AMERICAN RETIREMENT ASSOCIATION
Working for America's Retirement

American Retirement Association

Statement for the Record

For the House Small Business Committee

Democrats on

The Importance of Retirement Policy in the Tax Reform Debate

Held on September 7, 2017

The American Retirement Association ("ARA") thanks Ranking Member Velázquez, and the other members of the House Small Business Committee for holding a stakeholder meeting on the importance of retirement policy in the tax reform debate and for the opportunity to submit this statement for the record.

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 major objective of tax reform is to provide long term economic growth to build financial security for the middle class. The current tax incentives that underpin workplace-based retirement plans achieve this objective by enabling good savings behavior for the tens of millions of Americans who participate. This critical savings component results in $67 trillion or 59% of the non-bank financial capital provided to the equity and bond markets.[1] Tax reform could be an opportunity to simplify the retirement plans rules and expand retirement plan coverage in the workforce that will build even further on this success. Increasing retirement savings would increase long-term economic growth by 3% or $3,500 per person over the next 25 years.[2]

Tax reform could also pose a risk to retirement security. Reducing the tax incentives — like freezing the retirement plan contribution limits that are currently indexed to inflation or capping the retirement savings exclusion rate for individuals in certain income tax brackets — would be the wrong way to go. Reducing the incentives in these ways would discourage small business owners from offering and contributing to workplace-based retirement plans. The result would be fewer retirement plans and lower employer contributions for rank-and-file employees, putting the retirement security of middle class Americans at risk and undermining long term economic growth.

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[1]Oxford Economics, *Another Penny Saved: The Economic Benefits of Higher US Household Savings,* (June 2014), available at: http://www.oxfordeconomics.com/anotherpennysaved
[2]*Ibid.*

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 $31,000, and married couples with AGI of less than $62,000, 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 2017, 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 $54,000. 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 $60,000.

- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year's pay or $215,000. 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 $270,000 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 $270,000, 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 $54,000 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.

How is the tax benefit distributed?

The distribution of the tax benefit for saving in a defined contribution retirement plan is typically analyzed by applying the marginal tax rate to *current contributions*. This analysis reflects the progressive nature of the U.S. income tax system, because the value of the tax benefit of the deferral increases as the marginal tax rate increases.[3]

Focusing on contributions within the context of this progressive income tax structure, would lead one to expect the tax benefit for retirement savings would favor only higher income individuals. Yet, there are important characteristics of retirement savings that are omitted from this simplistic analysis.

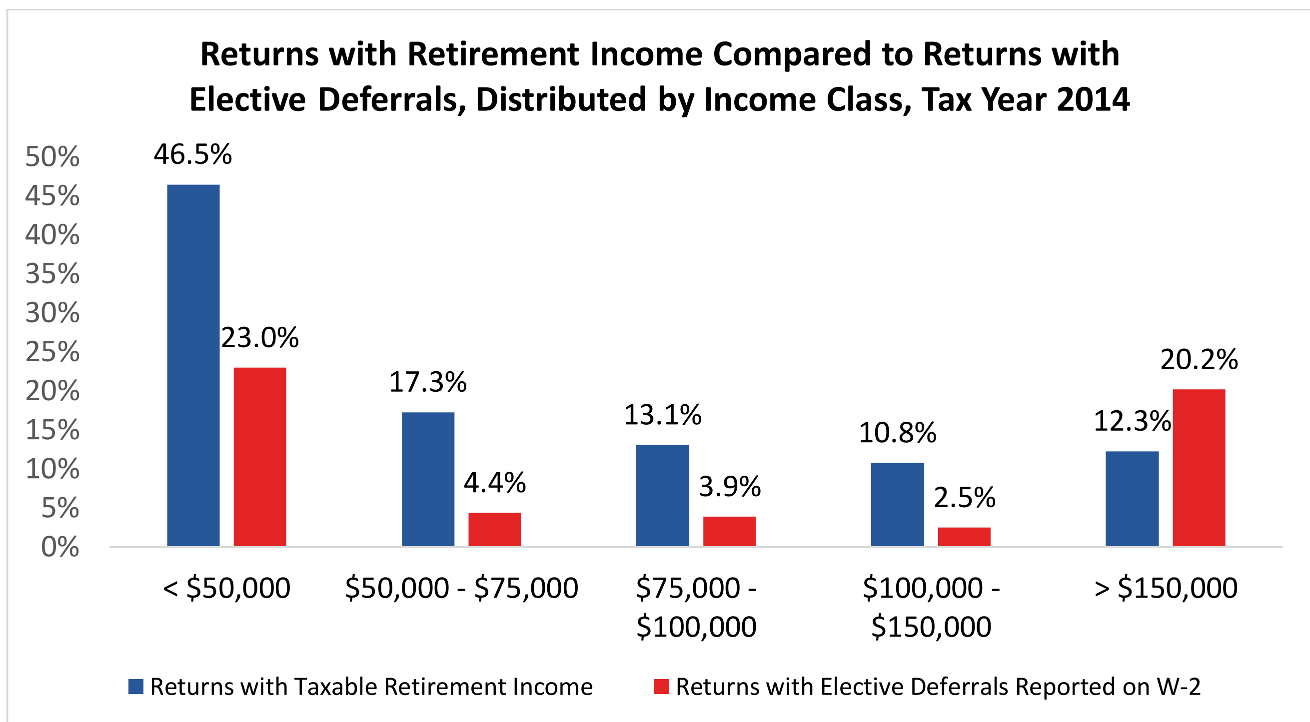
First, current contributions to employer plans are subject to non-discrimination rules and compensation limits. These rules limit not only the deferral rates permitted by higher income participants, but also limits the amount of compensation that may be considered for purposes of determining contributions. Together, these rules place limitations on the disparities in the contribution levels.

[3]In any given year, the number of contributors will outnumber the retirees making distributions, further exaggerating this distribution of tax benefits.

Second, retirement incentives encourage savings while the individual is working to provide income during retirement. The focus on contributions ignores the benefits to retirees. In retirement, lower income individuals tend to continue to receive tax benefits, as their retirement savings is typically subject to tax at a lower rate (compared to their working years).

Third, the analysis ignores that much, if not all, of the apparent tax savings to a small business owner accrues to employees in the form of employer contributions. Employer contributions represent a critical contribution to lower-wage participants. In many cases, complying with safe harbor rules means that the only savings many lower-wage participants receive are these employer contributions.

Chart One



IRS, SOI Table 1.4, Sources of Income by Adjusted Gross Income and W-2 Tabulations

Finally, analyzing the benefit for contributions in a given year provides only a snapshot of the benefits, and fails to recognize the disparity in tax rates applied to distributions and tax treatment of other retirement benefits. For example, small business owners' distributions will face a higher marginal income tax rate than for those with a history of lower contributions. In addition, the small business owner will be required to include more Social Security benefits in income. As a result, failure to consider future tax treatment tends to overstate these relative benefits offered by the current system.

The standard methodology for measuring the benefit of the tax incentive (multiplying marginal rate by income deferred) shows tax incentives for employer-sponsored retirement savings favor higher

income individuals. The analysis simply captures the inequality of income, rather than uneven tax benefits. However, because of the unique nature of this tax incentive, this methodology actually *understates* the benefits of the current retirement incentives. A more comprehensive analysis of the distribution of the tax incentives would show the current tax incentives for retirement savings are distributing benefits to low- and moderate- income workers.

Workplace Plans are the Foundation for A Secure Retirement

The tax incentives for retirement savings are unique in that the tax incentive is a deferral, not a permanent exclusion — so every dollar that is excluded from income this year will be included in income in a future year. The tax incentives for employer-sponsored retirement plans are also unique in that the nondiscrimination rules, coupled with dollar limits on contributions and a limit on the amount of compensation that can be included in determining benefits, assure that the plans do not unduly favor highly compensated employees.

The current system of tax incentives that powers workplace retirement plans has been successful at accumulating a large amount of assets to improve the retirement security of tens of millions of American households. Seventy-seven million households — 61 percent — have an employer-sponsored plan or an individual retirement account (IRA). At the end of 2016, private employer-sponsored defined contribution plans held about $7 trillion in assets, private employer-sponsored defined benefit plans held $2.9 trillion and state and local retirement plans held $3.9 trillion. Another $7.9 trillion is held in IRA accounts. Although IRAs include contributions made by individuals to the IRA on their own behalf, a substantial portion of IRA contributions are attributable to rollovers from employer-sponsored plans and direct employer contributions. Together, defined contribution plans and IRAs comprise 59 percent of retirement assets.[4]

Data show that 401(k) and similar plans — such as 403(b) and 457 arrangements — have been successful in getting workers to save for retirement. The most important factor in determining whether workers across the income spectrum save for retirement is whether there is a workplace-based retirement plan. Contrary to the common assertion that only half of working Americans are covered by a retirement plan, a recent update of a study from the Social Security Administration shows that 75 percent of private-sector workers have access to a retirement plan at work, and 82 percent of eligible workers with access to a plan participate in the plan.[5] The success of saving through a workplace-based retirement plan extends to moderate-income workers. More than 70 percent of workers earning $30,000 to $50,000 participate in a plan at work, but fewer than 5 percent will save through an IRA on their own (see chart two).[6] These plans primarily benefit the middle class: 68 percent of active participants in 401(k) plans have an adjusted gross income (AGI) of less than $100,000 per year. Thirty-five percent of participants have an AGI of less than $50,000 (see chart three).[7] Americans earning between $25,000 and $75,000 save seven times more in retirement savings than any other type of savings.[8]

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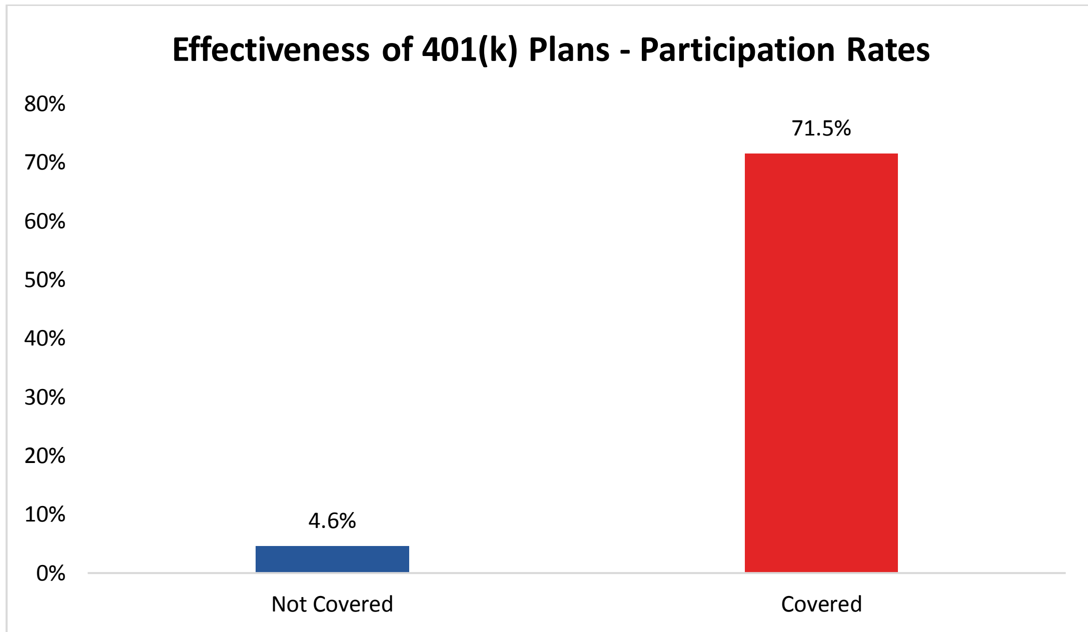
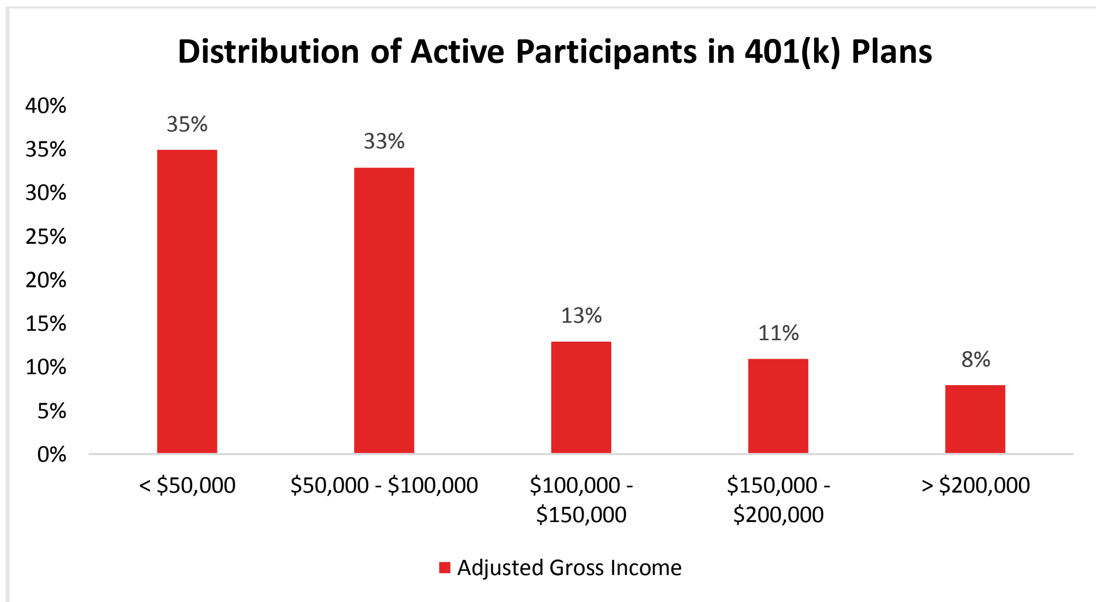
[4]Investment Company Institute, *2017 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, available at: http://www.icifactbook.org/ch7/17_fb_ch7
[5]Irena Dushi, Howard M. Iams, and Jules Lichtenstein, *Retirement Plan Coverage by Firm Size: An Update*, Social Security Bulletin (May 2015), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2604116
[6]Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan – IRA only)
[7]Internal Revenue Service, Statistics of Income, IRA Studies, 2014
[8]Employee Benefit Research Institute estimate of the 2013 Survey of Consumer Finance

Chart Two



Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan – IRA only)

Chart Three



Internal Revenue Service, Statistics of Income, IRA Studies, 2014

Conclusion

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. The current retirement savings tax incentives work well to promote good savings behavior for tens of millions of working Americans. If anything, these incentives – for both employers and employees – should be enhanced. At a minimum, any modifications to the current incentives should be evaluated based on whether or not the changes will encourage more businesses to sponsor retirement plans for their employees.

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 a tax reform proposal moves forward.