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U.S. House of Representatives Committee on Ways and Means
Tax Reform Working Group on Pensions/Retirement
Comments of the Investment Company Institute

April 15, 2013

The Investment Company Institute[1] is pleased to provide these comments in connection with the Committee on Ways and Means Tax Reform Working Group on Pensions/Retirement's examination of the current tax incentives for retirement savings. The Institute strongly supports efforts to promote retirement security for American workers. We thank the leadership and members of the Committee on Ways and Means for their past bipartisan support of retirement savings plan improvements, including provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Pension Protection Act of 2006 (PPA). Reflecting Congress' efforts to promote retirement savings, Americans currently have $19.5 trillion earmarked for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).[2] About half of DC plan and IRA assets is invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers.

The tax incentives for retirement savings are vitally important in encouraging employers to create retirement plans and encouraging workers to participate. The tax deferral on retirement accounts is *different*, however, from other deductions: while workers defer taxes on their retirement savings today, they will pay taxes as they withdraw savings in retirement. Studies find that, by a very large majority, Americans greatly value this tax deferral treatment and agree that incentives for retirement savings should be a national priority.[3]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.7 trillion and serve over 90 million shareholders.

[2] At the end of the fourth quarter of 2012, U.S. retirement assets totaled $19.5 trillion, DC plan assets were $5.1 trillion and IRA assets were $5.4 trillion. *See* Investment Company Institute, "The U.S. Retirement Market, Fourth Quarter 2012" (March 2013), available at www.ici.org/info/ret_12_q4_data.xls.

[3] *See* Figure 12, p. 23 in Holden and Bass, *America's Commitment to Retirement Security: Investor Attitudes and Actions, 2013*, Investment Company Institute (February 2013), available at www.ici.org/pdf/ppr_13_retir_sec_update.pdf.

The U.S. retirement system relies upon the complementary components of Social Security,[4] homeownership, employer-sponsored retirement plans (both defined benefit (DB) plans and DC plans, and both private-sector and government plans), IRAs (both contributory and rollover), and other savings. In retirement, different households will depend on each of these components in differing degrees, depending on lifetime income, work history, and other factors. For most households, however, employer-sponsored retirement plans are crucial: about eight in 10 near-retiree households hold retirement resources in DB or DC plans or IRAs.[5] Thanks to this system, successive generations of American retirees have been better off than previous generations.[6] Consistent with the views of the overwhelming majority of Americans,[7] we urge this Working Group to recommend that the Committee on Ways and Means continue its support for the current retirement savings tax incentives, including the contribution rates, and allow our successful employer-provided retirement system to flourish.

SUMMARY OF KEY POINTS

The key points that this Working Group should consider in its examination of current tax incentives for retirement savings are summarized below.

- **The current retirement tax incentive structure is the foundation of the system's success.** Limiting the tax incentives for retirement savings through employer plans or IRAs would undermine this system's foundation and put at risk our nation's progress on retirement security.
- Vast majorities of U.S. households want to preserve the key features of DC plans. Household survey data indicate DC account–owning households appreciate the tax advantages and investment features of DC plans.

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[4] While Social Security is outside the scope of our comments, no assessment of the U.S. retirement system can avoid a discussion of the significance of Social Security in ensuring retirement security—or retirement income adequacy—for American workers. Social Security benefits continue to serve as the foundation for retirement security in the United States and represent the largest component of retiree income and the predominant income source for lower-income retirees. In 2011, Social Security benefits were 57 percent of total retiree income (per capita) and more than 85 percent of income for retirees in the lowest 40 percent of the income distribution. Even for retirees in the highest income quintile, Social Security benefits represented one-third of income in 2011. *See* Figure 3, p. 8, and Figure 4, p. 9 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2011," *ICI Research Perspective* 18, no. 5 (October 2012), available at www.ici.org/pdf/per18-05.pdf. Social Security replaces 70 percent of average annual lifetime household earnings for the lowest lifetime household earnings quintile; 42 percent for the middle lifetime household earnings quintile; and 29 percent for the highest lifetime household earnings quintile. Figures represent the median initial replacement rates for retired workers in the 1940s birth cohort. *See* Exhibit 10, p. 16, in Congressional Budget Office, *The 2012 Long-Term Projections for Social Security: Additional Information* (October 2012), available at www.cbo.gov/publication/43648.

[5] *See* Figure 13, p. 29, and Figure 14, p. 31, in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[6] *Ibid, see* discussion pp. 10–14.

[7] *See* Figure 6, pp.12–13, and Figure 7, p. 17, in Holden and Bass, *America's Commitment to Retirement Security: Investor Attitudes and Actions, 2013.*

- A deferral of tax is not equivalent to a tax exclusion or a tax deduction. Exclusions and deductions reduce taxes paid in the year taken, but do not affect taxes in any future year. Tax deferrals—such as the deferral of tax on compensation contributed to an employer-provided retirement plan—reduce taxes paid in the year of deferral, but increase taxes paid in the year the income is recognized through distribution or withdrawal from a plan or account.

- Proposals to limit the up-front tax benefit of deferring compensation until retirement would substantially change the tax treatment of retirement contributions.[8] Proceeding in this direction would undermine retirement security by reducing the incentives for businesses to provide retirement plans.

- Proposals to limit the current income exclusion for contributions to DC plans unfairly target those deferrals.[9] Current DC plan limits are already low by historical standards.[10] These proposals would not only represent a further restriction, but would also break the link between limits on the generosity of DC plans and DB plans that has existed since limits were first introduced in 1974. This would arbitrarily punish workers based on how their employer structures their compensation. For example, a federal government worker with both a DB plan and a DC plan would be able to defer tax on more compensation than a private-sector worker who had a DC plan only.

- Capping accruals in individual savings accounts is unworkable and would discourage plan formation.[11] Any proposal to place a dollar a cap on individual retirement saving accounts would add complexity and confusion to our nation's system for retirement saving and would discourage employers from creating retirement plans and workers from contributing.

- The impact of such changes would not be limited to taxpayers in the higher tax brackets. With the loss of plans, lower-paid workers—who were never the intended target of the caps—would lose the many benefits of employer-plan participation. In addition to tax deferral, lower-paid workers covered by a plan benefit from the convenience of payroll deduction, the "nudge" of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-based plans.

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[8] The President's FY2013 and FY2014 budget proposals set limits on the tax benefit of itemized deductions and other tax preferences (including income exclusions and deductions for employee contributions to DC plans and IRAs) to 28 percent. The President's "28 percent" limitation would effectively reduce the value to 28 percent of the specified exclusions and deductions that would otherwise reduce taxable income in the 33 percent, 35 percent or 39.6 percent tax brackets.

[9] For example, the so-called "20/20 proposal" was proposed in the National Commission on Fiscal Responsibility and Reform Report. The 20/20 proposal would lower the limit on annual total employer and employee retirement plan contributions to the lesser of 20 percent of the employee's compensation *or* $20,000.

[10] *See* discussion pp.10–11 in Holden, Brady, and Hadley, "401(k) Plans: A 25-Year Retrospective." *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

[11] Included in the President's FY 2014 budget is a proposal that would also limit the total accruals in retirement saving accounts to $3.4 million (subject to adjustment tied to annuity purchase rates).

- Changes in retirement policy should build on the existing voluntary system—not put it at risk. We urge this Working Group to continue the Committee on Ways and Means' leadership in pursuing policies to build on the strengths and successes of the U.S. retirement system. Any improvements, however, should preserve the tax incentives and other features that successfully encourage millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement.

THE U.S. RETIREMENT SYSTEM IS HELPING MILLIONS OF AMERICANS ACHIEVE A SECURE RETIREMENT

Retirement policy discussions often start from the premise that retirees' pension income has fallen over time. Contrary to this conventional wisdom, private-sector pension income has become more prevalent and more substantial—not less prevalent or less substantial—over time. Since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), increasing numbers of retirees receive benefits from private-sector pension plans (DB and DC) and receive more in benefits from these plans:

- Data from the Department of Labor's Bureau of Labor Statistics show the share of retirees receiving private-sector pension income increased by more than 50 percent between 1975 and 1991, and has remained fairly stable since.[12]
- Among those receiving income from private-sector pensions, the median amount of inflation-adjusted income—which had remained fairly flat between 1975 and 1991—has increased nearly 40 percent since 1991.[13]
- Data from the Survey of Consumer Finances (SCF), conducted by the Federal Reserve Board, show that accrued benefits and asset accumulations in employer-sponsored retirement plans and IRAs constituted a resource for about 80 percent of near-retiree households in 2010.[14]

[12] *See* Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2011," *ICI Research Perspective* 18, no. 5 (October 2012), available at www.ici.org/pdf/per18-05.pdf.

[13] *Ibid.* The increase in pension income since ERISA is likely understated because the survey data used to analyze retiree income do not fully capture payments from DC plans and IRAs. *See also* Figure 20 and discussion, pp. 20–22, in Sabelhaus and Schrass, "The Evolving Role of IRAs in U.S. Retirement Planning," *Investment Company Institute Perspective* 15, no. 3 (November 2009), available at www.ici.org/pdf/per15-03.pdf.

[14] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 14, p. 31. Although, as noted above, benefits from employer-sponsored plans and IRAs are a resource for about 80 percent of near-retiree households, there is still a perceived "coverage gap," with a commonly referenced statistic that half of all American workers do not have access to employer-sponsored retirement plans. Looking at the percentage of all workers who have access to retirement plans at their employers at any single point in time understates the share of the population who will reach retirement with work-related retirement benefits. *See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2011," *ICI Research Perspective* 18, no. 4 (September 2012), available at www.ici.org/pdf/per18-04.pdf.

Academic analysis has found each successive generation has reached retirement wealthier than the last.[15]

- Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and population growth, retirement assets were nearly six times higher at year-end 2012 than at year-end 1975.[16]

- Poverty rates for people aged 65 or older have fallen over time. In 1966, the elderly poverty rate was nearly 30 percent. In 2011, it was 9 percent—and the elderly had the lowest poverty rate among all age groups.[17]

These statistics speak to the impact of the changes implemented over many years, with the increased generosity of Social Security benefits, the enactment of ERISA in 1974, the creation of the 401(k) plan in 1981, the enactment of EGTRRA in 2001, PPA in 2006, and other measures. A crucial foundation of this success is the current retirement savings tax incentives, including the compensation deferral rates, that motivate saving and encourage employers to maintain and contribute to employer-sponsored plans. While it is important to consider how the retirement system can be improved still further, Congress should *not* throw out decades of progress by taking away the ability of American workers to make full use of the retirement vehicles they value so highly.

THE VOLUNTARY EMPLOYER-PROVIDED RETIREMENT SYSTEM IS CHARACTERIZED BY INNOVATION AND FLEXIBILITY

A strength of the voluntary employer-provided retirement system is the flexibility built into its design. This flexibility has allowed a tremendous amount of innovation to take place over the past few decades, due to the combined efforts of employers, employees, and plan service providers. Some of these innovations—for example, making contributions through regular payroll deduction, which provides convenience and stability, or employer matching contributions, designed to further incentivize employee participation—are now taken for granted as standard plan features. There is good reason to believe that outcomes under a system dominated by DC plans will improve even more after recent innovations have time to reach their full impact. One of those important improvements has been

[15] *See* Haveman, Holden, Wolfe, and Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf.

[16] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 4, p. 11 (updated to year-end 2012).

[17] *See* U.S. Census Bureau, *Current Population Survey, 1967 to 2012, Annual Social and Economic Supplements*. In 2011, the poverty rate for individuals age 18 to 64 was 14 percent, while it was 22 percent for those younger than 18. *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 6, p. 14.

automatic enrollment to increase plan participation.[18] Another change, auto-escalation, gradually increases the share of pay contributed each pay period until it reaches a desired goal. Further, target date funds have also become increasingly popular both as a default and as an employee choice and have been successful in ensuring that investors have a diversified portfolio that rebalances to be more focused on income and less focused on growth over time.[19]

It is important to remember that the employer-sponsored retirement system is premised on its voluntary and flexible nature; employers can choose to provide retirement plans to their employees tailored to their specific needs—but they are not required to do so. The current tax structure—including allowing the deferral of tax on compensation contributed to employer-sponsored retirement plans—provides a strong and effective incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that provide significant benefits to American workers of all income levels. Untoward changes in the retirement tax incentives would require each employer to reevaluate and potentially redesign its retirement plan offerings and could prompt them to consider eliminating their plans entirely.

AMERICAN WORKERS SHOW STRONG SUPPORT FOR THE DEFINED CONTRIBUTION RETIREMENT PLAN SYSTEM

Given this progress in improving outcomes for retirees, it is no surprise that Americans highly value their DC plans and the features typically associated with them. A 2012/2013 household survey demonstrated American households' strong support for key features of DC plans, including their tax benefit, and their appreciation for the investment opportunity these plans provide.[20]

- Americans overwhelmingly support preserving the tax incentives for retirement saving. Eighty-five percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated. Eighty-two percent opposed any reduction in employee contribution limits.[21]

[18] The EBRI/ICI 401(k) Accumulation Projection Model demonstrates the increases in retirement income that can result from automatic enrollment. Replacement rates, modeled after adding automatic enrollment and investing contributions in a target date fund, increase significantly. *See* Holden and VanDerhei, "The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *Investment Company Institute Perspective* 11, no. 2, and *EBRI Issue Brief*, no. 283 (July 2005), available at www.ici.org/pdf/per11-02.pdf and www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf. Furthermore, studies find that adopting an automatic enrollment feature has a particular impact on improving participation rates among low-income and younger workers. *See, e.g.*, Nessmith, Utkus, and Young, *Measuring the Effectiveness of Automatic Enrollment,* Vanguard Center for Retirement Research (December 2007), available at https://institutional.vanguard.com/iam/pdf/CRRAUTO.PDF.

[19] *See* Charlson, "Diversification Pays Off for Target-Date Funds," *Morningstar Advisor* (January 17, 2013).

[20] *See* Holden and Bass, *America's Commitment to Retirement Security: Investor Attitudes and Actions, 2013.* The survey included 4,000 U.S. households interviewed between November 2012 and January 2013.

[21] *Ibid* (Figure 7, p. 17).

- Vast majorities of American households oppose altering key features of DC plans. Eighty-five percent of all U.S. households disagreed with the idea that individuals should not be permitted to make investment decisions in their DC accounts. Eighty-two percent disagreed with the idea of replacing all retirement accounts with a government bond.[22]

- Investors like choice and control of investments. Ninety-six percent of all DC account–owning households agreed that it was important to have choice in, and control of, the investment options in their DC plans. Eighty-four percent said their plan offers a good lineup of investment options.[23]

- Most households have positive attitudes toward the 401(k) system. Sixty-three percent of all U.S. households surveyed in 2012/2013 had favorable impressions of 401(k) and similar plan accounts, similar to the support shown in surveys taken in 2009, 2010, and 2011.[24] Nearly three-quarters of households expressed confidence that DC plan accounts could help participants reach their retirement goals.[25]

ICI's household surveys during the past five years find that despite the experience of a recent bear market and a broad economic downturn, Americans remain committed to saving for retirement and value the characteristics, such as the tax benefits and individual choice and control that come with DC plans.

TAX-DEFERRED COMPENSATION IS NOT TAX-FREE COMPENSATION

Discussion and policy proposals surrounding tax incentives for retirement often proceed from premise that compensation that is saved for retirement is "tax-free." That premise is false. The tax code allows workers to *defer* taxation on compensation that is set aside for retirement in a qualified employer plan or in an IRA. With a deferral, taxes are collected in the year the worker receives the compensation (through a plan distribution or an IRA withdrawal), rather than in the year the compensation is earned. When a distribution is taken, taxes are paid on both the original deferred compensation and the earnings on those deferrals.

A deferral of tax is *neither* a tax deduction *nor* a tax exclusion. Tax deductions (such as the deduction of mortgage interest expense) and tax exclusions (such as the exclusion of employer-paid health insurance premiums from taxable compensation) reduce taxes paid in the year taken, but do not affect taxes in any future year. In contrast, setting aside a portion of compensation until retirement reduces taxes paid in the year the compensation is earned, but *increases* taxes paid in the year the compensation is received.

[22] *Ibid* (Figure 7, p. 17).

[23] *Ibid* (Figure 6, pp.12–13).

[24] *Ibid* (Figure 4, p. 10).

[25] *Ibid* (Figure 11, p. 22).

The simple calculations used to quantify the tax benefits and revenue costs of tax exclusions and tax deductions accordingly do not apply to tax deferrals. Unlike a deduction or an exclusion, the benefits an individual receives from deferring tax on compensation cannot be calculated by simply multiplying the amount of compensation deferred by the individual's marginal tax rate. This is because the tax benefit is not the up-front deduction.[26]

Instead, the benefits of deferral depend on many factors, with the most important factor being the length of time a contribution remains invested (which in turn is generally driven by the saver's age at the time of the contribution). The dollar value of the tax benefit also will depend on an individual's marginal tax rate, but that relationship is complex. In fact, under current law, controlling for the length of deferral, there already is little difference in the dollar value of the tax benefit generated by a $1,000 retirement contribution among individuals in the top five federal income tax brackets (with marginal tax rates of 25, 28, 33, 35, and 39.6 percent).[27]

The key features of tax deferral drive at least two implications for proposals to limit or change tax incentives for retirement savings. First, a *tax deferral,* which is neither a *tax deduction* nor a *tax exclusion,* should not be lumped in with deductions and exclusions in tax reform proposals. In particular, because the tax benefit of a deferral is not the up-front tax savings, proposals that limit the up-front tax benefit of deferral change the tax treatment substantially. Second, proposals that focus on employee contributions to 401(k) plans and deductible contributions to IRAs unfairly target certain groups of workers based solely on the form of retirement benefits they receive. Under current law, these contributions represent qualified deferred compensation, and all qualified deferred compensation is treated equally—no matter whether the source is an employee deferral or an employer contribution, whether contributions are made to a DC plan or to a DB plan, or whether contributions are made to a plan sponsored by a private-sector employer or a government employer. Proposals to reduce limits solely on employee contributions to DC plans and IRAs would create glaring, unjustifiable inequities with other forms of qualified deferred compensation.

PROPOSALS TO LIMIT THE TAX BENEFIT OF DEFERRAL ARE MISGUIDED AND UNFAIRLY TARGET INDIVIDUAL CONTRIBUTIONS

Proponents present the idea of limiting the tax benefits of deductions and exclusions as a modest proposal that reduces, rather than eliminates, the tax benefits received by high-income

[26] As a rough approximation, the benefits of tax deferral are equivalent to facing a zero rate of tax on investment income. In the absence of deferral, an individual saving for retirement would first pay tax on her compensation, contribute the after-tax amount to a taxable investment account, and then pay taxes on investment returns each year. Other than tax on unrealized capital gains, no tax would be paid when account balances were withdrawn. Tax deferral changes the tax treatment at three different points in time: no tax is paid up front; no tax is paid on investment returns during the deferral period; and both contributions and investment returns are taxed upon withdrawal. If there is no change in an individual's marginal tax rate, the tax paid upon distribution pays back to the government, with interest, the up-front reduction in taxes. The remaining difference represents the tax benefit of deferral: tax-free investment income on the portion of the initial contributions that would have been contributed to a taxable account. *See* Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at: www.ici.org/pdf/ppr_12_tax_benefits.pdf.

[27] *Ibid.*

taxpayers. When applied to tax deferrals, however, the impact of these proposals is anything but modest. These proposals would substantially change the tax treatment of retirement contributions and would undermine retirement security by reducing the incentives for businesses to provide retirement plans.

For example, in its fiscal year 2013 and 2014 budget proposals, the Obama Administration called for "capping" the value of tax deductions, exclusions, and tax-deferred employee contributions to IRAs and employer-sponsored retirement plans, including 401(k) plans, at 28 percent. Under current tax law, a deduction or exclusion generally reduces a taxpayer's income tax by the amount of the item times the taxpayer's marginal tax rate. For example, for a taxpayer in the highest tax bracket, with a marginal rate of 39.6 percent, a $1,000 mortgage interest deduction reduces income taxes by as much as $396 (subject to income-based limits on itemized deductions). Under the proposal, the value of deductions, exclusions, and deferrals would be capped for taxpayers in the three highest tax brackets (33, 35, and 39.6 percent). In the example above, the $1,000 mortgage interest deduction would reduce income taxes by no more than $280.

To implement this proposal, Form 1040, the individual tax return, presumably would include additional lines to report a taxpayer's tax-deferred contributions to employer-sponsored retirement plans and IRAs. For taxpayers in the top three marginal tax brackets, those contributions would be subject to an additional tax at a rate calculated as the difference between the taxpayer's marginal tax rate and 28 percent. For example, a taxpayer in the 33 percent bracket would pay an additional tax of 5 percent (33 percent minus 28 percent), or $50 for each $1,000 of contribution, and a taxpayer in the highest tax bracket would pay an additional tax of 11.6 percent (39.6 percent minus 28 percent), or $116 for each $1,000 of contribution.

This additional "cap tax" would create a drag on a saver's return that can make tax-deferred retirement savings less attractive than saving in a regular taxable account. Under the proposal, the up-front value of the tax deferral is reduced by the amount of the cap tax, but the tax ultimately paid on income from the retirement account is not reduced. Thus, the taxpayer's benefit from participating in tax-deferred retirement savings is sharply reduced.

Taxpayers in the top three tax brackets would be better off (*i.e.*, would get better returns) saving in regular taxable accounts than in tax-deferred accounts subject to the cap unless their holding periods are long enough to offset the drag of the additional up-front tax. For example, a taxpayer in the 33 percent tax bracket (while working and in retirement) would fare better saving in a taxable bond account for any holding period less than four years.[28] If that taxpayer were investing solely in stocks, the holding period needed to offset the impact of the cap would be 9 years.[29] Those who choose to continue contributing would have the tax benefits of deferral reduced substantially. For example, even if invested

[28] Assumes 6.0 percent nominal rate of return with all returns in the form of interest income, no early withdrawal penalty, and no change in marginal tax rate over time.

[29] Assumes 6.0 percent nominal rate of return, no early withdrawal penalty, and no change in marginal tax rate over time. The 6.0 percent annual rate of return is assumed to be composed of 3.0 percent long-term capital gains and dividend payments, 0.5 percent short-term capital gains, and 2.5 percent unrealized capital gains.

for 20 years, a worker in the 33 percent tax bracket who invested in a stock portfolio would have the tax benefits of deferral cut in half.[30]

Reducing the value of tax-deferred retirement contributions will reduce the incentives for employers to offer DC plans to their employees. Highly paid employees will no longer assign as much value to the opportunity to save in employer-sponsored plans. Some employers likely will find that the benefits their employees receive no longer justify the expense of offering a plan, and may choose to eliminate their plans and use the savings to simply increase cash compensation. It is difficult to predict the size of the effect, but if the 28 percent cap or other similar proposals were applied to tax-deferred retirement contributions, this change would undoubtedly reduce the number of employers that voluntarily sponsor a retirement plan.

CONTRIBUTION LIMIT PROPOSALS UNFAIRLY TARGET DEFINED CONTRIBUTION PLANS

Limits on annual contributions to DC plans are already low by historical standards. For 2013, the Internal Revenue Code Section 415(c) limit for total DC plan contributions (employer plus employee) is $51,000. If the original limit set under ERISA ($25,000 in 1975) had been indexed to inflation, workers and employers would be able to contribute more than $112,000 in 2013 to an individual's account. If the limit set by the Tax Equity and Fiscal Responsibility Act of 1982 ($30,000 in 1983) had been indexed to inflation, it would be over $70,000 in 2013.

Proposals to reduce those limits further would represent an unprecedented restriction on the ability of working individuals to defer a portion of their current compensation until retirement. For example, the National Commission on Fiscal Responsibility and Reform's so-called "20/20 proposal" suggested limiting total annual contributions to DC plans to the lesser of $20,000 or 20 percent of compensation. That $20,000 limit would be below the original limit set in 1974 in *nominal* dollars.

As with proposals to "cap" the benefit of employee contributions, adopting the 20/20 proposal likely would cause some firms that previously offered retirement plans to terminate their plans. Employees affected by a lower contribution limit would face reductions in the tax benefits they receive. For some employers, the reduction in tax benefits received by their employees who currently have contributions in excess of the proposed limits, or who value the prospect of higher contributions later in their career, would tip the balance, and these firms would decide that offering a plan no longer reduces total compensation costs.

The 20/20 proposal also unfairly targets workers who only have access to an employer-sponsored DC plan by breaking the historic link between DB plan and DC plan limits in the tax code. The proposal reduces the Section 415(c) limit while leaving the Section 415(b) limit (which limits

[30] These effects are more pronounced for taxpayers in the 35 and 39.6 percent brackets. For example, using the same assumptions, a taxpayer with a 39.6 percent marginal tax rate would need to remain invested for eight years in a bond account and 16 years in an equity account before they were better off in a qualified plan. If invested for 20 years, a worker with 39.6 percent marginal rate invested in a stock portfolio would have the benefits of deferral cut by 84 percent.

annual benefits payments from DB plans) unchanged. Indeed, the National Commission on Fiscal Responsibility and Reform's proposal would increase the ratio between DB plan payouts and DC plan contributions to nearly ten-to-one, up from the four-to-one ratio established by the Tax Reform Act of 1986.

The result of the National Commission's proposal is that the amount of compensation that workers could defer until retirement would depend on how their employer structures their compensation. Consider two workers who both have an annual salary of $100,000. The first is a private-sector worker who only has access to a DC plan. Under the proposal, the maximum amount of deferred compensation—that is, the combination of elective employee deferrals and employer contributions—would be $20,000. The second is a federal government employee who is covered under the Federal Employee Retirement System (FERS). Under the proposal, this individual could contribute $15,000 to the Thrift Savings Plan (TSP) and receive $5,000 in employer contributions, for a total of $20,000 in contributions. However, the federal government employee would also be accruing DB pension benefits. For a worker approaching retirement, the additional DB benefit accrued in a year of work represents—depending on the length of service and other factors—an additional $20,000 to $50,000 in deferred compensation.

LIMITING ACCRUALS OF DEFERRED COMPENSATION WOULD ADD COMPLEXITY, COULD CAUSE SMALL BUSINESSES TO TERMINATE PLANS

The President's fiscal year 2014 budget proposal to limit the total amount that an individual could accrue in retirement benefits would make the system more complex, place additional compliance burdens on individuals, and likely cause some employers—particularly small businesses—to terminate their retirement plans. Current law limits on the amount of tax-deferred compensation generally apply to the benefits a worker receives from a single employer.[31] The proposal would place an additional limit on the total value of deferred compensation accumulated by any one individual—inclusive of accrued DB benefits, DC plan account balances, and IRAs.

Compliance with the new limit would require additional reporting from employer-sponsored plans to the IRS and place additional compliance burdens on individuals. Some employers, particularly small businesses, may choose to no longer offer a plan to their employees if the business owner or key employees can no longer accrue additional benefits. Such a change would also pose substantial difficulties for individuals as they plan for retirement or strategize about investing through their IRA. Consider, for example, an individual who 20 years ago bought shares of stock issued by a newly formed company or a successful company like Apple Inc. through her IRA. Now 20 years later, after the shares have substantially appreciated, the value of her IRA when combined with the value of her 401(k), which has also appreciated, could very well exceed the $3.4 million cap. Such an individual could find

[31] If an employer has multiple DB plans, the DB plan benefit limit would apply to all benefits accrued from the employer. Similarly, if an employer has multiple DC plans, the DC plan contribution limit would apply to all (employer and employee) contributions to plans sponsored by the employer. The lone exception to this rule is the limit on elective employee deferrals to 401(k)-type plans, which applies to the taxpayer rather than to the benefits received from a single employer.

herself in the situation, if such a proposal was enacted, of not being able to make additional contributions to her 401(k) or IRA to stay within the accrual limit—a limit that, because it is tied to annuity purchase rates, would likely change from year-to-year. Imposition of such a proposal would therefore not only create significant administrative burdens, but would effectively penalize people for being diligent about their planning and saving and for accumulating retirement resources. This outcome is simply incongruent with the Committee on Ways and Means' previous thinking and actions in the retirement policy sphere.

ALL EMPLOYEES WILL BE HURT WHEN FIRMS DROP RETIREMENT PLANS

The impact of the proposals which target DC plans would not be limited to taxpayers in the top three tax brackets, or workers with contributions in excess of $20,000. As discussed above, if these proposals are adopted, some firms that currently offer plans likely will decide to terminate their plans. With the loss of plans, lower-paid workers—who were never the intended target of the proposals—would lose the opportunity to save through an employer plan. While they receive substantial tax benefits from contributing, low- and moderate-income workers likely benefit as much or more from the non-tax features of employer-plans. For example, these workers may value more highly the convenience of payroll deduction, the economies of scale that reduce the cost of investing, and the professional investment management offered through employer plans. There is also evidence that workers with moderate and high income are willing to accept lower cash wages in exchange for retirement benefits, whereas lower-income workers are not.[32] Thus, employer contributions are more likely to represent an increase in total compensation for lower-income workers, rather than a shift in the form of compensation.

CHANGES IN RETIREMENT POLICY SHOULD BUILD ON EXISTING SYSTEM—NOT PUT IT AT RISK

As this Working Group considers the existing retirement tax incentives in the context of tax reform, the Institute urges you to focus on the following policy objectives and improvements to ensure that as many American workers as possible are successful in retirement:

- Continue to prioritize the goal of promoting retirement savings. Promoting retirement savings must remain one of the nation's top policy priorities. We urge this Working Group to continue the Committee on Ways and Means' leadership in pursuing tax policies to improve our nation's retirement system. As outlined above, the success of the current system has resulted in significant part from our existing and successful tax incentive structure, which works effectively to facilitate retirement plan savings by American workers and families. Even seemingly small changes that at first glance appear to affect only high-income individuals would, as detailed above, severely disrupt the success of the current system.

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[32] *See* Toder and Smith, "Do Low-Income Workers Benefit from 401(k) Plans?" *Center for Retirement Research Working Paper* 2011-14 (September 2011), available at: crr.bc.edu/wp-content/uploads/2011/10/wp_2011-14_508-1.pdf.

- Recognize the significance of Social Security. Social Security provides the foundation of retirement security for almost all American workers—and for the majority, it may be the largest single income source in retirement. Yet the Social Security system faces a projected long-term imbalance.[33] It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.[34]

- Foster innovation and growth in the voluntary retirement savings system. Policymakers, plan sponsors, and service providers strive to improve the ability of American workers to make sound decisions about retirement savings and investing. Congress was instrumental in encouraging rules that improved disclosure of 401(k) plan fees and associated investment information. Now, we urge Congress to go further by promoting electronic delivery of plan information, interactive educational tools, and materials to help American workers understand their savings options. Employers should be encouraged to use automatic enrollment if appropriate for their employee base; employers may want to enroll their workers at higher levels of savings and escalate the savings more substantially than is perceived appropriate under current law. As noted above, studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income and younger workers because these groups are typically less likely to participate in a DC plan where affirmative elections are required.[35]

- Offer simpler plan features for small employers. Small businesses often face particular challenges in establishing and maintaining retirement plans. Special attention should be given

[33] For projections related to these programs, *see* The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (April 2012), Washington, DC: U.S. Government Printing Office, available at www.ssa.gov/OACT/tr/2012/tr2012.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2012 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (April 2012), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2012.pdf; Congressional Budget Office, *The 2012 Long-Term Budget Outlook* (June 2012), available at www.cbo.gov/sites/default/files/cbofiles/attachments/06-05-Long-Term_Budget_Outlook_2.pdf; and Social Security Administration, "Detailed Reports on the Financial Outlook for Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds," (2012), available at www.ssa.gov/OACT/tr/index.html.

[34] Bringing the Social Security system into balance requires benefit cuts, tax increases, or some combination of the two. Regardless of the form they take, these changes will increase the burden on employer-sponsored retirement plans and IRAs. If Social Security benefits are cut, future retirees will need to accumulate more retirement resources. If taxes are raised on workers, net earnings will fall, but the amount of earnings that would need to be set aside to supplement Social Security benefits in retirement would remain largely unchanged. To the extent that either the benefit cuts or tax increases are structured to exempt workers with low lifetime earnings, it would place an even heavier burden on those already most dependent on employer-sponsored retirement plans and IRAs. For a discussion of how different methods of cutting Social Security benefits would impact workers with different levels of lifetime income, *see* Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* 9, no. 2 (April 2010): pp. 235–262.

[35] *See* note 18 and accompanying text, *supra.*

to addressing legal requirements that may create obstacles to plan sponsorship among smaller employers. Creating a new type of SIMPLE plan for small employers would encourage greater plan creation and coverage in smaller workplaces. The new plan would be modeled on existing SIMPLE plans, but would not require employer contributions. It would have contribution limits above traditional and Roth IRA limits, but below existing SIMPLE plan limits.

- Create government bond designed for retirement saving. The creation of a government bond designed specifically for retirement saving is also worth considering. Such an "R" bond could be used as a complement to the SIMPLE plan for small employers discussed above or a payroll deduction IRA. A retirement bond, for example, sold through the Treasury Direct system, would help limit both the administrative burden and potential fiduciary exposure associated with sponsoring a retirement plan. This type of savings vehicle could be ideal as well for workers who are not currently covered by a workplace plan—it could easily accommodate small amounts, and be an easy way for workers of very modest means to put away, on a voluntary basis, some money for use in retirement.

- Support flexible approaches to retirement saving. Employers have a number of options for savings plans today,[36] but it is important for Congress to recognize that mandating a particular plan or contribution level would not work for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.[37] The voluntary employer-provided retirement system recognizes that employers need the flexibility to design benefit packages that meet the unique needs of their particular workforce in the business's specific competitive environment.

* * *

The promotion of retirement savings—whether through employer-sponsored plans or IRAs—has long been one of the Committee on Ways and Means' top priorities and legacies. In recent years, the Committee strengthened the private-sector retirement system by raising contribution limits in 2001 (EGTRRA) and making those provisions permanent in 2006 (PPA). It would be a mistake to reverse course now and begin to radically alter a successful system that tens of millions of U.S. households rely on to help them achieve retirement security. Consistent with the views of the

[36] DC plans, traditional DB plans, hybrid plans, and SIMPLE IRAs all are available to meet the varying needs of employers.

[37] *See* Haveman, Holden, Wolfe, and Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf, noting that households are more likely to focus on saving for retirement as they get older and as their income increases, and that younger and lower-income households, which are already contributing 12.4 percent of income to Social Security, tend to earmark the balance of their additional saving for liquidity, education, future large purchases, or to purchase homes.

overwhelming majority of Americans, we urge this Working Group to support the maintenance of the current retirement savings tax incentives, including the compensation deferral rates without new caps or other limitations, and allow our successful employer-provided retirement system to flourish.