch-up contribution, would have a total limit of $59,000.

- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year's pay or $210,000. If retirement is before age 62, the dollar limit is reduced. Employers can deduct the amount required to fund promised benefits.

- Annual IRA contributions are limited to $5,500, plus "catch-up" contributions of $1,000 for those age 50 or over.

Compensation in excess of $265,000 cannot be considered in calculating contributions or in applying nondiscrimination rules under either defined benefit or defined contribution plans. For example, if a business owner makes $400,000, and the plan provides a dollar for dollar match on the first 3% of pay the participant elects to contribute to the plan, the match for the owner is 3% of $265,000, not 3% of $400,000.

What are the Current Nondiscrimination Rules?

The higher contribution limits for qualified retirement plans – both defined contribution and defined benefit plans – come with coverage and non-discrimination requirements. For example, a small business owner with several employees cannot simply put in a defined contribution plan and contribute $53,000 to his or her account. Other employees who have attained age 21 and completed 1 year of service with at least 1000 hours of work must be taken into consideration, and the employer must be able to demonstrate that benefits provided under the plan do not discriminate in favor of "Highly Compensated Employees" ("HCEs"), which would include the owner.

Generally, contributions or benefits that are proportionate to an individual's compensation are considered fair. Age can also be considered when determining the amount of contributions that can be made on a participant's behalf. A larger contribution (as a percentage of pay) can be made for older employees because the contribution will have less time to earn investment income before the worker reaches retirement age (usually age 65). Safe harbors are also available. For example, if all employees covered by a 401(k) plan are provided with a contribution of 3% of pay that is fully vested, the HCE can make the maximum elective deferral, regardless of how much other employees choose to contribute on their own behalf.

These nondiscrimination rules, coupled with the limit on compensation that can be considered under these arrangements, are designed to insure that qualified employer-sponsored retirement plans do not discriminate in favor of HCEs. *Non-discrimination rules do not apply to other forms of tax-favored retirement savings.* For example:

- IRAs share the incentive of tax deferral. However, if a small business owner makes a personal contribution to an IRA, there is no corresponding obligation to contribute to other employees' IRAs. However, under the current rules, the contribution limit for IRAs is set low enough (and the limit for employer-sponsored plans high enough) to make a qualified retirement plan attractive to a business owner who can afford it.

- Annuities purchased outside of a qualified plan share the benefit of "inside buildup" - the deferral of income tax on investment earnings until distributed from the arrangement – but have no limit on contributions or benefits, and no non-discrimination requirements.

This means the attraction of a qualified retirement plan for a small business owner is heavily dependent on the interaction of non-discrimination rules and the tax incentives for saving through a qualified retirement plan.

Corporate Integration

For purposes of this discussion, we consider a corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities. Taxpayers with a marginal tax rate of less than 35% would not be able to recover any portion of the withholding.

How would corporate integration affect the tax incentives for qualified retirement plans?

The tax incentive for saving through a qualified retirement plan is the deferral of income tax on the contributions made to the plan, and on investment earnings on those contributions, for so long as the funds are held in trust by the plan. Distributions from the plan are then included in ordinary income when payments are made from the plan, usually when the plan participant has retired. Corporate integration would result in taxation of dividends and interest earned by the plan's investments while held in the plan, with the contributions and remaining investment earnings taxed again when the amounts are withdrawn from the plan. The result would be a substantial reduction in the tax incentive to save through a qualified retirement plan relative to current law.

For example, consider a small business owner with $10,000 to contribute to a 401(k) plan. Assume the contribution earns a 5% annual rate of investment return. Under current law, the contribution and investment earnings will accumulate tax free until the employee terminates employment and begins to withdraw the account balance. If the accumulation period is 10 years, the account balance attributable to that contribution will have grown to $16,289. In 20 years, the balance would be $26,533. Income tax will be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be $11,728 after 10 years and $19,104 after 20 years.

Now assume a corporate integration proposal with mandatory 35% withholding is adopted. Instead of earning 5% per year, net investment return is only 3.25% (65% of 5%). After 10 years with 3.25% rates of return, the $10,000 contribution would accumulate to $13,769. After 20 years, the balance would be $18,958. Income tax will still be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be $9,914 after 10 years and $13,650 after 20 years.

In other words, corporate integration will have reduced the value of a retirement contribution by 13% after 5 years, and 25% after 10 years. In fact, *corporate integration without recovery of amounts withheld on dividends and interest paid to a qualified retirement plan's trust effectively eliminates the tax incentive for saving through a qualified retirement plan to the extent investment earnings are attributable to dividends and interest.* Assume the $10,000 is not contributed to a 401(k) plan. Income tax at the 28% rate would be paid on that amount, leaving $7,200 to be invested. After 10 years with a net investment earnings rate of 3.25%, the $7,200 would accumulate to $9,914 – the same as the after-tax accumulation in the 401(k) plan. After 20 years, the accumulation outside the plan would be $13,650 – same as the 401(k) plan. Amounts invested outside of a qualified retirement plan are not subject to the restriction for accessing monies in a 401(k) or similar account, so without the tax incentive, investing outside of the 401(k) plan could be more attractive than contributing to the plan.

For simplicity, these examples assume all investment earnings are comprised of interest and dividends on domestic securities. To the extent investment earnings include capital gains, the impact would be lessened.

<u>How would the reduced tax incentive affect small business retirement plans?</u>

The current tax incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Because of the nondiscrimination rules, a business owner can only save through the plan if other employees are also benefitting. As a result, a decision to establish and maintain a plan such as a 401(k) plan not only involves taking on fiduciary responsibilities and administrative costs, but often the cost of making contributions for the non-highly compensated employees who participate in the plan. For example, very small employers are often "top heavy", and are required to make contributions of 3% of pay for all eligible non-key employees – whether or not the employees contribute on their own behalf. Other small business owners contribute 3% of pay to satisfy a 401(k) nondiscrimination testing safe harbor. Still others contribute 5% or more to be eligible to apply other nondiscrimination testing approaches. The cost of these contributions can be significant, and the availability of the tax incentives to offset all or part of the cost is critical to the decision to maintain a qualified retirement plan.

The loss of deferral of income tax on dividends and interest with corporate integration would significantly reduce, and for more conservative investors even eliminate, the tax incentive for saving through a qualified retirement plan. Given the costs and obligations that come with sponsoring a qualified retirement plan, the result would be a reduction in the number of plans sponsored by small businesses, and a loss of coverage, and retirement security, for small business employees.

Small business employees would not be the only ones to suffer, however. The lack of deferral of income tax on dividends and interest will reduce the account balances of any participant whose account is invested in an asset that pays dividends and interest, and do serious harm to the retirement security of American workers.

Summary

Access to a retirement plan at work is the key to successfully preparing for retirement. Reducing the tax incentives to save through a qualified retirement plan will discourage small business owners from establishing and maintaining qualified retirement plans, and so reduce the availability of workplace savings. A corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities, including securities held in qualified retirement plans would substantially reduce the tax incentives for these plans, and so discourage plan formation and maintenance.

We thank you for the opportunity to submit these comments. The ARA would be pleased to work with this Committee to assure the tax incentives for qualified retirement plans are maintained or enhanced as this or other proposals move forward.