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WASHINGTON UPDATE



Promoting Savings at the Expense of 401(k) Plans

by Brian H. Graff, Esq., APM

As the debate around tax reform proceeds, a threat to employer-sponsored retirement plans may come from an unexpected source—namely some policymakers purporting to support a pro-savings agenda. As we all know, most Americans save at work through a company 401(k) plan. However, proposals currently being discussed to eliminate the tax on capital gains would threaten to undermine the incentive that drives many employers to offer these plans to their workers. Without 401(k) plans, the savings rates of middle and lower income workers would be greatly reduced.

Many conservatives make the argument that our current tax system discourages savings to the detriment of the economy. There is no debate that increasing our nation's savings rate is a worthy goal. Increased savings produces greater capital leading to lower interest rates, which is a good thing for a debtor nation such as ours. Policymakers and economists focused on this objective periodically suggest "consumption-model" taxation systems that exempt savings from tax as an effective means to encourage savings. Most commonly this approach takes the form of proposals to completely eliminate the tax on capital gains, dividends and interest.

These proposals have once again resurfaced as Congress begins its consideration of tax reform. Congressman Ryan, as chairman of the House Budget Committee, advanced this idea in his budget plan released earlier this year.



Newt Gingrich, newly minted presidential candidate and former Speaker of the House, has made tax-free capital gains and dividends a centerpiece of his economic agenda. And, just recently the Heritage Foundation released its comprehensive tax reform agenda, which included no tax on all savings.

As Congress considers how to reform our nation's tax system, there will no doubt be significant debate on what impact eliminating the capital gains tax would have on savings rates. Proponents will argue that it would lead to a major boost in aggregate national savings. Critics will counter that previous Congressional reductions in the capital gains tax rate in 1997, and then again in 2003, did not reverse the downward trend of personal savings rates that has persisted for nearly three decades.

401(k)s Work

What is clear, however, is that the savings vehicle that does the best job of creating retirement savings for middle and lower income taxpayers—the 401(k) plan—would become significantly less attractive to the small business owners who voluntarily establish these plans. Under current law, employers are encouraged to set up 401(k) plans because of the tax incentives—



deferral of income tax on both contributions and investment earnings. There are special nondiscrimination rules (*e.g.*, requiring matching contributions) to make sure that lower-paid employees benefit from the plan, not just the key employees. In other words, the business owner gets a valuable tax break if he or she is willing to help lower-paid employees save as well.

And it really works. According to the Employee Benefits Research Institute (EBRI), more than 70 percent of workers earning \$30,000 to \$50,000 will save when covered by a 401(k) plan, while less than 5 percent of workers with the same incomes will save on their own in an IRA. The 401(k) is the only way we have ever effectively encouraged moderate income workers to save. www.asppa.org/document-vault/pdfs/mediaroom/Effectivenessof401kPlans_EBRI2010.pdf.aspx

If taxes on capital gains were eliminated, the incentive for a small business owner to maintain a 401(k) plan would be dramatically reduced. The small business owner could now invest outside of a 401(k) plan, knowing there will never be any tax on the investment. It would be like a Roth IRA without any limits. With such an option, why would the small business owners incur the expense and liability of having a qualified plan? In many cases, the answer is they wouldn't, and without a plan we know that most of the employees won't save at all. And even for those small business owners who choose to keep a 401(k) plan for their employees, since the owner no longer has a stake in the plan it will likely be bare bones without incentives like matching contributions to encourage the workers to save.

Even beyond the issue of small business retirement plan coverage, proposals to eliminate the tax on capital gains and dividends would have a negative impact on retirement savings. Why would any workers, even if offered a retirement plan at work, contribute to a plan that would greatly limit access to their savings? They can garner the same tax benefits by investing outside the plan with unfettered access to their assets and no future worries about minimum required distributions. Again, it would be like an unlimited Roth IRA without any distribution restrictions. And the consequence would most certainly be reduced savings for retirement as many would be too tempted to spend that savings in advance of their retirement years.

The Right Incentive

Thus, any serious consideration of greatly reducing or eliminating the tax on capital gains and dividends must be accompanied by appropriate incentives to encourage the formation and maintenance of employer-based retirement plans and to continue to encourage workers to save in those plans.

One such incentive could be to provide the investment earnings in retirement plans with the same tax treatment as investment earnings outside the plan. In other words, contributions to retirement plans by employees, and by employers on behalf of their employees, would still be tax deductible, but only the amounts contributed would be subject to tax (on a pro-rata basis) upon distribution. In other words, the portion of the retirement plan distribution attributable to investment earnings would be tax-free. In this way, investment earnings would be exempt regardless of the savings vehicle, but a tax incentive for retirement savings would be retained.

Simply put, without maintaining some meaningful incentive for retirement savings, the elimination of the tax on capital gains and dividends alone will jeopardize the most reliable savings vehicle for American workers—the 401(k). That consequence is certainly not consistent with a pro-savings agenda. ↗



Brian H. Graff, Esq., APM, is the Executive Director/CEO of ASPPA. Before joining ASPPA, he was pension and benefits counsel to the US Congress Joint Committee on Taxation. Brian is a nationally recognized leader in retirement policy, frequently speaking at pension conferences throughout the country. He has served as a delegate to the White House/ Congressional Summit on Retirement Savings, and he serves on the employee benefits committee of the US Chamber of Commerce and the board of the Small Business Council of America. (bgraff@asppa.org)