AMERICAN RETIREMENT ASSOCIATION
Working for America's Retirement

American Retirement Association

Statement for the Record

For the

Senate Finance Committee Hearing on

Individual Tax Reform

Held on September 14, 2017

The American Retirement Association ("ARA") thanks Chairman Hatch, Ranking Member Wyden, and the other members of the Senate Finance Committee for holding a hearing on individual tax reform 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.

We wish to submit this statement for the record because we want to highlight our concern about the testimony of one witness – Lily Batchelder – who called for restructuring the tax incentives for retirement savings into a refundable tax credit. She also claimed that "the lion's share of tax incentives for retirement savings go to the wealthy." Unfortunately, the assertion that the tax incentives for retirement are *upside down* is a common myth that we would like to dispel. Thanks to the balance imposed by the current law contribution limits and stringent nondiscrimination rules, these tax incentives are *right side up* – even before properly considering other components of this incentive.

<u>How is the tax benefit distributed?</u>

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.[1]

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

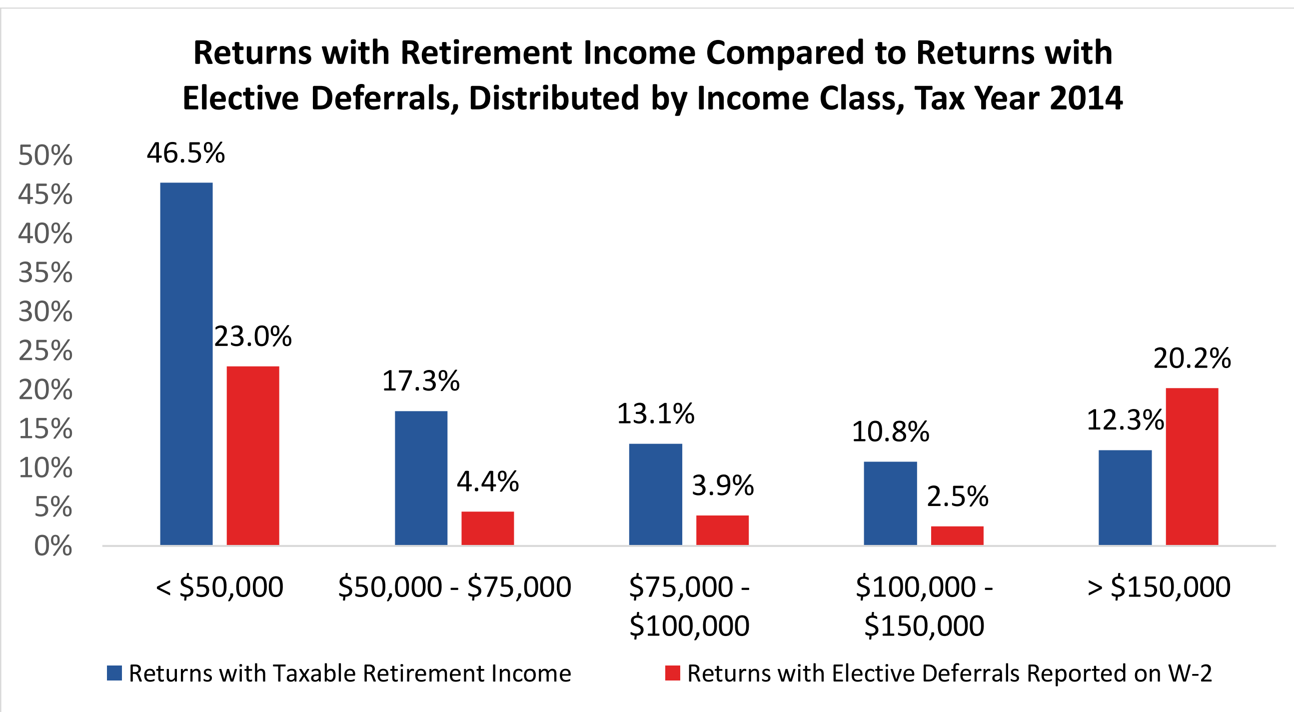
Focusing on contributions within the context of this progressive income tax structure, would lead one to expect the tax benefit for retirement savings would favor only higher income individuals. Yet, there are important characteristics of retirement savings that are omitted from this simplistic analysis.

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.

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 (see chart one).[2]

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

[2]Internal Revenue Service, Statistics of Income 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.

Replacing the Retirement Exclusion with a Credit

Lili Batchelder's testimony also stated that "the tax incentives for retirement savings are a particularly fruitful area for reform" without getting into further specifics about how to achieve her goal. However, we believe that she is referencing a recurring proposal that would convert the current year retirement plan contribution exclusion from income into a uniform tax credit.

How a proposal such as this affects retirement plan sponsors and participants depends, of course, on what the level of credit is, and whether or not it is deposited to a retirement savings account or directly offsets income tax liability. A past proposal[3] from William Gale of the Tax Policy Center offers both a 30 percent, which the paper says would be revenue neutral, and an 18 percent credit. This proposal purports to create additional savings by providing more incentive for taxpayers below the 23 percent and 15 percent marginal tax brackets to save.

Data shows the primary problem to be addressed in improving retirement security is increasing *access to workplace savings*, not a lack of incentive for take-up by moderate income participants with access. More than 70 percent of workers earning $30,000 to $50,000 participate in a workplace retirement plan at work, but fewer than 5 percent will save through an IRA on their own (see chart two).[4] 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).[5] Americans earning between $25,000 and $75,000 save seven times more in retirement savings – largely through participation in workplace retirement plans – than any other type of savings.[6]

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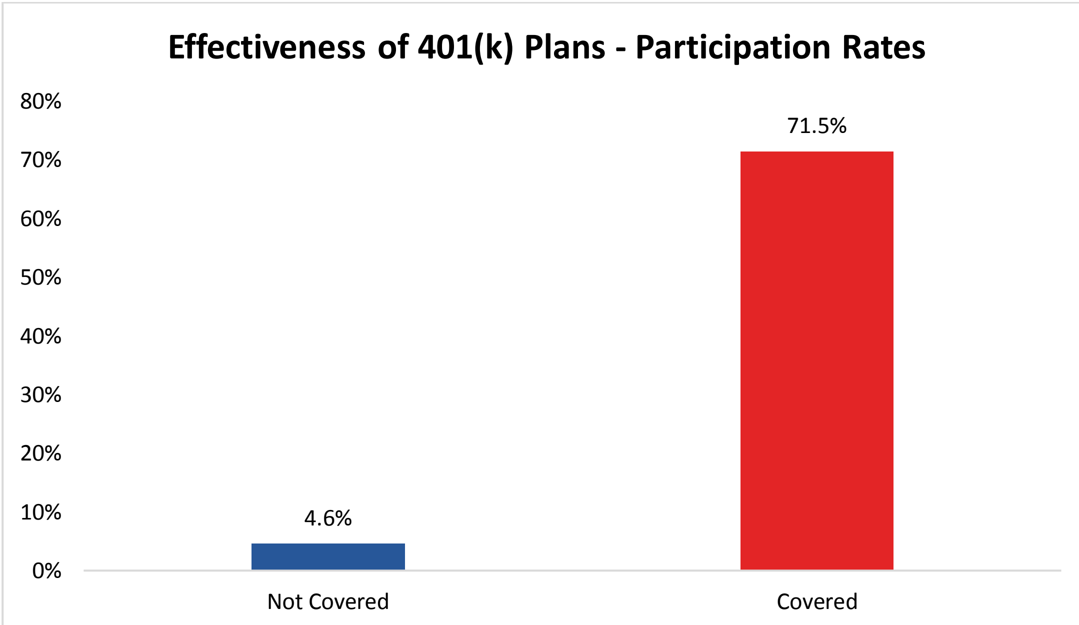
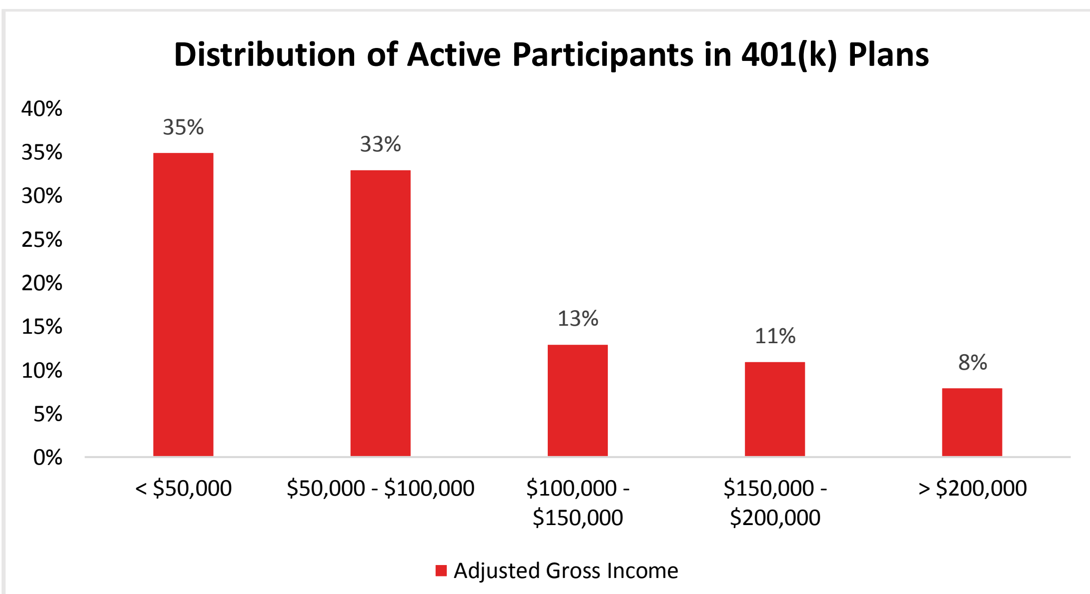
[3]William G. Gale, *A Proposal to Restructure Retirement Savings Incentives in a Weak Economy with Long-Term Deficits*, September 2011.
[4]Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan – IRA only)
[5]Internal Revenue Service, Statistics of Income, IRA Studies, 2014
[6]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

This proposal has several basic flaws. The proposal itself indicates that the current tax incentive for many decision makers would be reduced under the proposal. In fact, for the business owner, the reduction in the incentive would be *more* than illustrated in the proposal because contributions made on behalf of employees would become subject to FICA. In other words, the “problem” being addressed by this proposal is not the problem, and the “solution” will only make the situation worse.

If the credit is an offset from income tax liability, the size of the credit for a small business owner would determine if setting up or maintaining the plan is still worthwhile. If the credit were deposited to a retirement account, in many cases the resulting drain on cash would necessarily result in lower contributions for the small business owner and employees, or termination of the plan. For larger employers, the size of the credit will in no way offset additional FICA liability. They would have to take on the additional cost, or decrease contributions.

The paper notes that a 30 percent credit is equivalent to a 23 percent deduction. Similarly, an 18 percent credit would be equivalent to a 15 percent deduction. The equivalency is based on the theory that only the after-tax amount of income will receive the credit. For example, if an employee defers $1,000 under the current incentive system and is in the 15 percent bracket, under current rules, $150 of income tax liability is deferred. Under the proposal, the after-tax deferral would be $850. Eighteen percent of $850 is $150, so this credit is equivalent to the exclusion for income tax purposes. This analysis makes sense in the case of IRA contributions or elective deferrals, where FICA is already paid on the contribution amounts. It does not hold up, however, for employer contributions, where there is currently no FICA liability for either employees or employers.

Consider an employee in the 15 percent bracket contributing $1,000 as an elective deferral and receiving a $1,000 employer contribution. *If the level of employer contribution does not change*, the employee will not only offset the $1,000 elective deferral by the $150 income tax liability on the elective deferral, but also by the $150 income tax liability for the employer contribution and the $76 in FICA contributions the employee owes on this employer contribution amount. Instead of $2,000 in total contributions, there will be $1,624 ($2000 - $150-$150-$76). An 18 percent credit applied to $1,624 is only $292. So the employee has lost over $80 in this change to an “equivalent” 18 percent credit. For this situation, the equivalent credit would be about 23 percent. Note, however, that the higher the level of the employer contribution relative to the elective deferral, the higher the credit must be for the individual to break even. If there were a $2,000 employer contribution, an 18 percent credit would result in a reduction of over $171, after FICA is considered, and the equivalent credit would be over 25 percent.

Considering the FICA implications, this proposal has the effect of penalizing both business owners (through increased FICA taxes) and employees when the plan provides for matching or profit-sharing contributions, with the penalty increasing as the employer contribution increases. Regardless of the size of the credit, this is an incentive for all employers, not just small business owners, to reduce company contributions.

Conclusion

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. Restructuring the tax incentives for retirement savings into a uniform tax credit would fail this evaluation and should be rejected.