ICI VIEWPOINTS

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Tax Reforms Should Not Favor DB Plans over DC Plans

By Peter Brady

Fourth in a series of posts about retirement plans and the policy proposals surrounding them.

In *The Tax Benefits and Revenue Costs of Tax Deferral* and in two previous *Viewpoints* posts (post one and post two), I explained the benefits that workers get from deferring tax on compensation set aside for retirement.

Some policy discussions surrounding the tax treatment of retirement plans seem to miss the point that *all* forms of qualified deferred compensation provide the same tax benefit: the benefit of deferring tax on compensation until distributions are taken in retirement. Workers get this benefit from both defined contribution (DC) plans and from defined benefit (DB) plans, from both employee contributions and employer contributions.

Yet the two most prominent tax proposals for retirement plans affect only DC plans, with one focusing solely on tax-deferred employee contributions. These proposals would arbitrarily punish workers based on how their employer structures their deferred compensation. In particular, the proposals would hit workers in the private sector (where DB plans are increasingly rare) harder than government workers (where DB plans still are the norm).

A Brief History of Tax Deferral

Tax deferral is not new. For most of its 100-year history, the federal income tax has allowed workers to defer taxes on compensation set aside for retirement. Tax deferral means that employees pay no tax on compensation contributed to a qualified retirement plan in the year of the contribution, and no tax on investment returns when they are earned by the plan. Rather, taxes become due when employees take distributions from the plan.

Employer contributions to retirement plans—both DB and DC—have always been tax-deferred. Employee contributions initially received a more limited tax benefit: contributions by employees to either DB plans or DC plans were included in their taxable compensation, but taxes on investment returns were deferred until distributions were taken.

As explained in "401(k) Plans: A 25-Year Retrospective," Internal Revenue Service (IRS) rulings in the 1950s extended full tax deferral to employee contributions made through cash or deferred arrangements (CODAs). These CODAs were the precursor of the modern 401(k) plan. By allowing employees to make voluntary contributions, these plans gave workers the choice to defer a portion of their compensation rather than have it paid to them immediately in cash. In 1978, Congress added subsection (k) to Section 401 of the Internal Revenue Code, effectively codifying the earlier IRS rulings. When the IRS proposed regulations for the new code section in November 1981, the modern 401(k) plan was born and began its rapid growth.

Deferral was extended outside of employer-sponsored plans when Congress created the individual retirement account (IRA) in 1974. In addition to allowing the rollover and continuing tax deferral of accrued pension benefits, IRAs gave workers without access to an employer-sponsored retirement plan the opportunity to make tax-deferred contributions to their own account.

The 28 Percent Cap Proposal Targets Individual Contributions

The Obama Administration has proposed capping, at 28 percent, the up-front tax benefit of employee contributions to 401(k) plans and IRAs. The tax treatment of other forms of qualified deferred compensation would not be affected; employer contributions to both DB plans and DC plans would continue to be tax-deferred. In addition, there would be no change to the tax treatment of Roth

contributions—which, as explained in a previous *Viewpoints* post, can provide workers with the same benefits as tax-deferred contributions.

Capping the up-front tax benefit of qualified deferred compensation would be bad tax policy. I've noted before that a deferral of tax is neither a deduction nor an exclusion. And, as I've explained in a previous *Viewpoints* post, although the 28 percent cap could be interpreted as modest change to the taxation of deductions and exclusions, it actually would represent a fundamental change to the taxation of deferred compensation, such as retirement plan contributions.

Restricting the change in tax treatment to retirement contributions made by workers would make a bad tax policy even worse by arbitrarily penalizing only one form of deferred compensation. Workers would be penalized for making tax-deferred employee contributions, but could avoid the penalty if their employers restructured compensation, either by reducing salary and increasing employer contributions, or by allowing employees to make Roth contributions. The only workers who would pay the penalty would be those workers whose employers, for whatever reason, were unable to restructure their compensation. In addition, there would be no cap on the up-front tax benefit of annual pension accruals for high-wage workers with DB plans.

20/20 Proposal Targets DC Plans

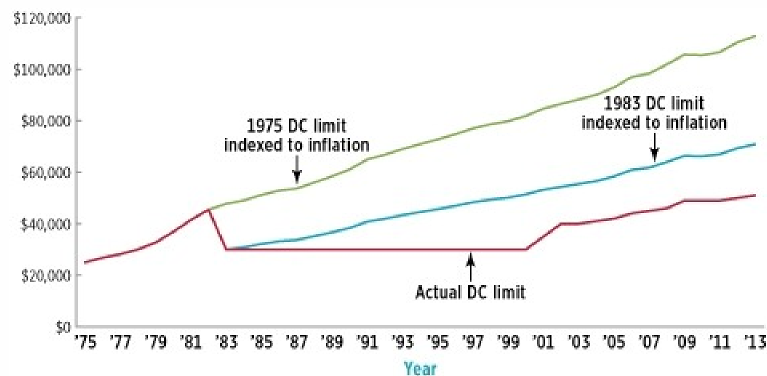
The so-called 20/20 proposal from the National Commission on Fiscal Responsibility and Reform would limit total (employer plus employee) annual contributions to DC plans to $20,000 or 20 percent of compensation, whichever is less. If implemented, this proposal would represent an unprecedented restriction on the ability of working individuals to defer compensation until retirement.

Under current law, DC plan limits are already low by historical standards. Limits on employer plan contributions and benefits were created by the Employee Retirement Income Security Act of 1974 (ERISA). As shown in the figure below, if indexed for inflation, the original contribution limit of $25,000 in 1975 would be equivalent to more than $112,000 today. Between 1975 and 1982, the limit was indeed indexed for inflation, but then Congress enacted legislation that cut the contribution limit to $30,000 in 1983 and then effectively kept it frozen until 1999. If the 1983 limit had been indexed to inflation, it would have been more than $70,000 in 2013.

The 20/20 proposal would cut the current limit of $51,000 to $20,000, which would be below the original 1975 limit *in nominal dollars*.

DC Plan Contribution Limit Is Low Relative to Historical Standards

Actual versus alternatives, DC plan annual contribution limit, nominal dollars, 1975 to 2013



Sources: Internal Revenue Service, U.S. Department of Labor, and Investment Company Institute

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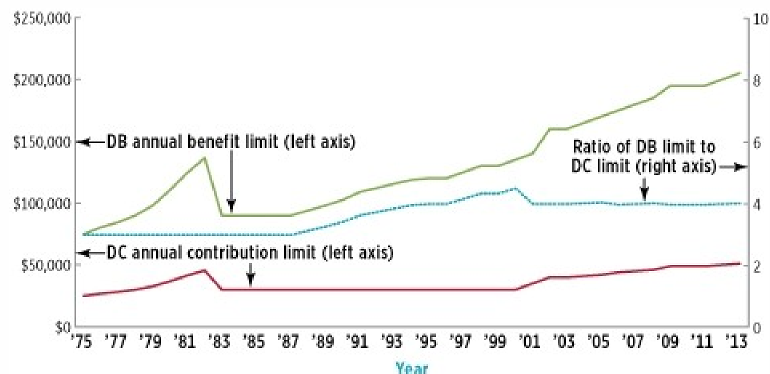
Perhaps more importantly, the 20/20 proposal would break the historic link between DB plan benefit limits and DC plan contribution limits.

The limits established by ERISA were intended to place roughly equivalent restrictions on the generosity of DB and DC plans. As shown in the figure below, the DB annual benefit limit was originally set at three times the DC annual contribution limit. Congress reduced both limits in 1982 and the limits remained unindexed until the passage of the Tax Reform Act of 1986 (TRA86). However, in an effort to encourage employers to offer DB plans, Congress suspended inflation indexing of the DC limit until the inflation-indexed DB benefit limit was four times that of the DC contribution limit. Because the 20/20 proposal reduces only the DC contribution limit, it would increase that ratio from four-to-one under current law to more than 10-to-one.

20/20 Proposal Would Break the Link Between DC Contribution Limit and DB Benefit Limit

DC plan annual contribution limit and DB plan annual benefit limit, nominal dollars, 1975 to 2013



Note: The ratio went above four-to-one for several years because TRA86 also included a $5,000 “round-down” rule—each year, the contribution limit was set by first adjusting the original limit for inflation and then rounding that value down to the nearest $5,000. Under current law, the limit is rounded down to the nearest $1,000.
Sources: Internal Revenue Service and Investment Company Institute

Qualified Plans Should Be Treated Equally

Though any comprehensive effort to address fiscal policy or tax reform should examine every option, such efforts should maintain one aspect of the current income tax: neutral tax treatment of qualified deferred compensation. Any changes to retirement plans should apply equally to DB plans and DC plans, to employer contributions and employee contributions.

The next post in this series will explain that the official revenue estimate of any proposal to restrict retirement plan contributions likely would overstate the long-term effect that the proposal would have on federal tax revenue.

Additional Resources:

The Tax Benefit and Revenue Costs of Tax Deferral

Other Posts in this Series:

- Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free
- Marginal Tax Rates and the Benefits of Tax Deferral
- A ‘Modest’ Proposal That Isn’t: Limiting the Up-front Benefits of Retirement Contributions
- Revenue Estimates of Restricting Tax Deferral: It Ain’t Necessarily So

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