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**US Senate Finance Committee**

**Submission of the Investment Company Institute**

**in Response to**

**Chairman Hatch's Request for Proposals to Improve the Tax System**

**July 17, 2017**

The Investment Company Institute[1] is pleased to provide these comments to the US Senate Committee on Finance in connection with the June 16, 2017 request by Chairman Hatch (R-UT) for advice and recommendations from interested stakeholders on comprehensive tax reform. The Institute strongly supports pro-growth tax reform and appreciates the Committee's efforts to create an Internal Revenue Code more conducive to sustained economic expansion. Our comments below relate to removing impediments and disincentives for savings and investment that exist in the current tax system, simplifying the taxation of derivatives in a manner beneficial to mutual fund shareholders, the importance of maintaining the tax exemption for municipal bond interest, and updating our international tax system in order to make our nation more competitive in the global economy and preserve our tax base.

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$19.9 trillion in the United States, serving more than 95 million US shareholders, and US$5.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

# I. EXECUTIVE SUMMARY

## A. The Finance Committee Must Continue Its Leadership in Fostering a Retirement System That Is Helping Millions of Americans Achieve a Secure Retirement

- **The consideration of impediments and disincentives for savings and investment that exist in the current tax system must be grounded in the crucial policy goals of:**
  - Continuing to prioritize the goal of promoting retirement savings through tax incentives that encourage retirement savings and encourage employers to sponsor retirement plans;
  - Fostering innovation and growth in the voluntary retirement savings system, including by using automated features to make inertia work in favor of saving at appropriate levels;
  - Simplifying saving plans to promote greater understanding among participants and easier compliance for employers; and
  - Supporting flexible approaches to retirement saving and lifetime income.
- **Efforts to strengthen the retirement system should be guided by an understanding of how the current system works and the evidence showing that it works well.**
  - Relying on the complementary components of Social Security, homeownership, employer-sponsored retirement plans, individual retirement accounts (IRAs), and other assets, the American retirement system is working for the majority of American workers and has grown stronger in recent decades.
  - Assets specifically earmarked for retirement have increased significantly over time and the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.
  - The flexibility built into the voluntary employer-provided retirement system has led to numerous innovations that benefit savers and decreasing costs for retirement plan products and services over time.
- **The current retirement-savings tax incentives are crucial to the effectiveness of the US retirement system and Congress should maintain and strengthen these incentives.**
  - **Survey data consistently show very strong support for the current retirement-savings tax incentives.** The vast majority of US households support the tax treatment of retirement savings and oppose eliminating the tax advantages of defined contribution (DC) plans or reducing contribution limits.

- **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-sponsored 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.

- **Tax deferral equalizes the incentive to save.** The incentive to save is the after-tax return savers earn on their savings. By effectively taxing all investment income at a zero rate, tax deferral simply ensures that a dollar of 401(k) contributions earns the same after-tax return regardless of the tax bracket workers are in.

- **Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.** Proposals to "cap" the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement. In fact, some workers may find that they would be better off simply paying income taxes on their wages and investing in a taxable account.

- **Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and defined benefit (DB) plan benefit accruals are unworkable and would discourage plan formation**. Any proposal to place a dollar cap on individual retirement accumulations would add complexity to our nation's retirement system and would discourage employers from creating retirement plans and workers from participating.

- **Limits on DC retirement plan contributions are already low by historical standards and should not be reduced further.** Adjusted for inflation, the current annual contribution limit to DC plans is less than half the limit originally established by the Employee Retirement Income Security Act of 1974 (ERISA).

- **Tax reform should not favor DB plans over DC plans.** Tax reform should maintain the neutral tax treatment of qualified deferred compensation, whether contributed to a DB plan or DC plan. Changing the rules for DC plans only would arbitrarily affect workers, depending on how their employer structures their compensation.

- **Mandatory Roth treatment could have adverse consequences for retirement savers.** Although mandating Roth treatment may be a tempting revenue raiser in the context of a 10-year budget window, due to the potential negative impact on encouraging retirement savings and promoting plan sponsorship, any consideration of a move to Roth treatment for employee contributions demands close scrutiny.

- **The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.** Reducing the

incentive for employers to offer plans will lead to fewer employers offering plans. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans. In addition to tax deferral, lower-paid workers covered by a DC 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-sponsored retirement plans.

- **Even with its many current strengths, the US retirement system can be strengthened further to help even more Americans achieve a secure retirement.** Our attached "Retirement Plan Modernization Proposals" describe policies supported by the Institute that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. These reforms would build upon the current system by expanding coverage, participation, and savings rates in DC plans and IRAs; improving the delivery and quality of information and education to plan participants and plan sponsors; enhancing flexibility in determining how and when to tap retirement savings; and eliminating unnecessary burdens in plan administration so that plans can function more effectively. The Institute also recognizes the significance of Social Security as the foundation of retirement security for almost all American workers. We urge Congress to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.

**B. The Taxation of Derivatives in Fund Portfolios Should Be Sensible and Practical**

- **The Institute believes that more uniform taxation of derivatives, with clear and administrable rules, is merited and long overdue.** Given the complexity of this topic, it nevertheless warrants careful consideration of both the benefits and the costs of any proposed changes, including the effects on the various types of taxpayers who use derivatives and the reasons therefor.

- **Funds use derivatives for many important non-tax reasons such as protecting shareholders by managing portfolio risk.** Any changes applicable to funds should reflect the impact on moderate-income investors saving for retirement and other medium-to-long-term needs.

- **Should mark-to-market treatment be adopted, gains or losses should have the same character as the underlying security.** If marks instead receive ordinary treatment, as some have proposed, at a minimum funds should be permitted to carry forward net operating losses (NOLs) indefinitely to prevent unfair and negative impacts on the funds and their shareholders.

- **Any new capital hedging regime should align the timing and character of derivatives and the investments being hedged in a manner that clearly reflects income while remaining practical and administrable.** For funds using derivatives to hedge risks in their portfolios, the

timing and character of the derivative should match that of the investment being hedged, similar to the existing rules for business hedging.

- **Finally, should fundamental reform to derivatives taxation occur, detailed guidance will be needed to address complexities, and substantial and costly operational and programming updates will be needed to implement the new rules**. Consequently, any significant change to current law should provide at least two years before the new rules become effective.

### C. Municipal Bonds are a Mainstay of Public Finance That Must Be Preserved

- **The Institute strongly supports the current tax exemption for municipal bond interest.** Proposals to cap or eliminate the tax benefit for municipal bonds would impose an onerous and retroactive tax on existing bond investments – by causing their value to drop immediately – and would likely force state and local government to reduce infrastructure spending.

- **The burden of any change would fall disproportionately on seniors, who own directly or through funds a substantial majority of all municipal bonds**. These individuals purchased lower-yielding municipal bonds because, on an after-tax basis, their returns were comparable to higher-yielding taxable bonds. This retroactive impact is particularly unfair given that the tax exemption's benefit – lower borrowing costs – flowed directly to the states and localities that issued the bonds.

### D. Foreign Investment in RICs Should Be Encouraged

- **The global market for funds, particularly in Asia, Europe, and Latin America, is expanding rapidly.** Virtually no US mutual fund is marketed or offered on a cross-border basis, however, even though many cross-border mutual funds invest in US assets.

- **The US tax law requirement that US funds seeking to prevent double taxation of their income must distribute each year essentially all of their income and gains creates a substantial barrier to marketing US funds abroad.** Many foreign funds, in contrast, are permitted to retain (or "roll up") their income without either current taxation of the fund or any obligation to distribute the income to investors.

- **US funds should not be required to make distributions to foreign investors because these distributions cause foreign investors to incur a home-country tax that would not be due if the investment were made instead in a foreign fund.** To prevent any revenue loss, however, all US withholding tax that would be collected from the distribution of the funds' income should be paid currently to the US government.

## II. THE FINANCE COMMITTEE MUST CONTINUE ITS LEADERSHIP IN FOSTERING A RETIREMENT SYSTEM THAT IS HELPING MILLIONS OF AMERICANS ACHIEVE A SECURE RETIREMENT

The Institute strongly supports efforts to promote savings and investment opportunities for American workers. We thank the leadership and members of the Committee on Finance for their past support of bipartisan retirement savings plan improvements, including provisions in the Pension Protection Act of 2006 (PPA) which made permanent the increased contribution limits and catch-up contributions for older workers introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Thanks in no small part to Congress' efforts to promote retirement savings, Americans currently have $26.1 trillion earmarked for retirement, with more than half of that amount in DC plans and 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.

This Committee's consideration of impediments and disincentives for savings and investment that exist in the current tax system must be grounded in the crucial policy goals of—

- Continuing to prioritize the goal of promoting retirement savings through tax incentives that encourage retirement savings and encourage employers to sponsor retirement plans;
- Fostering innovation and growth in the voluntary retirement savings system, including by using automated features to make inertia work in favor of saving at appropriate levels;
- Simplifying saving plans to promote greater understanding among participants and easier compliance for employers; and
- Supporting flexible approaches to retirement saving and lifetime income.

The foundation of these guiding principles is the tax incentives for retirement savings. 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.

In this part of our submission, after first documenting the important role the current system plays in helping American workers have a secure retirement, we explain the importance of the current tax incentives and the potential negative impact of various proposals to modify the tax treatment of

[2] At the end of the first quarter of 2017, US retirement assets totaled $26.1 trillion, DC plan assets were $7.3 trillion and IRA assets were $8.2 trillion. See Investment Company Institute, "The US Retirement Market, First Quarter 2017" (June 2017), available at www.ici.org/info/ret_17_q1_data.xls.

retirement savings. We also describe reform proposals that the Institute believes would serve to strengthen the US retirement system to help even more Americans achieve a secure retirement.

### A. The US Retirement System is Helping Millions of Americans Achieve a Secure Retirement

Consideration of ways in which the US retirement system can be strengthened further should be guided by a clear understanding of Americans' retirement prospects and the role that the current system plays in helping American workers reach their retirement goals. The Institute believes that a careful examination of the facts will lead this Committee to continue its support for policies that protect the national voluntary retirement system and scrutinize with caution ideas that would reduce the tax incentives for retirement savings.

- **While there is opportunity for improvement, the retirement system is working for millions of American workers.** A wide range of work by government, academic, and industry researchers who have carefully examined Americans' saving and spending patterns, before and after retirement, shows that the American system for retirement saving is working for the majority of American workers and has grown stronger in recent decades. Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and growth in the number of households, retirement assets were more than seven times the level at year-end 2016 than at year-end 1975.[3]

- **The US retirement system relies upon the complementary components of Social Security, homeownership, employer-sponsored retirement plans (both DB plans and DC plans offered by both private-sector and government employers), IRAs (both contributory and rollover), and other assets.** In retirement, different households will depend on each of these components in differing degrees, subject to overall saving levels, work history, and other factors. For most households, however, employer-sponsored retirement plans are crucial: about eight in 10 near-retiree households have retirement assets (DC plans or IRAs), DB benefits, or both.[4] Thanks to this multi-faceted system, successive generations of American retirees have been better off than previous generations.[5]

- **The significance of Social Security must be considered in any assessment of the US retirement system.** Social Security provides the foundation of retirement security for almost all American workers—for the majority, it may be the largest single income source in

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[3] See Figure 4, p. 11 (updated to year-end 2016), in Brady, Burham, and Holden, *The Success of the US Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[4] See Figure 7.4, p. 135, in Investment Company Institute, *2017 Investment Company Fact Book* (2017); available at www.ici.org/pdf/2017_factbook.pdf.

[5] See discussion, pp. 10–14, in Brady, Burham, and Holden, *The Success of the US Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

retirement[6]—and it replaces significant portions of income for lower-income retirees. In this respect, Social Security replaces 83 percent of average inflation-indexed annual earnings for workers in the lowest lifetime household earnings quintile; 54 percent for workers in the middle lifetime household earnings quintile; and 34 percent for workers in the highest lifetime household earnings quintile.[7] Yet the Social Security system faces a projected long-term imbalance.[8] It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.[9]

- **Effective policymaking requires a better understanding of the "coverage gap."** Discussions about pension plan coverage often rely on misleading or incomplete coverage statistics. The fact is that the majority of private-sector workers needing and demanding access to pensions as part

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[6] Since 1975, there has been little change in the importance of Social Security benefits in providing retiree income. 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 2013, Social Security benefits were 57 percent of total retiree income and 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 2013. See Figure 4 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2013," *ICI Research Perspective* 20, no. 7 (October 2014); available at www.ici.org/pdf/per20-07.pdf.

[7] Figures represent the mean replacement rates for retired workers in the 1960s birth cohort, assuming the workers claim Social Security benefits at age 65. See Figure 7.3, p. 134, in Investment Company Institute, *2017 Investment Company Fact Book* (2017); available at www.ici.org/pdf/2017_factbook.pdf.

[8] For projections related to these programs, see The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2016 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (June 2016), Washington, DC: US Government Printing Office, available at www.ssa.gov/oact/tr/2016/tr2016.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2016 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (June 2016), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2016.pdf; Congressional Budget Office, *The 2017 Long-Term Budget Outlook* (March 2017), available at www.cbo.gov/system/files/115th-congress-2017-2018/reports/52480-ltbo.pdf; and Social Security Administration, "Detailed Reports on the Financial Outlook for Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds," (2016), available at www.ssa.gov/OACT/tr/index.html.

[9] Regardless of the form they take, changes to Social Security will likely increase the importance of employer-sponsored retirement plans and IRAs to provide for retirement adequacy. 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.

of their compensation have pension plan coverage.[10] Efforts to expand coverage will be more successful if policymakers better understand the reasons underlying why specific populations are not participating in retirement savings vehicles.

- **The voluntary employer-provided retirement system is characterized by flexibility, competition, and innovation.** A strength of the voluntary employer-sponsored retirement system is the flexibility built into its design. Combined with competition—among employers to offer attractive benefits packages that include retirement plans and financial services firms to provide services to those plans—this flexibility has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.

- **Retirement plan sponsors and investors are cost conscious and 401(k) plan assets tend to be concentrated in lower-cost mutual funds, as 401(k) plan services have expanded.** The cost of 401(k) plans has fallen over time. Fees paid on mutual funds in particular have trended down over the past two decades—both on mutual funds invested in 401(k) plans and industrywide—and investors tend to concentrate their assets in lower-cost funds.[11] In addition, employers sponsoring 401(k) plans and their financial services providers have worked together to automate and simplify the enrollment process, expand the range of investment options, expand the services provided by the plans, and broaden the array of educational materials offered participants.

### B. The Current Retirement Tax Incentive Structure is the Foundation of the US Retirement System's Success

A crucial component of the success of the US retirement system is the current retirement-savings tax incentives, including the contribution limits, that motivate saving and encourage employers to maintain and contribute to employer-sponsored plans. We fully appreciate the Chairman's request to keep in mind the fiscal, economic, and procedural constraints inherent in tax reform. At the same time, 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 strongly. Consistent with the views of the overwhelming majority of Americans,[12] we urge Congress to maintain the current retirement-savings tax incentives, including the contribution limits, and other features that successfully encourage

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[10] See Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf.

[11] See Collins, Holden, Duvall, and Chism, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2016," *ICI Research Perspective* 23, no. 4 (June 2017); available at www.ici.org/pdf/per23-04.pdf.

[12] See Figures 2 and 3 in Holden, Schrass and Bogdan, "American Views on Defined Contribution Plan Saving, 2016," *ICI Research Report* (February 2017); available at www.ici.org/pdf/ppr_17_dc_plan_saving.pdf.

millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement.

Survey data consistently show very strong support for current retirement-savings tax incentives:[13]

- 80 percent of households with DC plan accounts agree that the tax treatment of their retirement plan is a big incentive to contribute.
- 89 percent of all US households oppose taking away the tax advantages of DC plans; and 90 percent oppose reducing DC plan employee contribution limits.
- 62 percent of full-time workers indicate that being able to deduct their retirement savings plan contributions from their taxable income is "very important" in encouraging them to save for retirement, with those in the lowest household income category ($15,000 to less than $25,000) having the largest percentage of respondents characterizing the tax deductibility of contributions as very important (76 percent).[14]

ICI's household surveys during the past eight 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.

The following principles are essential to an understanding of the current retirement tax incentive structure and its impact on Americans' retirement security.

**1. A deferral of tax is not equivalent to a tax exclusion or a tax deduction.**

Discussion and policy proposals surrounding tax incentives for retirement often proceed from the premise that compensation that is saved for retirement is similar to an exclusion or deduction, or in other words "tax-free." That premise is false. 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-sponsored 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.

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[13] See Holden, Schrass, and Bogdan, "American Views on Defined Contribution Plan Saving, 2016," ICI Research Report (February 2017), available at www.ici.org/pdf/ppr_17_dc_plan_saving.pdf. The survey included 2,027 US adults interviewed in December 2016. Survey results were weighted to be representative of US households.

[14] See Employee Benefit Research Institute "The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results from the 2011 Retirement Confidence Survey" *EBRI Notes* (March 2011); available at www.ebri.org/pdf/notespdf/EBRI_Notes_03_Mar-11.K-Taxes_Acct-HP.pdf.

### a. The tax benefit of deferral is not the up-front deduction.

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.[15] 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).[16]

### b. Tax deferral equalizes the incentive to save.

A criticism often leveled against tax deferral is that it provides an "upside-down" incentive to save. That is, it is argued that tax deferral results in higher-income workers having a larger incentive to save than lower-income workers.

The incentive to save is the rate of return earned on investments after accounting for taxation. Because savings is defined as current income less current spending, increasing savings requires an individual to reduce spending. The reward for reducing spending today is that spending can be increased in the future. The tradeoff between current and future spending represents the incentive to save: If I reduce my spending by $1 today, how much can I increase my spending in the future? It is the after-tax rate of return earned on investments that determines the terms of this trade-off.

Far from providing an "upside-down" incentive to save, tax deferral equalizes the incentive to save.[17] Normal income tax treatment discourages savings by reducing the after-tax rate of return.

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[15] 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.

[16] Ibid.

[17] See Brady, *How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits*, Investment Company Institute (2016); available at www.ici.org/pdf/rpt_16_america_supports_retirement.pdf; and Brady "How

Because the tax on investment returns increases with income, higher-income taxpayers have the lowest incentive to save in a taxable investment account. Tax deferral removes the disincentive to save inherent in an income tax and effectively taxes investment returns at a zero rate.[18] This allows all workers, regardless of marginal tax rate, to receive the full market rate of return on their savings.

### 2. Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.

Several proposals intended to limit the up-front benefit of tax-deferred retirement plan contributions have been introduced in recent years. Starting with fiscal year 2011 (FY2011), the Obama Administration's budget included a proposal to "cap" the benefits of itemized deductions at 28 percent. Starting with the FY2013 budget, the proposal was expanded so that the 28 percent cap also applied to tax-deferred employee contributions to DC plans and tax-deferred IRA contributions. In his Tax Reform Act of 2014, H.R. 1 from the 113th Congress ("Camp bill"), former House Ways and Means Committee Chairman Dave Camp (R-MI) included a proposal that would subject tax-deferred employee and employer contributions to DC plans to a 10 percent surtax. Although the 10 percent surtax proposal appears to be much different from the 28 percent cap proposal, the combination of the surtax with a top marginal rate of 25 percent is equivalent to having a top marginal rate of 35 percent and a 25 percent cap.[19]

The idea of limiting the tax benefits of deductions and exclusions, rather than eliminating them altogether, may seem at first glance to be a modest proposal. Under current tax law, a deduction or exclusion generally reduces a taxpayer's income tax by the amount of the item multiplied by the taxpayer's marginal tax rate. For example, an additional $1,000 of mortgage interest deduction would reduce income taxes by $350 for a taxpayer in the 35 percent tax bracket, and by $250 for taxpayer in the 25 percent tax bracket. Under both the Obama Administration's 28 percent cap proposal and the Camp bill's 10 percent surtax proposal, the tax benefit of the mortgage interest deduction would

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America Supports Retirement: The Incentive to Save Is Not Upside Down," *ICI Viewpoints* (February 25, 2016); available at www.ici.org/viewpoints/view_16_how_america_supports_04.

[18] For an explanation of why this is the case, see discussion in 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; and Brady, "Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free," *ICI Viewpoints* (September 16, 2013), available at www.ici.org/viewpoints/view_13_deferral_explained. If a taxpayer's marginal tax rates at the time of contribution and the time of distribution are the same, tax deferral is equivalent to taxing investment income at a zero rate. If tax rates are lower at the time of distribution, the benefits of tax deferral are increased. If tax rates are higher at the time of distribution, the benefits of tax deferral are reduced.

[19] For a discussion of these proposals and their equivalence, see Brady, *How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits*, Investment Company Institute (2016); available at www.ici.org/pdf/rpt_16_america_supports_retirement.pdf.

remain unchanged for the 25 percent marginal rate individual, but would be reduced to $280 or $250, respectively, for the 35 percent marginal rate individual.

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. To implement a cap on the up-front benefit, taxpayers would pay an additional "cap tax" or "surtax" on retirement plan contributions. For example, a taxpayer in the 35 percent bracket would pay a tax on a $1,000 contribution of $70 (7 percent, or 35 percent less 28 percent) under the 28 percent cap proposal, a tax of $100 with a 10 percent surtax, and a tax of $200 (20 percent, or 35 percent less 15 percent) with a 15 percent credit. Taxes paid in retirement would remain unchanged, however, with all distributions from the account subject to tax.[20] Thus, the up-front value of the tax deferral is reduced by the "cap tax," but the tax ultimately paid on income from the retirement account is not reduced. In effect, taxpayers would be taxed on contributions made to the retirement account and again as they receive the amounts in the form of distributions.

The additional "surtax" or "cap tax" would create a drag on a saver's return, sharply reducing the benefits of tax deferral. In fact, some workers close to retirement age may find that they would have been better off paying taxes on the wages and investing in a taxable account.[21] For example, a worker invested in stocks would need to hold the investment for 13 years before the benefits of deferral offset the impact of a 10 percent surtax.[22]

Proposals to "cap" the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement.

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[20] Responding to criticism that workers could be made worse off by contributing to a retirement plan, the Obama Administration's FY2014 proposal included a provision for an unspecified basis adjustment. Any basis adjustment that would ensure no worker is made worse off contributing to a retirement plan would be unintuitive, complex, burdensome on taxpayers, and difficult for the IRS to enforce. And, in the end, the benefits of tax deferral would still be reduced substantially.

[21] See Brady, *How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits*, Investment Company Institute (2016); available at www.ici.org/pdf/rpt_16_america_supports_retirement.pdf.; and Brady, "A 'Modest' Proposal That Isn't: Limiting the Up-Front Benefits of Retirement Contributions," *ICI Viewpoints* (September 18, 2013), available at www.ici.org/viewpoints/view_13_limiting_upfront_benefits.

[22] This calculation assumes the up-front benefit is capped at 25 percent and the taxpayer is subject to a 35 percent marginal tax with no change in marginal tax rate over time and is not subject to penalty for early withdrawal. Investments are assumed to earn a 6.0 percent nominal rate of return 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.

### 3. Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and DB plan benefit accruals are unworkable and would discourage plan formation.

The Obama Administration's budget proposal (starting in FY2014) 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.[23] 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 no longer to 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. 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's previous thinking and actions in the retirement policy sphere.

### 4. Contribution limits already are low by historical standards and should not be reduced.

Several proposals have been made to reduce contribution limits to DC plans. The National Commission on Fiscal Responsibility and Reform's so-called "20/20 proposal" suggested limiting the combination of employer and employee contributions to DC plans to the lesser of $20,000 annually or 20 percent of compensation. The Camp bill would have suspended inflation adjustments to DC plan contribution limits and DB plan benefit limits for 10 years.

Contribution limits are already low by historical standards.[24] As illustrated in the figure below, for 2017, the Internal Revenue Code Section 415(c) limit for total DC plan contributions (employer

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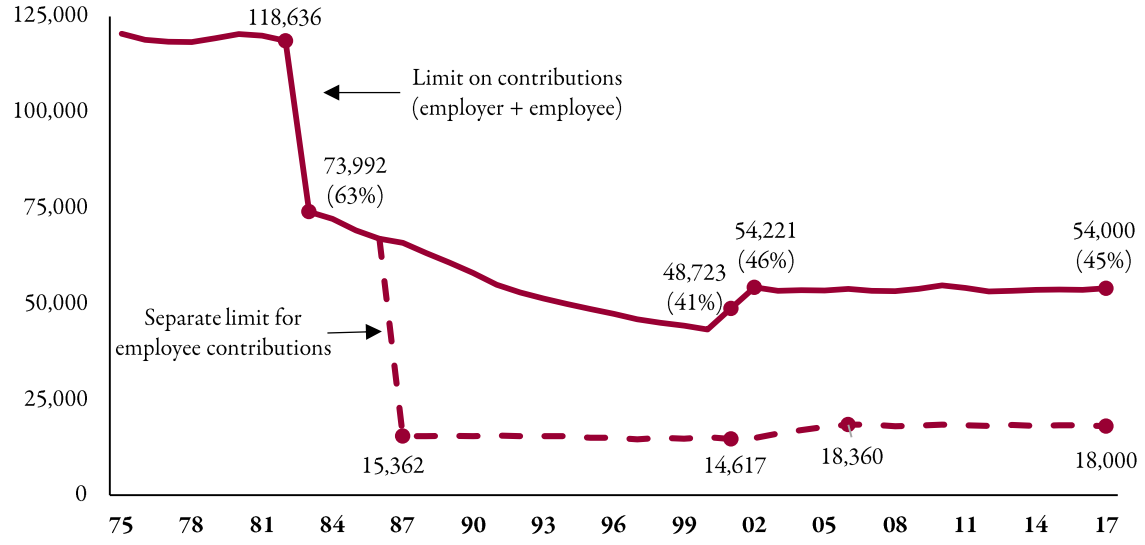
[23] If an employer has multiple DB plans, the DB plan benefit limit would apply to all benefits accrued from the employer. Similarly, if an employer has multiple DC plans, the DC plan contribution limit would apply to all (employer and employee) contributions to plans sponsored by the employer. The 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.

[24] For a discussion of the history of contribution limits, see 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.

plus employee) is $54,000. The original limit set under ERISA ($25,000 in 1975; or about $119,000 in today's dollars) was indexed to inflation until 1983, when it was reduced to $30,000 (or about $74,000 in today's dollars) and subsequently frozen. The Tax Reform Act of 1986 delayed reinstating inflation adjustment and implemented a $5,000 "round-down" rule. The combined effect was the limit was unchanged until an inflation adjustment increased the limit to $35,000 (or about $49,000 in today's dollars) in 2001. EGTRRA subsequently increased the limit to $40,000 (or about 54,000 in today's dollars) in 2002 and indexed the new limit to inflation subject to a $1,000 "round-down" rule. The current limit, however, is less than half of the original limit in inflation-adjusted dollars. In addition, the Tax Reform Act of 1986 instituted a separate limit on employee contributions, whereas previous law only limited the combination of employer and employee contributions. EGTRRA increased the employee contribution limit in steps from 2002 to 2006, at which point the limit was indexed for inflation.

**DC Plan Contribution Limits Are Low by Historical Standards**

*Limit on annual contributions to defined contribution plans, constant 2017 dollars, 1975–2017; percentage of ERISA limit, various years*




Source: Investment Company Institute

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. Based on Congressional Budget Office (CBO) inflation assumptions, a 10-year freeze would effectively reduce contribution limits by about 20 percent. A $20,000 limit would be below the original limit set in 1974 in *nominal* dollars.

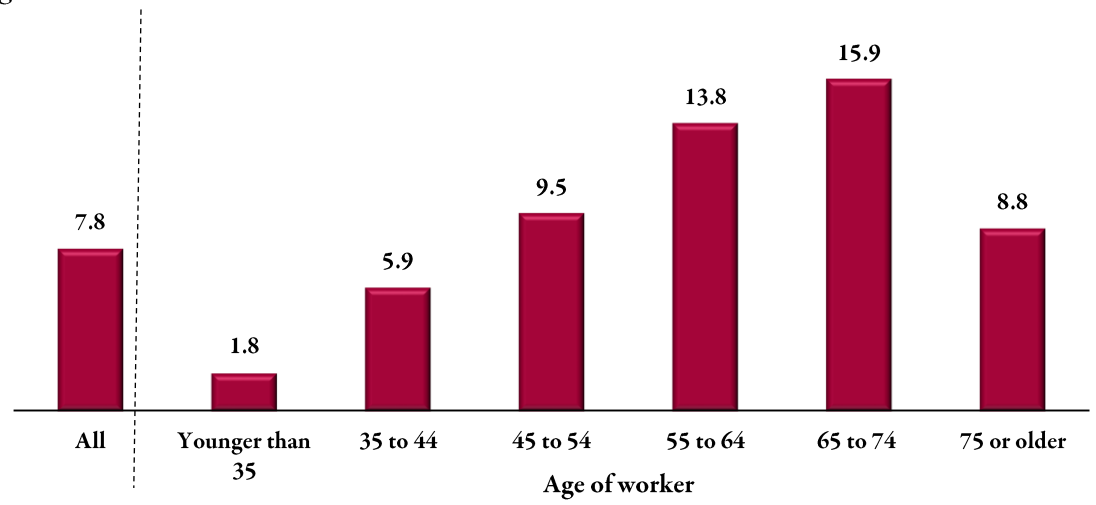
DC plan contribution limits are particularly important because of the uneven life-cycle pattern of retirement savings. The amount that workers contribute to their 401(k) plans is unlikely to be smooth and steady throughout their career. As a group, younger workers are less focused on retirement savings. They typically invest in other ways, such as funding education, purchasing a home, and raising children. Retirement savings typically ramps up as workers get older, both because earnings typically increase with age and because other expenses, such as childcare and education, decline.

The impact of the life-cycle pattern of retirement savings can be seen in statistics on workers who make the maximum allowable employee contribution to a DC plan.[25] Limit contributors typically are in their prime savings years and have moderate income: 68 percent of limit contributors were aged 45 to 64, and 50 percent had adjusted gross income (AGI) of less than $200,000.[26]

Although contribution limits may impact few workers in any given year, many more workers are affected at some point in their career. Only about 8 percent of workers with elective deferrals contributed the maximum allowed by law in 2013, but the share of workers at the limit increases with age (see figure below). For example, only 2 percent of workers younger than 35 contribute at the limit, but that percentage increases to 14 percent for workers aged 55 to 64.

**Workers Are More Likely to Contribute at the Limit as They Approach Retirement**

*Percentage of W-2 workers with elective deferrals who contribute at the 402(g) elective deferral limit, by age, 2013*




Source: Internal Revenue Service Statistics of Income Division

[25] The statistics used in this analysis are from IRS Statistics of Income Division (SOI) Form W-2 study (January 2017), available at www.irs.gov/pub/irs-soi/13inallw2.xls. The data are from the 2013 tax year, the most recent available. Limits are adjusted for catch-up contributions for workers age 50 or older. Some workers will be prevented from contributing the maximum allowed by law by rules established by their employer's plan. These workers are not included in the statistics for limit contributors.

[26] Ibid.

### 5. Tax reform should not favor DB plans over DC plans.

Any comprehensive effort to address fiscal policy or tax reform should maintain one aspect of the current income tax: neutral tax treatment of qualified deferred compensation. Tax-deferred contributions to both DB plans and DC plans are treated equally under the tax code. Employees pay no tax on compensation contributed on their behalf to a qualified retirement plan, and no tax on the investment earnings of a plan while they accrue. Taxes are due only when employees take distributions from a plan. In addition, limits on DC plan contributions are intended to be roughly equivalent to the restrictions on the generosity of DB plans.

Many proposals focus on limiting the tax benefits of DC plans. For example, proposals to limit the up-front benefit of deferral only apply to DC plans. The Camp bill's 10 percent surtax proposal would apply only to employee and employer DC plan contributions. The Obama Administration's 28-percent proposal would apply only to employee elective deferrals to DC plans and tax-deferred IRA contributions. The 20/20 proposal would reduce the DC plan contribution limit, but leave the DB plan benefit limit unchanged. As a result the ratio of the DB benefit limit to the DC contribution limit would move from four to one to nearly ten to one.

Changing the rule only for DC plans means that benefits a worker gets from deferral will depend on how their employer structures their compensation. For example, consider the impact of the 20/20 proposal on 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. The federal government employee, however, 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.

To maintain the neutrality of the current tax code, any changes to retirement plans should apply equally to DB plans and DC plans.

### 6. Mandatory Roth treatment could have adverse consequences for retirement savers.

The Camp bill would have cut the maximum employee pre-tax contribution to 401(k) plans in half, with the remaining half of today's annual pre-tax limit available to employees as a Roth account contribution. This provision would also apply to 403(b) and 457(b) plans. For example, for 2017 the

limit on effective deferrals is $18,000, with an additional $6,000 available to employees age 50 and older as a catch-up contribution for a total of $24,000. Under the proposal, any contributions in excess of half of these limits ($9,000 and $12,000 respectively) would need to be made to a Roth account. Plans sponsored by employers with 100 or fewer employees would not be subject to this requirement.

According to the Camp bill summary, this provision was intended to help Americans achieve greater retirement security by making more available to them at retirement on a tax-free basis because Roth benefits generally are not taxed upon distribution. However, American workers will not achieve greater retirement security if the loss of the up-front deferral causes them to save less for retirement. In this respect, the proposal disregards the importance of tax-deferral in encouraging savings and especially small business plan sponsorship.

The up-front deferral plays a significant role in the decision by an employer to sponsor a plan. For example, a 2012 study by Matthew Greenwald & Associates found that eight in ten employers said that the exclusion of employee contributions and employer contributions from current taxation is important to their company's decision to sponsor a plan and provide a means of retirement savings to their workforce. [27]

Although mandating Roth treatment may be a tempting revenue raiser in the context of a 10-year budget window, due to the potential negative impact on encouraging retirement savings and promoting plan sponsorship, any consideration of a move to Roth treatment for employee contributions demands close scrutiny. Key factors include:

- Low- and moderate-income workers would lose the ability to make pre-tax contributions. This in turn could lead to a reduction in the amount they are willing or able to contribute to retirement plans, as they move to maintain take-home pay.

- Small business owners that lose deferral treatment would be less inclined to start or continue their company DC plans.

### 7. The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.

Reducing the value of tax-deferred retirement contributions through any of the aforementioned proposals will reduce the incentives for employers to offer DC plans to their employees and will lead to fewer employers offering plans. 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

[27] See Matthew Greenwald & Associates, "Attitudes of Employee Benefits Decision Makers Toward Retirement Plan Tax Proposals" (2012). See also 2011 study by Harris Interactive showing that nearly all plan sponsors (92 percent) said the ongoing tax deferral for employees is important to offer a DC plan.

eliminate their plans and use the savings to simply increase cash compensation. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans.

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-sponsored retirement 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. In addition, lower-paid workers covered by a DC plan benefit from the "nudge" of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-sponsored retirement 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.[28] 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.

### C. Changes in Retirement Policy Should Build on Existing System—Not Put It at Risk

Even with its many current strengths, the US retirement system can be strengthened further to help even more Americans achieve a secure retirement. Attached to this submission, please find a document titled "Retirement Plan Modernization Proposals," describing policies supported by the Institute that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. These reforms would build upon the current system by expanding coverage, participation, and savings rates in DC plans and IRAs; improving the delivery and quality of information and education to plan participants and plan sponsors; enhancing flexibility in determining how and when to tap retirement savings; and eliminating unnecessary burdens in plan administration so that plans can function more effectively. We were pleased to see some of these proposals in the Retirement Enhancement and Savings Act of 2016 (RESA), which was approved by the Committee on Finance by unanimous vote in September 2016.

As Congress considers changes to the US retirement system in the context of comprehensive 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.** As explained above, promoting retirement savings must remain one of the nation's top policy priorities.[29] We urge

[28] See Toder and Smith, "Do Low-Income Workers Benefit from 401(k) Plans?" *Center for Retirement Research Working Paper* no. 2011-14 (September 2011), available at: crr.bc.edu/wp-content/uploads/2011/10/wp_2011-14_508-1.pdf.

[29] A vast majority (79 percent) of US households surveyed from November 2012 to January 2013 agreed that continuing retirement savings incentives should be a national priority. See Figure 12 in Holden and Bass, "America's Commitment to

this Committee to continue its 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.

- **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.[30] It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.[31]

- **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.[32] 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.[33]

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Retirement Security: Investor Attitudes and Actions, 2013," *ICI Research Report* (February 2013), available at www.ici.org/pdf/ppr_13_retir_sec_update.pdf.

[30] See note 8, supra.

[31] See note 9, supra.

[32] A provision in RESA would eliminate the 10 percent cap on automatic escalation of contributions (after the first year of enrollment) under the PPA's nondiscrimination safe harbor for qualified automatic contribution arrangements. The Institute supports this change, as detailed in the attachment.

[33] 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 particularly strong impact on improving participation rates among low-income and younger workers. See, e.g.,

- **Offer simpler plan features and easier access to multiple employer plans ("MEPs") for small employers**. Small businesses often face particular challenges in establishing and maintaining retirement plans. Special attention should be given to addressing legal requirements that may create obstacles to plan sponsorship among smaller employers. This concept underlies several provisions approved by the Finance Committee in 2016 as part of RESA. Most notably, RESA would ease restrictions on "open" MEPs, allowing unrelated employers to pool assets and participants under a single plan. The Institute supports the open MEP concept, but we recommend targeting the provision to employers with fewer than 100 employees—the employer segment most in need of solutions to encourage retirement plan sponsorship.[34] In addition, 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.[35]

- **Support flexible approaches to retirement saving and lifetime income**. 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' specific competitive environment. This flexibility is also important in the context of proposals intended to assist plan participants and retirees in

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Utkus and Young, *How America Saves, 2017: A report on Vanguard 2016 defined contribution plan data*, Vanguard Center for Retirement Research (2017), available at https://institutional.vanguard.com/iam/pdf/HAS17.pdf.

[34] For a discussion of how pension coverage varies by plan size, see Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014).

[35] We note that a conceptually similar provision, referred to as the "starter k" plan, has been proposed by Ranking Member Orrin Hatch (R-UT) in S. 1270, the "Secure Annuities for Employee (SAFE) Retirement Act of 2013."

[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), 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.

ensuring that they do not run out of income in retirement or in determining how much retirement income they can generate from a 401(k), IRA, and other savings. All retirement income products and strategies involve tradeoffs and consideration of an individual's personal circumstances, such as the amount of annuitized income to be received from Social Security,[38] other assets or income, health status and life expectancy, the need for emergency reserves, specific goals in retirement, and the need to provide for other family members. As a matter of public policy then, it is important to ensure a level playing field for all products and services.

* * *

The promotion of retirement savings—whether through employer-sponsored retirement plans or IRAs—has long been one of the Committee on Finance's 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). We welcome the Committee's continued leadership in pursuing policies to improve our nation's retirement system. But any changes should only build upon a successful system that tens of millions of US households rely on to help them achieve retirement security. Consistent with the views of the overwhelming majority of Americans, we urge this Committee to preserve 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.

## III. ENSURING THAT THE TAXATION OF DERIVATIVES IN FUND PORTFOLIOS IS SENSIBLE AND PRACTICAL

The taxation of derivatives is a topic that has received bipartisan consideration over the past few Congresses. Most agree that the current rules in the Internal Revenue Code are complicated, disjointed, and ripe for reform. Instruments with similar economics can have vastly different tax consequences, and well-advised taxpayers effectively can choose the timing and character of any income, gains or losses based on the instrument that is purchased.

Although the taxation of derivatives should be reformed, the Institute strongly believes that one size does not fit all. As discussed below, requiring funds that are regulated investment companies (RICs) to apply a strict mark-to-market regime to all derivatives and those investments being hedged ultimately will harm fund shareholders. Sound tax policy and administrability should not be sacrificed in an attempt to achieve questionable levels of simplicity.

[38] See discussion of Social Security replacement rates and how the role of Social Security varies by income and wealth on pages 7-8, supra.

### A. Derivatives and the Mutual Fund Industry

RICs and other funds registered under the Investment Company Act of 1940 provide average retail investors with professionally-managed, diversified portfolios that these individuals cannot replicate on their own. These investors often are saving for retirement, college, or other financial needs, and funds provide a sound means for achieving those goals. As shareholders in funds, these Americans benefit from the investment management tools that funds are designed to utilize.

Funds use derivatives to advance successful long-term non-tax investment strategies. Various derivatives are used for various purposes but are a fundamental part of how funds build their portfolios. For instance, in the fixed income context, derivatives are used to manage a fund's exposure to things such as credit risk, inflation, interest rates, and currency movements. To achieve these results, funds use, among others, futures contracts on bonds and Treasuries, forward contracts on currencies, interest rate swaps, credit default swaps, and sales and repurchase agreements ("repos").[39] While the fund industry most commonly uses derivatives in fixed income funds, derivatives also may be used in equity funds to achieve specific investment goals. For example, funds may use derivatives to gain exposure to foreign markets in which it may be difficult or expensive to hold the securities directly. Derivatives can help funds meet certain benchmarks. Funds also may use derivatives temporarily to accommodate investor cash flows into and out of funds in a manner that minimizes disruptions to the funds' investment strategies.

It is important to note that funds typically manage the risks described above on a portfolio-wide level. Thus, there often will not be a one-to-one relationship between a specific security and a derivative. Portfolio managers will look at the investments as a whole and determine how best to use derivatives to achieve their investment goals.

In sum, derivatives permit funds to fine tune their portfolios to better achieve the funds' investment objectives, while reducing transaction costs and risks. Their use of derivatives thus directly benefits the fund shareholder. If the tax laws negatively affect the use of derivatives, funds may not be able to efficiently or satisfactorily limit the risks on their portfolios or meet their investment goals. This will result in lower yields and more risk, including volatility, for the people who have invested in those funds, in both tax-advantaged retirement accounts and taxable accounts.

Funds and their investors generally would benefit from more uniform tax treatment of derivatives. The lack of precise and cohesive rules may lead to inconsistent treatment among reasonable and compliant taxpayers. Tax certainty is particularly important to funds because they are subject to stringent qualification and distribution requirements under Subchapter M of the Code; these

[39] Although repos generally are not considered derivatives, we include them here because some proposals have included them in the definition of "derivatives" that would be subject to a mark-to-market regime.

requirements include asset diversification and income tests that funds must meet to qualify as RICs. RICs also must distribute substantially all of their income each year to avoid income and excise taxes at the entity level. The uncertain tax treatment of derivatives can make this tax compliance effort particularly difficult.

The fund industry believes that more uniform taxation of derivatives, with clear and administrable rules, is warranted and long overdue. Given the complexity of this topic, it nevertheless warrants careful consideration of both the benefits and the costs of any proposed changes, including the effects on the various types of taxpayers who use derivatives and the reasons therefor.

**B. Mark-to-Market Accounting for Derivatives**

Although we agree that more uniform taxation of derivatives is warranted, it is not clear that the mark-to-market approaches advanced by former House Ways and Means Committee Chairman Dave Camp (R-MI) in 2014 during the 113th Congress (H.R. 1, the Tax Reform Act of 2014, hereinafter referred to as the "Camp bill") and in the Modernization of Derivatives Act of 2017 (S. 1005, hereinafter referred to as "MODA") are the appropriate means for achieving that goal. We understand that a broad mark-to-market approach may be appealing because, at least theoretically, it appears relatively simple to apply. Many derivatives, for example, already are marked to market for tax and/or book purposes. A mark-to-market regime, however, is not the most appropriate tax treatment for all derivatives, particularly for those instruments for which income already is recognized on an accrual basis.

For example, the Internal Revenue Code and the regulations thereunder already provide rules for debt instruments, such as contingent payment debt instruments (CPDIs) and variable rate debt instruments (VRDIs), that require current accruals of income. It is not clear that these rules need to be replaced with another regime. Similarly, taxpayers that hold interest rate swaps recognize income currently; there is no need to also mark the swap to market.

In addition, although a mark-to-market approach for all derivatives may be more uniform than the current derivatives taxation regime, it would come with its own potential complexities, uncertainties, and irregularities. Notably, it would subject derivatives to a fundamentally different timing regime than that which is generally applicable to non-derivatives. This could lead to similar investments[40] being subject to different timing rules, creating opportunities for tax planning and impacting investment decisions, while also presenting traps for the unwary. There are both advantages and disadvantages to a mark-to-market approach for derivatives; we thus urge the Committee to weigh these carefully, as well as other timing rules, before any changes are made.

[40] For example, a direct investment in stock would not be subject to mark-to-market but long exposure to the stock through a swap would be.

### C. Character of Gain and Loss

The mark-to-market proposals advanced by the Camp bill and MODA would treat any gains or losses recognized as ordinary. We argue that the better answer is to treat any mark-to-market gains or losses as having the same character as the underlying security.[41] At a minimum, if all marks remain ordinary, funds should be permitted to carry forward net operating losses (NOLs) indefinitely to prevent unfair and negative impacts on the funds and their shareholders.[42]

We do not believe that requiring ordinary tax treatment for derivatives achieves tax fairness. Requiring gains and losses from derivatives to be treated as ordinary could be punitive or beneficial to the taxpayer, depending on the circumstances. For example, capital gains generally are preferred over ordinary income, but ordinary losses generally are preferable to capital losses.

Providing consistent tax treatment between the character of a derivative and its underlying security is more appropriate, particularly given that most underlying assets, including stocks and bonds, are capital assets. We do not see any obvious tax policy reasons for having the character of gains or losses from derivatives differ from that of the underlying assets. Consistent treatment, which would mandate capital treatment for most derivatives, also would resolve several fund-specific problems that would arise if all mark-to-market gains and losses were treated as ordinary.

The current mark-to-market proposals in most cases would create significant disparities between the treatment of derivatives and their underlying assets. The difference in character would eliminate some planning opportunities but create several others. One complaint about the current state of the taxation of financial products is that instruments or transactions that are economically similar can have materially different tax results. A mark-to-market regime that treats all marks as ordinary income or loss partially would address this problem by treating all derivatives in the same manner, but it still would allow for different tax treatment of stocks and bonds, on one hand, and economically equivalent derivatives on the other. Thus, a taxpayer that wants capital treatment could invest directly in stock, but an investor that prefers ordinary treatment could invest in a total return swap (or some other derivative or combination of derivatives) that provides the same economic exposure as direct

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[41] In most cases, the assets underlying derivatives are capital assets. There are some assets, such as currency, however, that generate ordinary income and loss. Thus, although mark-to-market gains and losses from most derivatives should be treated as capital, it may be generally appropriate to treat mark-to-market gains from derivatives such as currency forwards as ordinary. We also recommend that the section 988(a)(1)(B) election (or an equivalent) continue to be available to treat as capital gain or loss the gain and loss on currency-related forwards, futures, and options that are held as capital assets. Depending on the nature of the other investments in the portfolio in which the currency forwards, futures, or options are being used, capital or ordinary treatment may be more appropriate or desirable. The section 988(a)(1)(B) election serves an important purpose and should be retained.

[42] Under current law, RICs are permitted to carry forward capital losses indefinitely but are not permitted to carry forward NOLs to any future taxable years.

ownership. We thus believe that tying the tax treatment of derivatives to the underlying security would be more appropriate and would limit these planning opportunities.

Also, as discussed above, funds use derivatives for a number of important non-tax reasons. The most important reason that mutual funds use derivatives is to manage risk in their portfolios. Imposing ordinary tax treatment, however, may affect how funds use derivatives. This in turn will negatively affect investors in funds, who typically are not sophisticated taxpayers, but rather are ordinary individuals who are saving for retirement, education expenses, or simply a rainy day.

Ordinary income treatment would create unique difficulties for funds. One such difficulty arises because, under current law, funds cannot carry forward NOLs. As most funds today typically have ordinary income in excess of their ordinary losses and expenses, the absence of carryforward treatment has not been particularly problematic. If mark-to-market losses were ordinary, however, funds would be more likely to experience NOLs more frequently and in greater dollar amounts. Fund investors thus could be unfairly "whipsawed."[43] This "whipsaw" treatment would occur if a fund had net mark-to-market gains in some years and net mark-to-market losses in other years. Assume, for example, that a fund had $100 of ordinary income in year one, $100 of ordinary loss in year two, and another $100 of ordinary income in year three. Over this period, the fund would need to distribute $200 of taxable income to its shareholders even though its economic income was only $100. The ability to carry forward NOLs—thereby allowing the fund to reduce its year three income by the year two loss—could address this unfairness.[44]

Funds also would be subject to an additional whipsaw in that they may not be able to offset capital losses on their portfolio securities (such as stocks or bonds) with ordinary gains on their derivatives or vice versa. As discussed above, derivatives are a fundamental part of how many funds build their portfolios. If gains and losses on portfolio securities could not be offset against losses and gains on the fund's derivatives, however, average investors would see a significant change in how their RIC investments are taxed. To remain compliant with Subchapter M distribution requirements, funds could be forced to distribute additional amounts resulting from the ordinary gains from derivatives, even though no actual cash flows were received from those derivatives. Shareholders thus would be forced to pay tax on income that the RIC did not actually receive. Gains from derivatives may be offset

[43] Bond funds today receive fairly predictable and recurring amounts of interest income from their portfolio holdings. Bond fund investors, consequently, expect regular (generally monthly) and fairly constant dividends from these funds. Offsetting ordinary losses from derivatives against this interest income would cause distributions to vary and/or change the tax character of the distributions from taxable to return of capital and potentially create a disconnect between the economics of the fund's portfolio and the fund investors' tax consequences. Further, it would upset investor expectations.

[44] MODA includes a provision permitting RICs to carry forward NOLs indefinitely.

by losses in the portfolio and vice versa under current law, but the character mismatch created by the Camp bill and MODA could prevent this.[45]

We thus recommend that any mark-to-market gains or losses have the same character as the underlying security while retaining the election under section 988(a)(1)(B). Barring this result, at the very least, any gains or losses recognized should be treated as short-term capital gains or losses; this treatment would ameliorate for funds many of the concerns raised by ordinary treatment.[46]

**D. Investment Hedging Regime for RICs**

MODA would require taxpayers to match certain derivatives and the underlying investment that is being hedged if the two instruments meet a specific "delta" test. The entire unit then would be marked to market annually, and any gains or losses would be treated as ordinary.

This proposal presents a number of problems for funds. First, given how derivatives are used by funds to hedge risk, it could convert substantial portions of the gains and losses from a fund's portfolio from capital to ordinary. We do not believe that this result is appropriate as it unfairly harms fund shareholders.

Second, the delta test used in the proposal is not a calculation that is used in the marketplace for the types of hedging activities for which funds use derivatives. Funds often use derivatives to hedge all or a portion of a portfolio, or to hedge interest rate or currency risk on a bond. Thus, there typically is not a one-to-one ratio between a derivative and an underlying security, and it is unclear how the delta test would be applied in these situations.

Third, fund portfolios may contain thousands of long and short positions in any given period, and those positions change daily or even by the minute. Current systems cannot identify the derivatives and the positions being hedged in real time; it is unclear whether such identifications are even possible.

Proposals to create a capital hedging regime should align the timing and character of recognition on the components of the hedging transactions. When derivatives are used to hedge risk on a large portfolio, the timing and character should be driven by the investment that is being hedged, not the other way around. We believe that this treatment more clearly reflects the income of the taxpayer.

Sections 1221 and 446 currently provide such a business hedging regime for ordinary assets. The taxpayer is not required to mark the hedging transaction to market; rather, the timing and character of the derivative is determined by the investment being hedged. We encourage the Committee to explore an investment hedging regime that expands the "clear reflection of income"

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[45] Because gains and losses from derivatives are treated as capital under Generally Accepted Accounting Principles (GAAP), this also could result in potentially problematic book-tax differences.

[46] Any short-term capital gains recognized would be taxed at the same rates as ordinary income. Importantly, however, short-term capital gains and losses could be offset against other capital gains and losses in the portfolio, and, as noted above, RICs may carry forward capital losses indefinitely under current law.

approach currently applicable to business hedges. Under such a regime, the character of derivatives that are used to hedge other investments generally would match the character of those other investments. Gains or losses on the derivative would be deferred until gains or losses are recognized on the hedged assets. Similarly, gains on appreciated positions would not be triggered merely because a taxpayer entered into a derivative to hedge the position. This type of regime would more clearly reflect the economics of derivatives used to hedge investment or portfolio risk. It also would resolve many of the industry's concerns with the current mark-to-market proposals while still achieving the goal of aligning the timing and character of income recognition on the components of the hedge.

### E. Effective Date

It is important to recognize that the adoption of any sort of fundamental reform to derivatives taxation will present the need for further guidance to address the questions and complexities that will follow. Replacing the current rules with a different regime will require significant time and resources by the Internal Revenue Service and Treasury Department to provide necessary guidance. Taxpayers then will need sufficient time to implement these changes, as explained and clarified by the government. This is especially true for large portfolios, like RICs, which will require substantial and costly operational and programming updates to implement the new rules. At the very least, any significant change to current law should provide at least two years before the new rules become effective.

## IV. MUNICIPAL BONDS ARE A MAINSTAY OF PUBLIC FINANCE THAT MUST BE PRESERVED

The Institute strongly supports the current tax exemption for municipal bond interest. Proposals to cap or eliminate the tax benefit for municipal bonds would impose an onerous and retroactive tax on existing bond investments and would likely force state and local government to reduce infrastructure spending.

Investors held $905 billion of the $3.8 trillion municipal bond market (or 24%), at the end of the first-quarter of 2017, through hundreds of registered investment companies, including municipal bond funds and tax-exempt money market funds. Individual investors held directly another $1.6 trillion (or 43%) of municipal bonds. Seniors hold, directly or through funds, more than half of all municipal bonds.[47]

State and local governments pay municipal bond holders lower interest rates on their investments because the interest payments are exempt from tax; thus, the economic benefit of the exemption accrues to the governments when they issue the bonds. Investors accept the lower interest rate because the after-tax return is comparable to that on a taxable bond.

[47] More than 60 percent of income from municipal bonds is earned by taxpayers over the age of 65. IRS Statistics of Income Division, 2014.

In effect, investors in municipal bonds paid an implicit tax on their securities by accepting a lower interest rate when they purchased their investments. Imposing a retroactive tax on their existing investments' interest payments imposes a tax burden for a benefit that these investors did not receive. It is unfair to impose retroactive taxation on investors, many of whom are seniors, on the basis of an economic benefit that flowed to the states and localities that issued the bonds.

Repealing or limiting the municipal bond tax exemption would impose significant losses on existing investors as the value of all outstanding municipal bonds would drop immediately. Experts estimate that a 28 percent cap, for example, would destroy over $200 billion of existing market value.[48] Seniors would bear almost $120 billion of these losses.

Retroactive taxation, moreover, could trigger mandatory redemption provisions in $150 billion of existing municipal bonds. Many municipal bond indentures were written with provisions that force municipalities to immediately redeem any bonds whose tax-exempt interest becomes taxable by operation of a change in the tax laws. Mandatory redemptions of existing bonds will require municipalities to immediately refinance outstanding debt at higher rates.

The $3.8 trillion municipal bond market is the primary financing tool used by states and counties to finance three-quarters of the total US investment in infrastructure, including in schools, roads, bridges, hospitals, sewer and water systems, and other projects that provide essential services. Between 2000 and 2014, the tax exemption saved state and local governments an estimated $714 billion in additional interest costs.[49] Without the tax-exemption, state and local governments either would pay far more to raise capital[50]—a cost that ultimately would be borne by taxpayers, through higher taxes—or be forced to reduce infrastructure spending.

The Institute believes that retaining the current tax exemption for municipal bond interest is consistent with Congress' goal of improving and simplifying the tax code in a manner that spurs economic growth.

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[48] George Friedlander, Mikhail Foux, and Vikram Rai, *US Municipal Strategy Special Focus: The Case for the Tax Exemption Remains Strong, Even As Threats Grow*, Citi Research (October 2012).

[49] International City/County Management Association, *Municipal Bonds and Infrastructure Development – Past, Present, and Future, August 2015.*

[50] A study released by four major trade organizations representing states and municipalities found that, had a 28 percent cap applied from 2003-2012, state and local communities would have paid an additional $173 billion in interest. The Government Finance Officers Association, *Protecting Tax-Exempt Bonds for Infrastructure and Jobs*, February 2013.

## V. FOREIGN INVESTMENT IN RICS SHOULD BE ENCOURAGED

The Institute strongly supports the international competitiveness of US mutual funds. Today, almost 47 percent of all mutual fund assets are held by US-domiciled funds.[51] The percentage of global fund industry assets held by US funds, however, has declined as investment markets have globalized.

Changes taking place in Asia, Europe, and elsewhere are providing many significant opportunities for growth in the asset management industry. "Cross-border mutual funds" (*i.e.*, mutual funds that are domiciled in one country but offered for sale in other countries) have enjoyed explosive growth. At the end of 2016, there were more than 100,000 foreign mutual funds and ETFs in existence, compared to fewer than 10,000 mutual funds and ETFs domiciled in the United States.[52] Today virtually no US mutual fund is marketed or offered on a cross-border basis, even though many cross-border mutual funds invest in US assets.

The US tax law requirement that US funds seeking to prevent double taxation of their income must distribute each year essentially all of their income and gains creates a substantial barrier to marketing US funds abroad. Many foreign funds, in contrast, are permitted to retain (or "roll up") their income without either current taxation of the fund or any obligation to distribute the income to investors.

The US distribution requirements cause foreign investors to incur a home-country tax that may not be due if they invest instead through such a foreign fund. Foreign investors may also be subject to higher tax rates if their home country treats capital gain dividends paid by RICs as dividends that are not eligible for preferential capital gains tax rates.

US mutual funds could compete effectively against foreign mutual funds if they were not required to distribute their income currently to their foreign investors. To prevent any revenue loss, however, all US withholding tax that would be collected from the distribution of the funds' income should be paid currently to the US government. We would be pleased to work with the Committee on legislation to allow US funds to compete in the rapidly globalizing investment markets.

Attachment

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[51] https://www.ici.org/pdf/2017_factbook.pdf, Table 65.

[52] Id. Table 66.

# RETIREMENT PLAN MODERNIZATION PROPOSALS

INVESTMENT COMPANY INSTITUTE®

**DECEMBER 15, 2016**

# RETIREMENT PLAN MODERNIZATION PROPOSALS

The Investment Company Institute supports the following proposals intended to improve the successful defined contribution plan system and better equip American workers with the tools needed to build a secure retirement. The proposals would expand coverage, participation, and savings rates in defined contribution plans and IRAs; improve the delivery and quality of information and education to plan participants and plan sponsors; enhance flexibility in determining how and when to tap retirement savings; and eliminate unnecessary burdens in plan administration so that plans can function more effectively.

**Expand Coverage**



**Increase Participation and Savings Rates**



**Help Participants Make Informed Decisions**



**Permit Greater Flexibility for Participants**



**Improve Plan Administration**



**Strengthen Social Security**

**Improve Fiduciary Advice Regulation**

# EXPAND COVERAGE: ESTABLISH NEW SIMPLER PLAN DESIGN

## Current Law

Small employers have many different plan options to choose from: payroll-deduction IRAs, SEP IRAs (which allow only employer contributions), SIMPLE IRAs or SIMPLE 401(k) plans, as well as full-blown tax-qualified plans such as 401(k), profit-sharing, or defined benefit plans.

One such option—the SIMPLE IRA plan—is, as its name implies, a very simple plan to establish and maintain. It also has attractive employee contribution limits as compared to a regular traditional or Roth IRA ($12,000 vs. $5,500 in 2014). Under Internal Revenue Code ("Code") §408(p), employers with 100 or fewer employees who received at least $5,000 in compensation from the employer in the prior year may establish a SIMPLE IRA plan. The employer may not maintain any other retirement plan while maintaining a SIMPLE IRA plan. The employer can choose to cover all employees or only employees who received at least $5,000 in compensation during any two prior years and are reasonably expected to receive at least $5,000 during the current year. Employees may contribute up to $12,000 in 2014 (plus a $2,500 catch-up contribution for individuals age 50 or older). Employers must either match employee contributions 100 percent up to 3 percent of compensation or make a nonelective contribution of 2 percent of each eligible employee's compensation. All contributions must be fully vested. Each year, employees must receive notice of their rights under the plan, an election form, and a summary description. There is no annual reporting required (such as Form 5500), beyond reporting participation and contributions on an employee's W-2. The IRS provides model forms for establishment of a SIMPLE IRA plan, including a model notice to eligible employees and a model salary reduction agreement (*see* Forms 5304-SIMPLE and 5305-SIMPLE). Many financial institutions offering SIMPLE IRA plans use the IRS forms (although they could instead provide their own plan document). SIMPLE IRA plans generally are subject to Title I of the Employee Retirement Income Security Act ("ERISA"), but have more limited fiduciary obligations than a 401(k) plan for example.

## Need for Improvement

While the SIMPLE IRA and many other plan options offer a relatively simple solution to plan sponsorship, none of the existing plan options work well 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. Many small employers may like to offer employees the option to contribute to a 401(k) or similar plan, but cannot meet the non-discrimination tests and do not have the capacity to make the required employer contributions associated with the safe harbor 401(k) plan or a SIMPLE plan. For employers whose workforce places less value on compensation paid as retirement benefits, the required employer contributions discourage the adoption of SIMPLE plans.

## Proposal

We propose a very modest change to current law that would build on the existing framework for SIMPLE plans.[1] In its simplest form, the new plan would work the same as the SIMPLE IRA, except that employer contributions would not be required and the employee deferral limit would be set lower than that for SIMPLE IRAs ($12,000 for 2014), but higher than the regular IRA contribution limit ($5,500 for 2014). To implement this change, Congress could amend Code §408(p) (Simple Retirement Accounts) to add an option with no employer contribution required and lower deferral limits. The IRS would revise certain existing guidance on SIMPLE IRAs (Notice 98-4) to reflect the new option, make any necessary conforming changes to IRS regulations, and revise their model forms to reflect the new option.

The Simpler plan should be an attractive, low-cost option for employers currently reluctant to offer a plan. Because the Simpler plan would be available only to small employers (100 or fewer employees)—the group least likely to currently offer plans—we believe the new option would not detract from the successful 401(k) system. Indeed, as these employers grow and become accustomed to the basic responsibilities of sponsoring a plan, they may be more inclined to step up to offering a 401(k) plan with its higher contribution limits and additional flexibility.

# EXPAND COVERAGE: EXPAND USAGE OF MULTIPLE EMPLOYER PLANS

## Current Law

Most retirement plans subject to ERISA and the Code are "single employer plans" and are maintained by a single employer for its employees (and other employees of companies within the same "controlled group"). ERISA also allows multiple employers to sponsor a plan, as a sponsor of plan may include "…any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity."

The Department of Labor (DOL) has issued guidance analyzing when an entity may establish a single ERISA plan that covers multiple employers. Most of the guidance addresses associations, but some addresses other types of organizations (*e.g.*, financial institutions, franchises, employee leasing and professional service organizations). This guidance generally provides that for a single ERISA plan to exist, the employers that participate in the plan must be tied together by a common economic interest or organizational relationship unrelated to the provision of benefits.

[1] The new plan could be structured as either a SIMPLE IRA or a SIMPLE 401(k) plan, but we focus here on SIMPLE IRAs because very few employers that offer SIMPLE plans elect to use the SIMPLE 401(k) format. The draft language includes an amendment to Code section 401(k)(11) to allow for a Simpler plan under the SIMPLE 401(k) format.

To the extent there is no such relationship each participating employer is treated as establishing and maintaining a separate employee benefit plan for its own employees.

In contrast to DOL guidance requiring a common interest or relationship between the participating employers, the Code provides special tax-qualification rules that accommodate plans sponsored by two or more employers that are not in the same controlled group or otherwise related. Under these rules, employers participating in the multiple employer plan are treated as one employer for certain purposes (*e.g.*, minimum participation testing; vesting) and as separate employers for certain other purposes (*e.g.*, nondiscrimination and minimum coverage testing; deduction rules). Current law provides that a violation of the Code's tax-qualification requirements by one participating employer in a multiple employer plan could result in the disqualification of the entire plan for all participating employers. For example, if one participating employer in a multiple employer plan fails to satisfy the top-heavy rules then the multiple employer plan may be disqualified for all of the employers in the plan.

## Need for Improvement

Rulings[2] that preclude small employers from banding together to participate in a single retirement plan maintained by a single service provider impact the ability of small employers to gain the same efficiencies that larger employers enjoy. These efficiencies come in the form of reduced compliance and administrative burdens (*e.g.*, a single Form 5500, a single vendor relationship to manage). However, DOL guidance has essentially foreclosed the operation of retirement plans covering groups of unrelated employers under ERISA. In addition, employers are discouraged from joining a multiple employer plan by the Code provision that violations of qualification requirements by one participating employer disqualifies the entire plan.

Allowing small employers to participate in a single, multiple-employer ERISA plan (often referred to as a "MEP")—regardless of the employer's industry or any other preexisting relationship with other participating employers or the plan sponsor—will reduce administrative and compliance costs and burdens, and ultimately improve the availability of retirement plans to employees of small employers.

Studies have found that concern about administrative costs and burdens are a significant reason that more small businesses do not offer retirement plans. Small employers maintaining their own plan are required to prepare their own plan documents, summary plan descriptions and other participant disclosures, file individual Form 5500s, obtain a separate financial audit, and establish a single trust. Because of the fixed administrative costs of sponsoring a plan, small plans may not qualify for lower cost investment options or lower recordkeeping fees. Allowing multiple, unrelated small employers to participate in a single plan with reduced compliance and administrative burdens and centralized administration will reduce plan costs and help them obtain pricing similar to larger plans.

In addition to administrative and compliance burden, smaller employers may be challenged by the fiduciary responsibility and liability of selecting and monitoring service providers and plan

[2] *See* DOL Advisory Opinions 2012-03A and 2012-04A.

investment options. By providing a level of liability relief for investment options offered under the plan, small employers would be encouraged to participate in a multiple employer plan, while at the same time ensuring that plan participants are protected.

## Proposal

The proposal would amend the definition of "employee pension benefit plan" in ERISA to provide that a qualified multiple small employer plan ("QMSEP") will not fail to be treated as a single, ERISA-covered pension plan solely because contributing employers (meeting the definition of a "small employer") to the plan do not share a common economic relationship unrelated to the provision of benefits.

The QMSEP would be a multiple employer plan as described in the Code and Treasury regulations thereunder that is an individual account plan. The QMSEP would only be available to small employers. The term small employer would be defined as meaning any employer with no more than 100 employees who received $5,000 or more of compensation from the employer for the preceding year. If a participating employer fails to be an eligible employer for a subsequent year after participating in the plan for one or more years (including as a result of any acquisition, disposition or similar transaction), it would continue to be treated as an eligible employer for the five years following the last year the employer was an eligible employer.

Key legal protections for plan participants would be as follows –

- Employers would transfer fiduciary responsibility for selecting and monitoring plan investment options to the sponsor of the QMSEP, who would be the "named fiduciary."

- Participating employers in the QMSEP would retain fiduciary responsibility for the selection and monitoring of the QMSEP "named fiduciary." The named fiduciary would be permitted to delegate investment responsibility only to investment managers (who are by definition well-regulated professionals) as already permitted under ERISA. If the named fiduciary delegates its investment authority to an investment manager, the named fiduciary would remain liable for the prudent selection and monitoring of the investment manager. Importantly, as noted above, participating employers would be relieved of the liability of selecting and monitoring the particular investment options – an important incentive to join a QMSEP and offer a retirement plan to employees.

- The named fiduciary would be required to acknowledge in writing that he is a fiduciary to the QMSEP that is subject to all the requirements of ERISA. The named fiduciary, or its designee, would also be required fulfill the role of the QMSEP's "administrator," which means he ultimately would be responsible for all ERISA statutory disclosure responsibilities. The named fiduciary could delegate recordkeeping and other administrative functions to another entity.

- The named fiduciary would be required to register with the DOL and demonstrate to the DOL that it meets requirements related to fiduciary ability, capacity to account for the interests of a large number of individuals, fitness to handle funds, and rules of fiduciary

conduct. These requirements would be similar to those that apply to non-bank trustees of individual retirement accounts.

- The DOL would have authority to conduct audits of the QMSEP's named fiduciary to ensure that he is meeting its legal requirements. The named fiduciary would also be required to disclose to participating employers any pending or past (within the 24-month period preceding the named fiduciary's appointment) investigation or enforcement action by the DOL, Internal Revenue Service, or Securities and Exchange Commission concerning his conduct as a fiduciary or party in interest with respect to any plan, or any pending claims or final judicial adjudication or settlement with third parties for any violation of ERISA.

- All QMSEP assets would be required to be held in trust by a bank or trust company supervised by a State or Federal agency.

- The QMSEP would be prohibited from subjecting participating employers to unreasonable restrictions or fees, or any penalties, that restrict participating employers' ability to cease participation in, or transfer assets from, the plan. This requirement would not prohibit an investment fund from imposing fees or charges normally assessed to any shareholder or investor in the normal course of business, such as redemption fees.

- The QMSEP would include in its Form 5500 the name and identifying information of each participating employer. The DOL would be directed to provide regulatory guidance on how the SPD, Form 5500 and pension benefit statement requirements would apply in the case of a QMSEP.

In addition, the Treasury Department would be directed to prescribe final regulations under which a QMSEP may be treated as satisfying the tax Code qualification requirements despite the violation of those requirements with respect to one or more participating employers. The regulations could require that the portion of the plan attributable to the participating employers violating the qualification requirements be spun off into separate plans maintained by those employers.

*Different variations of this proposal appear in the Retirement Security Act of 2014 (S. 1970 Collins, R-ME, and Nelson, D-FL), the Universal Secure and Adaptable (USA) Retirement Funds Act of 2014 (S. 1979, Harkin, D-IA, and Brown, D-OH), the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT), and the Small Business Add Value for Employees Act of 2011 (H.R. 1534, Kind, D-WI).*

# INCREASE PARTICIPATION AND SAVINGS RATES: MODIFY EXISTING AUTOMATIC ENROLLMENT SAFE HARBOR AND OFFER ADDITIONAL AUTOMATIC ENROLLMENT SAFE HARBOR

## Current Law

To encourage use of automatic enrollment, the Code includes a safe harbor that eliminates the need for a 401(k) plan to run complicated non-discrimination tests. The Pension Protection Act of 2006 created a new nondiscrimination safe harbor, known as a qualified automatic contribution arrangement (or QACA). A plan that adopts a QACA is deemed to have satisfied top-heavy requirements and the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) nondiscrimination tests. The Code provides that to qualify as a QACA, employees must automatically be enrolled at an elective contribution equal to a "qualified percentage," defined to be met if the percentage is applied uniformly and is at least 3% for the first plan year beginning when the automatic contribution arrangement is established; at least 4% the subsequent year; at least 5% the year after that; and at least 6% for any subsequent year. While these percentages are minimums, the Code provides that a percentage exceeding 10% will not qualify as a QACA. The plan also must make a matching contribution to all non-highly compensated employees equal to 100% of elective contributions up to 1% of compensation, plus 50% of elective contributions between 1% and 6% of compensation. Alternatively, the plan can make a nonelective contribution equal to 3% of compensation. The matching contribution may be applied to both elective deferrals and employee contributions.

## Need for Improvement

For plan sponsors that rely on the QACA safe harbor, the 10% ceiling is a barrier to escalating automatic contributions to levels that in some cases may be more appropriate for ensuring retirement adequacy. (In fact, even plan sponsors that do not rely on the QACA safe harbor often perceive the rule's 10% as a ceiling.) Accordingly, there is broad agreement across the retirement plan community for removing the 10% cap on automatic escalation deferral rates for plan participants.

In addition, while the QACA safe harbor has been applauded for encouraging the use of automatic enrollment, many plan sponsors believe that the default contribution levels are too low and that higher contribution levels are necessary to ensure a secure retirement for plan participants.

## Proposal

Amend the safe harbor provisions in Code section 401(k)(13)(C)(iii) to remove the phrase "does not exceed 10 percent" and clarify that the qualified percentages are not maximums. As under current law, a participant would always be able to stop the escalation of his or her contribution

rate at any time, select another percentage, or opt out of the plan. A plan sponsor could also set a maximum (but no lower than 6 percent).

Create a new automatic enrollment safe harbor—which would give employers another option alongside the QACA safe harbor—under which the default contribution would be would be at least 6% in the first year, at least 8% in the second year, and at least 10% in all subsequent years. There would be a 10% cap on the default level of contributions in the first year but no cap would apply thereafter. The employer would be required to make matching contributions equal to 50% of participant's contribution up to 2% of compensation and 30% percent of elective contributions exceeding 2% of compensation, up to a total of 10% of compensation. This arrangement "stretches" the current matching contribution to encourage participants to contribute at least 10% of pay. Like the QACA safe harbor, matching contributions could be applied to both elective deferrals and employee contributions. Nonelective contributions would not be allowed in this safe harbor. A tax credit also might be included to encourage small employers to adopt the new automatic enrollment safe harbor. Another incentive to adopt the new safe harbor could be the option to apply a three-year cliff vesting period to employer matching contributions. The current QACA safe harbor would not be affected.

*This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA), and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). A slightly modified version of the second proposal appears in the Retirement Security Act of 2014 (S. 1970 Collins, R-ME, and Nelson, D-FL).*

## INCREASE PARTICIPATION AND SAVINGS RATES: INDEX IRA CATCH-UP LIMITS

### Current Law

Tax law imposes contribution limits on all tax-advantaged retirement savings vehicles. In almost all cases, to ensure workers' ability to save for their future is not eroded by increases in the cost of living, contribution limits are automatically increased periodically to reflect inflation. Because many workers tend to enter and leave the workforce to raise children and because workers tend to have more income available to save for retirement later in their career, Congress in 2001 created "catch up" contributions for all of the important retirement savings vehicles. The catch-up contribution limit for 401(k), 403(b) and 457(b) plans are all inflation indexed. But the catch-up contribution limit for individual retirement accounts—which was last adjusted to $1,000 per year in 2006—is not.

### Need for Improvement

Since their creation in 1974, IRAs have played a vital role in building retirement security for workers without access to a retirement plan at work, for small business owners, and for non-working spouses. The general contribution limit for IRAs is indexed so that its value is not

eroded over time. The catch-up contribution limit for IRAs should also be indexed for inflation for the same reason, which simply brings it in line with catch-up contribution limits for those who save at work.

### Proposal

Amend Code section 219(b)(5)(B) to provide that, in the case of any taxable year beginning after enactment, the $1,000 catch-up contribution amount will be adjusted for inflation from the year of enactment in the same manner as adjustments under IRC § 415(d). Although cost-of-living adjustments relating to retirement savings contributions typically are adjusted by multiples of $500, because of the small amount involved in this case, smaller increments could be used (such as $200). For example, any increase that is not a multiple of $200 will be rounded down to the next lower multiple of $200.

## HELP PARTICIPANTS MAKE INFORMED DECISIONS: MODERNIZE E-DELIVERY DISCLOSURE RULES

### Current Law

The IRS and the Department of Labor have no less than four separate regulatory standards that govern the circumstances under which an employee can be given a plan-related document electronically, and the four are not consistent with each other:[3]

- Treasury Regulations permit electronic delivery of notices and disclosures if a participant has the "effective ability to access" electronic media.
- Any disclosures required under ERISA can be made electronically (a) to a participant who has effective access to the document electronically at work and use of electronic information systems is an integral part of the participant's duties or (b) to a participant or beneficiary who offers affirmative consent.
- For pension benefit statements, a DOL Field Assistance Bulletin (FAB) allows the "post and push" method, whereby plan sponsors can use a continuous access secure website for the posting of benefit statements, provided that individuals are notified how to access the website and that they can opt out and receive free paper disclosures instead.
- Participant fee disclosures can be made electronically if the participant voluntarily provides an email address, but the fact that the employer assigns the employee an email address is not sufficient.

[3] Treas. Reg. § 1.401(a)-21; DOL Reg. § 2510.104b-1; DOL Field Assistance Bulletin 2006-03; DOL Technical Release 2011-03R.

## Need for Improvement

Allowing plans to make e-delivery the default method for communicating with participants (but allowing participants to opt for paper) will enhance the effectiveness of ERISA communications, maintain security of information, and produce cost savings for the economy and plans that decide to opt for e-delivery. Notably, the President has recognized this; the new *my*RA program promises: "Enrollment and participation in the program will be primarily electronic and individuals will be encouraged to receive program-related payments electronically."

## Proposal

Under the proposal, any document that is required by ERISA or the Code to be furnished to a participant, beneficiary or other individual (a "recipient") may be furnished electronically under a number of alternative methods:

- By direct delivery of the document to the recipient's email address.
- By posting on a continuously available website, if the recipient is notified that the document is available.
- Any other electronic means reasonably calculated to ensure actual receipt.

The proposal includes robust safeguards for participants who prefer to receive documents in paper form. Recipients must be informed of the right to request delivery of paper format, and a recipient who requests delivery of a paper document would be entitled to receive it. Any electronically furnished document must be presented in a manner that is consistent with the style, format, and content requirements applicable to the particular document taking into account the electronic form of the document, and the system must incorporate measures reasonably designed to protect personal information.

*This proposal is a modified version of a provision in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). A similar proposal for modernizing the rules for electronic disclosure appeared in an earlier version of the Retirement Plan Simplification and Enhancement Act (H.R. 4050, 112th Cong., Neal, D-MA).*

# HELP PARTICIPANTS MAKE INFORMED DECISIONS: CONSOLIDATE NOTICES

## Current Law

Over the years, the number of notices that must be provided to participants and beneficiaries has exploded. When ERISA was enacted in 1974, Congress intended that one document—the summary plan description—would be the notice that informed participants of their rights and obligations. Since then, a large number of additional notices have been imposed on retirement plans under ERISA and the Code—now numbering more than 30 that apply just to retirement

plans. Many of these notices must be provided upon enrollment and annually thereafter, although the specific timing requirements vary according to applicable regulations. The additional notices include:

- *Qualified default investment alternative notice*. *(ERISA §§ 404(c)(5)(B), 514(e)(3))*: Explains how a participant's account will be invested in the absence of an investment election by the participant.
- *Participant fee and investment disclosure*. *(DOL Reg. § 2550.404a-5)*: Provides participants in participant-directed individual account plans with key information about their plan and the investments available under the plan.
- *Safe harbor notice*. *(Code § 401(k)(12)(D))*: Informs participants that the employer will satisfy the Code's nondiscrimination requirements by making matching or nonelective contributions to the plan and explains participants' rights and obligations under the arrangement.
- *Autoenrollment safe harbor notice*. *(Code § 401(k)(13)(E))*: Informs participants in plans using the qualified automatic contribution arrangement safe harbor to satisfy nondiscrimination rules about their rights and obligations under the arrangement, including the default investment.
- *Permissive withdrawal notice*. *(Code § 414(w)(4))*: Informs participants in automatic enrollment plans that allow permissible withdrawals about their rights and obligations under the arrangement, including the right to stop automatic contributions and withdraw them within 90 days.

These notices, taken together, form a second "mini summary plan description" that explains key plan features that a participant might want to know to make the initial decision to enroll, including what happens if the participant takes no action. In practice, these notices may be provided as separate notices in the enrollment packet that employees receive on their first day of work.

## Need for Improvement

In implementing these rules, the Departments of Labor and the Treasury have explicitly or implicitly discouraged combining these notices, even though together the notices provide interrelated information about a 401(k) plan's features. This discourages an integrated communication approach, complicates plan administration, and inundates participants with notices. Particularly with technical materials, more is often less, and the proliferation of notices, sent at different times, may serve to confuse many participants and cause many notices to be overlooked. In addition, the annual notice is in some cases unnecessarily tied to the plan year.

## Proposal

A single notice (which could be referred to as the "Quick Start" notice) could combine the information currently in the following 11 notices:

1. Qualified default investment alternative notice (*ERISA § 404(c)(5)(B) and DOL Reg. § 2550.404c-5(d)*)

2. Notice of availability of cash or deferred election (*Treas. Reg. § 1.401(k)-1(e)(2)*)
3. Participant fee and investment disclosure (*DOL Reg. § 2550.404a-5*)
4. Safe harbor notice (*Code § 401(k)(12)(D) and Treas. Reg. § 1.401(k)-3(d)*)
5. ERISA automatic contribution arrangement notice (*ERISA § 512(d)(3)*)
6. Eligible automatic contribution arrangement notice (*Code § 414(w)(4) and Treas. Reg. § 1.414(w)-1(b)(3)*)
7. Qualified automatic contribution arrangement notice (*Code § 401(k)(13)(E) and Treas. Reg. § 1.401(k)-3(k)(4)*)
8. Automatic enrollment under eligible combined defined benefit and defined contribution notice (*Code § 414(x)(5)(B)*)
9. ERISA notice regarding availability of investment advice (*ERISA § 408(g)(6) and DOL Reg. § 2550.408g-1(b)(7)*)
10. Code notice regarding availability of investment advice (*Code § 4975(f)(8)(F)*)[4]
11. Proposed regulations regarding target date funds (*75 Fed. Reg. 73987 (Nov. 30, 2010)*)

Plans could decide which of the aforementioned notice requirements to satisfy through the combined Quick Start notice. In addition, a number of notices have become redundant or irrelevant. The following notices would be eliminated:

- *Summary annual report* (*ERISA § 104(b)(3)*). This notice summarizes the annual report (Form 5500) filed by the plan with the Department of Labor, Internal Revenue Service, and Pension Benefit Guaranty Corporation. For example, it reports total assets, expenses, and income of the plan, and information on how to obtain the full annual report. The summary annual report is much less useful than the pension benefit statement provided to participants, which has specific information on the participant's account or benefits. In addition, the "Quick Start" will alert participants that they can request a copy of the annual report.
- *Deferred vested pension statement* (*Code § 6057(e)*). This section requires plan administrators to provide participants who have separated from service with a statement of deferred vested benefits. In practice, this is now duplicated by the pension benefit statement requirement under ERISA section 105.
- *Pension benefit report* (*ERISA § 209*). This section requires a plan administrator to furnish a report to employees sufficient to determine their benefits. This notice is redundant because of the pension benefit statement requirement under ERISA section 105, which requires benefit statements either on a periodic basis or upon request.

*This proposal is a modified version of provisions in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT) and the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA).*

[4] The notice would continue to apply in the case of individual retirement plans and similar arrangements.

# HELP PARTICIPANTS MAKE INFORMED DECISIONS: MAKE PERFORMANCE DISCLOSURE FOR TARGET DATE FUNDS MORE EFFECTIVE

## Current Law

In 2010, the Department of Labor finalized a regulation under ERISA section 404(a) requiring participants in participant-directed individual account plans to receive certain information about their plans and the investment options available under the plans. The rule is intended to ensure that all participants in such plans have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings. The regulation includes a requirement that the historical performance (1-, 5-, and 10-year returns) for each designated investment alternative for which the return is not fixed, be compared to an appropriate broad-based securities market index.[5] For example, for an equity fund, a plan would provide participants the 1-, 5-, and 10-year returns of the equity fund, alongside returns of an appropriate broad-based index (like the S&P 500, which represents the same asset class). This rule does not specifically address investments like target date funds that include a mix of asset classes. In the preamble to the final regulation and subsequent interpretive guidance,[6] DOL indicated that a plan could provide the required benchmark and *additional* benchmarks, so long as the additional benchmarks are not inaccurate or misleading. For example, for an investment option that has a mix of asset classes, an additional benchmark could be created by blending the returns of more than one appropriate broad-based securities market index. (The blended benchmark must proportionally reflect the actual holdings of the investment option.) The DOL benchmarking rule is based on a similar requirement under the securities laws for mutual fund prospectuses,[7] which requires a fund (in its prospectus) to compare its performance to an appropriate broad-based securities market index and allows comparison to another broad-based index, so long as the comparison is not misleading. In order to provide a blended benchmark index for a given investment option, if there is no appropriate broad-based index that reflects a mix of asset classes, the disclosure materials may need to include at least two different benchmarks for the option, which could confuse participants and unnecessarily lengthen the disclosure.

## Need for Improvement

In the context of DOL's participant disclosure rule (in which key information, such as performance and fees, about each designated investment option under a plan must be provided in a comparative format so that participants can directly compare the options and allocate their investments among them), providing two different benchmarks for a target date fund, for example—one that tracks the fund's allocation and one that does not—detracts from the usefulness of the comparative chart. For purposes of the comparative chart, plans should have the option to provide a single benchmark that tracks the asset allocation of the particular fund, so

[5] DOL Reg. § 2550.404a-5(d)(1)(iii).
[6] *See* 75 Fed. Reg. at 64916-17; Field Assistance Bulletin 2012-02R, Q&A-16.
[7] *See* Form N-1A, Item 27(b)(7).

that participants can make more focused comparisons of the different investment alternatives available to them.

### Proposal

DOL would be directed to modify its participant disclosure regulation so that an investment that uses a mix of asset classes can be benchmarked against a blend of broad-based securities market indices, provided (a) the index blend reasonably matches the fund's asset allocation over time, (b) the index blend is reset at least once a year, and (c) the underlying indices are appropriate for the investment's component asset classes and otherwise meet the rule's conditions for index benchmarks. (These conditions are important to prevent the blended benchmark from being manipulated.)

*This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA) and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).*

## PERMIT GREATER FLEXIBILITY FOR PARTICIPANTS: UPDATE REQUIRED MINIMUM DISTRIBUTION RULES

### Current Law

Workers are required to begin taking distributions from qualified retirement plans and IRAs at age 70½. These "required minimum distributions" were first added to the Code in 1962 to prevent business owners from using retirement vehicles for estate planning. Congress has since applied the RMD rule to virtually all tax-advantaged retirement accounts, but has never reexamined the required beginning age to reflect changing patterns of retirement savings or increases to life expectancy.

### Need for Improvement

Research shows that workers tend to roll their retirement savings into IRAs at retirement, where they tend to preserve them until the law *forces* a distribution.[8] According to the Social Security Administration's Period Life Expectancy Table, the life expectancy of a person aged 65 in 2013 is about five years longer for men and four and a half years longer for women than it was in 1962 (when the 70½ rule was first added).[9] In fact, with a married couple both aged 65 in 2000, there is a 72% chance that one will live to age 85 and a 45% chance that one will live to age 90.[10]

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[8] Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2013," *ICI Research Perspective* 19, no. 11 (November 2013); available at www.ici.org/pdf/per19-11.pdf.
[9] *See* 2014 OASDI Trusties Report Table V.A3. Period Life Expectancy, Social Security Administration; available at www.ssa.gov/oact/TR/2014/lr5a3.html#hist.
[10] https://personal.vanguard.com/us/insights/retirement/plan-for-a-long-retirement-tool.

### Proposal

Amend Code section 401(a)(9) to increase the required beginning age from 70½ to at least 75, and permit those receiving RMDs to stop if they have not yet reached the new required beginning age.

## PERMIT GREATER FLEXIBILITY FOR PARTICIPANTS: SIMPLIFY HARDSHIP RULES

### Current Law

While retirement assets generally should be held for use in retirement, the Code recognizes that allowing distributions for heavy financial need actually encourages savings because workers know that they can access their savings in an emergency. Current IRS regulations impose a number of unnecessary administrative burdens on hardship distributions. First, unlike other distribution events, when a participant receives a hardship distribution from elective deferrals, only the participant's contributions, and not any earnings, may be removed. Second, safe harbor employer contributions, qualified non-elective contributions, and qualified matching contributions – unlike all other employer contributions to a profit-sharing plan – may not be distributed upon hardship. Third, a hardship distribution generally may not be taken until a participant exhausts all loans available under the plan. Finally, a participant is restricted from making elective or employee contributions for six months after the hardship is received.

### Need for Improvement

Unnecessary restrictions on hardship distributions complicate plan administration. These restrictions are unnecessary to discourage hardship distributions because the Code already applies a 10% penalty for any hardship distribution before age 59½. In addition, the IRS safe harbor rule restricting the employee from making contributions for six months after a hardship distribution reduces retirement preparedness.

### Proposal

The proposal would make the following changes:

- Hardship withdrawals can be made from all employer contributions to a profit-sharing plan or stock bonus plan, including safe harbor contributions, qualified nonelective contributions (as defined in section 401(m)(4)(C)), and qualified matching contributions (as described in section 401(k)(3)(D)(ii)(I)).
- A hardship withdrawal can include earnings on contributions.

- In determining whether a hardship has occurred, the Secretary of the Treasury cannot take into account whether a participant makes elective or employee contributions for any period after the withdrawal.

*This proposal appears in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). The provision relating to contributions after a hardship withdrawal appears in the Shrinking Emergency Account Losses Act of 2013 (S. 606, Nelson, D-NE, and Enzi, R-WY) and in the discussion draft entitled "Tax Reform Act of 2014"released by Ways and Means Chairman Camp (R-MI).*

## IMPROVE PLAN ADMINISTRATION: EXPAND EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

### Current Law

Under a literal reading of applicable law, certain imperfections in a plan document or any single failure to operate a plan in accordance with the plan's written terms disqualifies the entire plan and trust, resulting in severe income tax consequences to innocent participants. The IRS' Employee Plans Compliance Resolution System (EPCRS) allows qualified plans and 403(b) plans to correct inadvertent errors in a plan document or plan administration without unnecessary tax consequences befalling innocent participants. It is widely recognized as a very successful program.

Under the program, certain errors can be self-corrected by the plan; other errors require a voluntary correction filing (called VCP) which can be expensive to prepare and which can take a long time for the IRS to process.

### Need for Improvement

Because the IRS releases updates somewhat infrequently and because of limited IRS resources, EPCRS has not kept up with the ever growing complexity of plan administration.

In particular, a common error that requires a VCP filing is the correction of a single loan error. The cost of correcting a loan error typically would be less than the cost of the VCP filing itself. Similarly, it would be helpful to permit self-correction of missed required minimum distributions within a reasonable time frame.

There currently is no correction program available for errors relating to IRAs.

### Proposal

Treasury would be directed to modify EPCRS:

- to allow for self-correction of loan errors (directing the Secretary of Labor to treat any loan self-corrected under EPCRS as also meeting the requirements of Labor's voluntary correction program);
- to allow self-correction, without an excise tax, of a required minimum distribution that is made within 180 days after the distribution was required to be made from the plan;
- to provide the same comprehensive program of correction for governmental 457(b) plans; and
- to expand EPCRS to allow custodians of IRAs to address inadvertent errors for which the individual owner was not at fault (including waiver of the excise tax for failure to make required minimum distributions; and inadvertent rollovers, such as a rollover by a nonspouse beneficiary or a rollover from a non-governmental 457 plan).

*This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA) and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).*

## IMPROVE PLAN ADMINISTRATION: SIMPLIFY 403(b) TERMINATION

### Current Law

In 2007, Treasury and IRS completed a comprehensive overhaul of the regulations governing 403(b) plans. For the first time, the regulations provided that a 403(b) plan may be terminated. But the regulations provide only limited guidance regarding the mechanics of plan termination. When a 403(b) plan is invested in annuities, the termination can occur through distribution of a fully paid annuity contract to the participants. When the 403(b) plan is invested in regulated investment companies in a custodial account (as the Code allows), the administrative process is more difficult. When a participant can be located and responds to communication from the plan, the account can be rolled over into an IRA. It is inevitable, however, that there will be participants who are either not located or unwilling to voluntarily liquidate their existing 403(b) accounts, perhaps because they prefer their current investment provider or because of sales charges. The problem of missing participants is particularly problematic in the context of 403(b) plans because these plans are often funded through a number of different vendors. Many participants will hold contracts issued by vendors that do not have a current relationship with the employers. The IRS issued a ruling in 2011 (Rev. Rul. 2011-7) that appears to require an election by the participant to distribute funds in the custodial account, which is often not possible to obtain.

### Need for Improvement

Unlike with 401(k) and other qualified plans, the Code does not provide a process for terminating 403(b) plans, which has left the IRS with little guidance. Providing an orderly

process for termination which protects participants and maintains the tax qualified nature of the account is consistent with prior Congressional efforts to harmonize the rules for 403(b) plans with qualified plans. Providing for the "in-kind" distribution of a custodial account to a participant upon plan termination, so that the account retains its 403(b) status outside of the plan, also would provide parity for 403(b) participants who invest in mutual fund custodial accounts and want to remain invested in the same vehicle after plan termination, just like 403(b) annuity contract holders who can maintain their contract after plan termination.

**Proposal**

The proposal would provide that if an employer terminates a 403(b) plan under which amounts are contributed to a custodial account, an account of a participant or beneficiary shall be considered "distributed" for plan termination purposes if the account is distributed "in-kind" to the participant or beneficiary (in which case amounts actually distributed from the account will be taxed in the year in which so distributed under Code section 72, unless rolled over to another qualified account). A custodial account would not be considered "distributed" to a participant or beneficiary if the employer has any material retained rights under the account, but the employer would not be treated as retaining material rights simply because the custodial account was originally opened under a group contract.

*This is a modified version of a proposal that appears in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).*

## STRENGTHEN SOCIAL SECURITY: PLACE SOCIAL SECURITY ON SOLID FINANCIAL FOOTING FOR THE INDEFINITE FUTURE

The foregoing proposals would go a long way toward improving the successful defined contribution plan system and better equipping American workers with the tools needed to build a secure retirement. Any assessment of the US retirement system is incomplete, however, without recognizing the significance of Social Security. Social Security provides the foundation of retirement security for almost all American workers—for the majority, it may be the largest single income source in retirement—and it replaces significant portions of income for lower-income retirees. In this respect, Social Security replaces 85 percent of average inflation-indexed annual earnings for workers in the lowest lifetime household earnings quintile; 55 percent for workers in the middle lifetime household earnings quintile; and 34 percent for workers in the highest lifetime household earnings quintile.[11] Yet the Social Security system faces a projected long-term imbalance.

[11] Figures represent the mean replacement rates for retired workers in the 1950s birth cohort, assuming the workers claim Social Security benefits at age 65. *See* Exhibit 10 in Congressional Budget Office, *CBO's 2014 Long-Term*

It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans. ICI urges Congress to strengthen Social Security and maintain its current character. We do not support proposals to transform Social Security benefits into individual private accounts.

## IMPROVE FIDUCIARY ADVICE REGULATION: MODIFY FIDUCIARY RULE TO PRESERVE ACCESS TO INFORMATION AND ADVICE

ICI urges Congress to work with the Department of Labor (DOL) to modify DOL's new regulation defining who is a fiduciary for purposes of providing investment advice under section 3(21)(A)(ii) of ERISA. Changes to the rule are necessary to ensure that it does not deprive retirement savers of access to the information, tools, and advice they need to achieve retirement security.

ICI strongly supports the principle that financial professionals should act in the best interest of their clients when offering personalized investment advice. Unfortunately, DOL chose to impose a best interest standard through a complicated, back-door regulatory regime that will impose significant new liability on those serving retirement savers. The final rule will have the effect of limiting available advice options for many savers and reducing service provider and product choices for all. As a result, implementation of the rule will make it more difficult for low- and middle-income Americans to save for retirement. Small businesses, in particular, will find it more difficult to offer their employees saving opportunities.

Our research shows that low- and moderate-income investors with modest IRA balances will lose access to the financial advice on which they rely unless substantial changes are made to the rule. Far from benefiting investors, the rule when implemented could cost investors $109 billion in lost returns and added fees over the next ten years.

Ultimately, we support a consistent best interest standard of care that applies to both retirement and non-retirement investment advice and that will ensure the continuation of affordable access to financial guidance to help individuals prepare for their retirement needs.

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*Projections for Social Security: Additional Information* (December 2014); available at www.cbo.gov/publication/49795.

**APPENDIX**

# LIFETIME INCOME DISCLOSURE ACT

## Current Law

Section 105 of ERISA requires 401(k) plans to give participants quarterly benefit statements showing the participant's total benefits accrued (current account balance), the value of each investment to which assets are allocated, and certain other enumerated information.

## Need for Improvement

Information on how an account balance might translate into a regular stream of income in retirement is useful and helps workers see if their retirement savings is on track. While the information is not currently required, some plan providers successfully include estimates of what monthly income the participant might receive from the account at retirement. Any legislation should allow current best practice to continue.

The Lifetime Income Disclosure Act has been introduced in the past five Congresses. The Institute has recommended certain changes to the bill language. Any amendment to ERISA to require plans to give participants lifetime income estimates should:

- Allow plans the option to project future contributions and investment experience of the account to give participants, especially those far from retirement, a more realistic estimate of monthly income.
- Not specify a single method but rather allow plans to express the estimate as an annuity payment, a percentage of the account balance designed to spread payments over the participant's life, a life expectancy calculation based on IRS minimum distribution rules, or other appropriate method. This recognizes, as the Departments of Treasury and Labor have stated, that there is no single way to obtain a lifetime income stream from a retirement account.
- Require certain explanations to help participants understand the information.
- Not freeze innovation and evolution of best practice disclosure. Letting this competitive market evolve will better serve the interests of plan participants – the users of this information – than codifying a single approach at this time.

## Comparison of Proposed Alternative Language and Past Bill Language

We compare ICI's proposed Alternative language to that of S. 868, as introduced in the 115th Congress.

*Both the Alternative language and S. 868 would require plans to give workers annually an estimate of the monthly income the participant might receive from the account at retirement.* Annual Social Security statements also illustrate future benefits as monthly income.

*S. 868 requires the income stream to be expressed as an annuity.* S. 868 identifies just one specific method for translating the account balance into a lifetime income stream – the annuity equivalent. Other effective methods in use today or any additional methods that may be developed in the future could not be used to satisfy the proposed disclosure. The Alternative language makes clear plans have the choice to express the estimate as an annuity payment or use existing methods that have been well-received by plans and participants. While an annuity is one way to generate a lifetime income stream, as the Departments of Treasury and Labor have acknowledged, there are also other ways. These include dividing the projected account balance by the life expectancy stated on IRS tables at a certain age, such as age 65, or to start with a percentage (such as 3 or 4 percent) of the projected final account balance at retirement – the approach some financial planners use. The law should not lock in one specific method for calculating the estimated income stream.

*S. 868 uses the current account balance in estimating the future income stream.* S. 868 restricts the disclosure to a snapshot of the participant's current account balance (including future earnings only if permitted by DOL), which would not reflect the impact of future contributions to the participant's account – thus providing only a limited view of the potential income stream. The Alternative language allows plans the option either to use only the current account balance or to include projections of contributions and investment experience. The latter approach follows the lead of Social Security, which calculates estimated benefits based on the assumption that an individual will continue to work and earn the same salary until certain specified retirement ages. Because the accounts of new workers who just began making contributions (even those contributing the maximum) will be small and generate very small annuity equivalents, using only the current account balance to estimate retirement income may provide an incomplete picture and discourage plan participants (or encourage workers changing jobs to cash out their accounts). Plans should be able to satisfy the income stream disclosure requirement by including useful projections of future contributions and investment experience.

*S. 868 would direct the Department of Labor to develop the specific assumptions used in calculating the annuity equivalent and a model disclosure form.* Instead of requiring detailed DOL rulemaking to implement the new disclosure requirement, the Alternative language requires plans to explain that the lifetime income stream equivalent is an illustration and an estimate, explain how the amount was calculated, and disclose any applicable assumptions. Section 105 of ERISA already requires benefit statements to be written in a manner calculated to be understood by the average plan participant. Our approach avoids delay in implementing the disclosure requirement by not specifically requiring rulemaking. DOL has broad authority under ERISA section 505 to promulgate interpretive rules, which would allow it to provide guidance or step in if it perceives any problems. By not mandating up front that the DOL create a model form and determine applicable assumptions, the Alternative language allows disclosure best practices to continue to evolve and develop.

# LIFETIME PAYMENT ACCOUNTS

## Proposed Tax Exclusion for Annuity Payments

Bills have been introduced in past Congresses that would provide an exclusion from gross income for a specified portion lifetime annuity payments received from a qualified retirement plan (and in some bills, from a taxable account), for a specified number of years. The annual exclusion typically is capped at a specified amount and may be phased out at certain income levels.

The insurance products covered by these bills go beyond immediate annuities and would also include variable annuities, including guaranteed minimum benefit products. More specifically, under the bills, "the amount of the periodic payments [covered by the bill] may vary in accordance with investment experience, reallocations among investment options, actuarial gains or losses, . . . or similar fluctuating criteria." Furthermore, "[t]he availability of a commutation benefit or other feature permitting acceleration of annuity payments (or a modification of the period during which such a benefit is available), a minimum period of payments certain, or a minimum amount to be paid in any event shall not affect the treatment of a distribution as a lifetime annuity payment."

Thus, among other things, the bills would cover contracts that go beyond pure annuities, permitting the holder to receive payments that vary based on the performance of underlying investments and allowing the holder to reallocate account balances among those underlying investments. In this respect, the bills would cover products that are similar to the managed withdrawal accounts, or Lifetime Payment Accounts (withdrawals based on remaining life expectancy) described below. It has always been our position that similar products should receive similar tax treatment. We have difficulty understanding why the special tax benefits provided by the bills to insurance company sponsored products should not be extended to managed withdrawal accounts under the circumstances here.

In pursuing the laudable policy goal of making retirement savings last a lifetime, Congress should recognize and include the varied alternatives of financial services and products that fulfill this purpose, including Lifetime Payment Accounts.

## Need for Product Neutrality and Preservation of Consumer Choice

Policymakers are concerned both with helping individuals build up retirement savings and encouraging their careful distribution so that savings last throughout the retirement years. For some people entering retirement, insurance products may offer all or part of that distribution help. However, no one financial product is best suited to address all of the risks that individuals can potentially face in retirement, and more than one financial product enables individuals to secure a lifetime stream of payments.

For example, Lifetime Payment Accounts ("LPAs") are systematic withdrawal programs that provide periodic distributions from mutual fund accounts over the investor's life. For many people entering retirement, this will be the simple, flexible and affordable path that is best suited to their needs and their families' needs. Any distribution assistance should recognize and encourage this option, too – otherwise, many of the retirement savers in need of this help may find themselves left out.

**Mutual Funds Can Provide a Lifetime of Security**

LPA distributions are determined based upon long-established IRS methodology. This methodology requires only two pieces of data, both of which would be known to the mutual fund; these data elements are the investor's age on December 31 of that year and the account's beginning-year balance. From this data, the mutual fund will calculate the calendar-year LPA distribution. The size of the LPA would vary over time, with diversification protecting the downside and continued investment providing the growth needed to address inflation. The LPA will never be fully depleted. Upon the investor's death, the LPA's remaining balance would go to the investor's designated heirs.

**Mutual Fund LPAs Provide a Needed Complement to other Lifetime Distributions**

***Competition*** – Competition among financial services and products is good for American consumers. Tax incentives for promoting lifetime distributions should be afforded to the range of financial services and products that meet the policy goals of lifetime security and the broad range of retirement savers who need and value those varied options.

***Lower Income Households*** – Many low-income households have limited amounts of assets to annuitize beyond Social Security, and their purchasing an annuity typically produces only a modest annuity payment. The monthly payment provided by additional insurance, while helpful, may not provide the needed or desired level of income replacement and may deprive them of flexibility they need to access resources in case of health care needs or other emergencies. These households may be better served by tax incentives to encourage LPAs so that they are helped to withdraw carefully but without losing the affordable flexibility they need.

***Costs*** – Insurers must impose a risk charge associated with the company's obligation to continue payments if an annuitant lives beyond life expectancy. In addition, there may be other costs associated with an insurance company's distribution system. Consequently, LPAs will generally be subject to lower and simpler costs and provide an alternative means of balancing safety and investment that many retirees will need.

***Early Death*** – While annuities protect retirees who live longer than expected, they also penalize retirees who may die before reaching their projected life expectancy. Upon death, annuity payments cease, and there often is no residual value. LPAs, on the other hand, allow individuals who die to pass the remaining LPA assets on to their heirs.

***Inflation Risk*** – Annuities can be subject to significant inflation risks because the payments tend to be fixed at the time of the annuity's purchase. Some annuities are inflation adjusted and can

increase over time, but their initial payout is reduced relative to a fixed annuity to pay for this "inflation risk" feature. LPA savers in mutual funds are generally protected against inflation risk because market returns will typically adjust when expectations of inflation increase. With the average life expectancy of 65-year-old individuals extending into their 80s, a reasonable amount of market risk – as part of a diversified investment portfolio with the potential for greater returns – is appropriate for most individuals to address inflation risk and the resulting decline in purchasing power.