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UNDERSTANDING THE ROLE OF TAX TREATMENT IN THE EMPLOYER PROVIDED RETIREMENT SYSTEM

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EXECUTIVE SUMMARY

- Eliminating or diminishing the current tax treatment of employer provided retirement plans will jeopardize the retirement security of tens of millions of American workers, dramatically reduce retirement assets in capital markets, and create new and ominous government challenges in maintaining the quality of life for future generations of retirees.
- Lower contribution limits will reduce the willingness of employers to offer a retirement plan. Many workers' retirement savings will drop disastrously. Low and moderately-paid workers are 19.5 times more likely to participate in an employer provided retirement plan than contribute to a traditional IRA.
- Employers add immeasurable value to these plans by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making very significant employer contributions, providing financial education, and encouraging and facilitating savings through payroll deductions.
- Contribution limits and income deferrals should not be viewed in a vacuum. The current tax treatment, with its strict coverage and discrimination requirements, and the top-heavy rules, have resulted in broad-based employer provided plans with substantial participation and savings by low and moderate-income workers. In addition, the Saver's Credit is a benefit available only to low and moderate-income savers.

The recent report of the National Commission on Fiscal Responsibility and Reform recommends a significant reduction in the limits of the special tax treatment of employer provided defined contribution plans that permits deferral of income recognition by participants until benefits are distributed, while permitting a current deduction for employer contributions. Under the “Illustrative Tax Plan” proposed by the Commission, the combined annual contributions from employers and employee salary deferrals in a defined contribution plan can not exceed the lesser of \$20,000 or 20 percent of a participant’s income. Under current law, the section 415(c) annual defined contribution combined limit for employee and employer contributions is \$49,000, not including a \$5,500 catch-up contribution for older workers. The report also includes an alternative recommendation in which the special tax treatment is entirely eliminated.

Other commissions, the Congressional Budget Office, and the Brookings Institute have suggested other reductions in the tax preferences afforded to savings in defined contribution plans. While it is absolutely appropriate for policymakers to examine tax expenditures as part of a comprehensive deficit reduction effort, it is critical that the treatment of employer provided employer plans and its role in creating retirement income for American workers be fully understood.

Simply put, any erosion of the current tax treatment of employer provided retirement plans will result in fewer Americans saving for retirement. Low and moderate income workers’ retirement savings will drop disastrously without the employer provided system. To the extent that they save, it likely will be in general purpose accounts where access to use savings for current needs will reduce amounts available for retirement.

Absent an attractive tax incentive, a significant majority of employers will not offer a retirement plan to their workers. Contrary to popular belief, employers gain no tax benefit from offering a retirement plan as opposed to merely providing additional deductible cash compensation. In fact, they incur significant additional administrative and compliance costs, and fiduciary exposure, as the result of offering a retirement plan. Management and higher paid employees will be indifferent to whether or not their employer offers an after-tax savings program. In fact, highly paid employees may find more attractive investment alternatives outside their employer’s plan.

According to the Investment Company Institute, total retirement assets were \$18.2 trillion as of June 30, 2011.¹ Fourteen trillion dollars of that amount is attributable to employer provided retirement plans. The Bureau of Labor Statistics reports that in March 2011, employer provided retirement plans were available to 73 percent of full time and 64 percent of all private sector workers.² A ground-breaking analysis by the Social Security Administration that utilized tax records found that in 2006, 72 percent of all private sector workers were offered a plan at work and 58 percent participated.³ The Department of Labor Form 5500 analysis for 2008 (latest available data) reports 717,530 private sector retirement plans covering 86 million workers.⁴

¹ *The U.S. Retirement Market, Second Quarter 2011*, Investment Company Institute, September 2011.

² *Employee Benefits in the United States*, Bureau of Labor Statistics News Release, July 26, 2011.

³ *Social Security Bulletin, Volume 71, No .2, 2001, Assessment of Retirement Plan Coverage by Plan Size, Using W-2 Tax Records*, Irena Dushi, Howard M. Iams, and Jules Lichtenstein, 2011. .

⁴ *Private Pension Plan Bulletin, Abstract of 2008 Form 5500 Annual Reports*, U.S. Department of Labor Employee Benefits Security Administration, January 2011.

It is widely recognized that practically no retirement savings occurs outside employer plans or IRAs. In recent Congressional testimony, Jack VanDerhei, Research Director at the Employee Benefits Research Institute, while discussing retirement income adequacy, noted “If you eliminated the expected retirement income generated by defined benefit pensions, defined contribution plans, and IRAs, the at-risk percentages would be even larger than without Social Security benefits.”⁵

The tax treatment of employer provided retirement plans, particularly the treatment of salary deferrals under 401(k) and similar plans, is often misunderstood. Critics complain that the tax benefit applies inordinately to those in higher income brackets. Given our progressive income tax regime, that should surprise no one. What most critics do not understand, or sometimes fail to mention, is the significant nondiscrimination and coverage requirements that ensure that tax qualified employer provided plans provide meaningful and substantial benefit to workers at all income levels. Critics also complain that tax qualified retirement savings merely replace other savings that would be made regardless of any special tax treatment. They are partially correct – a small but not insignificant number of participants will save for retirement without qualified employer provided plans. They overwhelmingly will be high income individuals.

All tax qualified private sector employer provided retirement plans, including 401(k), profit sharing, and defined benefit pension plans, must meet broad coverage and nondiscrimination rules that guarantee that the plans are offered to rank and file workers and that benefits are fairly provided. The maximum deferral percentage rate for highly compensated participants, composed of those earning \$110,000 or more in 2011, the “top-paid” group, or business owners, is mathematically tied to the average deferrals of nonhighly compensated employees. This often results in the inability of high income workers and owners to defer the maximum amount permitted under law. To address this problem, plan sponsors undertake significant measures to induce participation in the employer’s plan through educational campaigns, offering matching contributions, or providing safe harbor plans that are deemed to meet the nondiscrimination tests if certain vesting and matching or nonelective contribution requirements are satisfied. In PSCA’s annual survey of the 2010 plan year, 32 percent of plans used a safe harbor design to meet the nondiscrimination rules and another 39 percent of plans limited the deferral rates of highly compensated participants below the statutory limits in order to meet the nondiscrimination requirements.⁶ Vanguard’s analysis of 2010 activity of 550 plans and 1.1 million workers reveals that participants earning between \$30,000 and \$50,000 deferred an average 5.8 percent of salary into a 401(k) type plan, compared to 6.8 percent for all participants.⁷

Other tax provisions provide benefits solely to low and moderate-income workers. The top heavy rules that impact small businesses add a second layer of onerous vesting and contribution requirements if 60 percent of plan assets are held by key employees – a very common occurrence in small employer plans. As an additional incentive for lower-paid workers, the Saver’s Credit provides a nonrefundable matching income tax credit based on retirement plan contributions.

The tax treatment of employer provided retirement plans should not be judged by an income distribution analysis, but on its effectiveness in providing retirement benefits to working

⁵ Testimony by Jack VanDerhei, EBRI research director, before the Senate Health, Education, Labor and Pensions Committee, on “The Wobbly Stool: Retirement (In)security in America”, October 7, 2010.

⁶ *54th Annual Survey Reflecting 2010 Plan Experience*, Plan Sponsor Council of America. September 2011.

⁷ *How America Saves 2011 – A Report on Vanguard Defined Contribution Plan Data*, Vanguard, July 2011.

families. In that regard, the evidence is overwhelming that the existence of an employer provided retirement plan is the preeminent criteria in determining the retirement assets of American workers. The Congress Research Service recently reported that in 2007 only 2.6 percent of taxpayers with adjusted gross incomes between \$25,000 and \$50,000 contributed to a traditional IRA.⁸ In comparison, the author's analysis of the Employee Benefit Research Institute's study of the March 2010 Current Population Survey (for 2009) reveals that 53.4 percent of private sector wage and salary workers age 21-64 earning between \$20,000 and \$50,000 worked for an employer or union that sponsors a retirement plan and 43.5 percent participated. For all workers (private sector and public) in the same category, 59.4 percent are covered and 50.6 percent participate.⁹ While this is not an apples-to-apples comparison, in this analysis low and moderately-paid workers are 19.5 times more likely to participate in an employer provided retirement plan than contribute to a traditional IRA.

The implications for policymakers are clear. The current tax treatment, with its strict coverage and discrimination requirements, has resulted in broad-based employer provided plans for low and moderate-income workers. These workers are exceedingly more likely to accumulate and retain retirement assets if they are offered a retirement plan at work. Employers add immeasurable value to these plans by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making very significant employer contributions, providing financial education, and encouraging and facilitating savings through payroll deductions. Eliminating or diminishing the current tax treatment of employer provided retirement plans will jeopardize the retirement security of tens of millions of American workers, dramatically reduce retirement assets in capital markets, and create new and ominous government challenges in maintaining the quality of life for future generations of retirees.

⁸ *Ownership of Individual Retirement Accounts (IRAs) and Policy Options for Congress*, Congressional Research Service, November 5, 2010.

⁹ *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2009*, Employee Benefit Research Institute Issue Brief 348, October 2010.