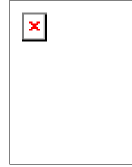
Statement for the Record
Committee on Ways & Means
Hearing on the President's Economic Growth Proposals



March 6, 2003

Introduction

Thank you for this opportunity to submit ASPPA's views on the impact of Treasury's proposal to eliminate the double taxation of corporate earnings contained in H.R. 2, the Jobs and Growth Act of 2003. ASPPA is a national organization of over 5,000 retirement plan professionals who assist hundreds of thousands of small businesses throughout the country in establishing and maintaining qualified retirement plans for their workers.

We would like to begin by thanking the members of the Ways and Means Committee for their efforts over the last decade to improve the retirement security of our nation's workers. In particular, we greatly appreciate the efforts of Chairman Thomas, and Representatives Portman, Cardin, Pomeroy, and others for their emphasis on expanding the retirement plan coverage rates of our nation's small business workers, which have lagged behind the coverage rates of workers at larger firms.

The critical role of employer-sponsored plans in promoting savings by American workers cannot be understated. According to the Employee Benefit Research Institute, middle-income workers are more than 10 times as likely to save if they are covered by a workplace retirement plan than on their own. Further, workplace retirement plans have made middle income Americans owners in the stock market. According to the Investment Company Institute, almost half of the over 50 million American households that own stock first purchased stock through a workplace retirement plan. Noting that 79 percent of equity owners participate in employer-sponsored plans, the president of the Securities Industry Association recently emphasized, in a 2002 press release, "the important role that employer-sponsored retirement plans play in introducing Americans to investing."

The Administration began 2003 by unveiling an almost $700 billion stimulus package intended to jump-start the economy. The centerpiece of this package is a proposal that would generally exclude from shareholders' taxable income corporate dividends that have already been taxed. Specifically, under the Administration's proposal, all dividends that are paid out of corporate earnings that have already been fully taxed at the corporate level would be excludable from the income of the shareholder who receives them. Alternatively, the proposal provides that if the company retains already fully taxed earnings, the shareholder will be entitled to a basis adjustment to reflect the already fully taxed retained earnings. However, the proposal specifically does not apply to stock held in tax-favored retirement vehicles such as qualified retirement plans and IRAs.

In a general sense, the tax effect of the Administration's proposal is similar to the operation of a Roth IRA. Amounts are invested on an after-tax basis and earnings (already taxed at the corporate level) are tax-free. However, unlike a Roth IRA, there are no limits on the amounts that can be invested nor are there any restrictions or penalties on early distributions. Consequently, questions have been raised about the potential impact of the Administration's proposal on retirement savings, particularly savings by workers of our nations' small businesses. While the Administration's proposal may arguably address reasonably sound tax policy concerns about making sure that corporate income is taxed only once, it potentially could have an unintended, adverse impact on small business retirement plan coverage.

Impact on Retirement Savings Generally

Since the proposal was announced, the Administration has been arguing that the dividend exclusion proposal does not disfavor retirement savings. The basis for their argument is that a deductible IRA and a Roth IRA are economically neutral, assuming the same tax rates at the time of contribution and distribution. For example, assume a $1,000 contribution to a deductible IRA and a 5 percent rate of return. If it were withdrawn one year

later, assuming a 40 percent tax rate and ignoring early withdrawal penalties, the taxpayer would net $630. If, instead, the same taxpayer contributed to a Roth IRA, the contribution would be $600. Assuming everything else is the same, after the first year, the taxpayer would again net $630. Given this economic neutrality, the Administration argues that because their proposal has a similar tax effect as the Roth IRA, it is at most equally neutral as compared with a deductible tax-favored retirement savings vehicle. In the Administration's view, tax-favored retirement savings vehicles remain more attractive because they inherently have more investment flexibility.

Contrasting views have been expressed suggesting that if the Administration's proposal were enacted the investment community would most certainly develop competitive products to take advantage of the new law. Further, unlike retirement savings vehicles, the investments made under the President's proposal would be advantaged since they would not be subject to limits or restrictions, or penalties upon early distribution. Regardless of which of these views seems more persuasive, though, one thing is clear—the relative value of tax-favored retirement savings vehicles would be somewhat lessened if the Administration's proposal were enacted.

Effect on Small Business Retirement Plan Coverage

For many small business owners, the decision to establish a qualified retirement plan is particularly sensitive to the value of the tax incentives provided through qualified plan rules. There is no question that the law provides qualified plans with valuable tax incentives—contributions to the plan are tax-deductible and earnings are tax-deferred until distributed. However, qualified plans are also subject to stringent nondiscrimination and top-heavy rules that require small business owners to make contributions on behalf of their employees in order to make contributions on behalf of themselves. Given the valuable tax incentives accorded qualified plans, Congress determined it appropriate to impose these nondiscrimination requirements in order to provide rank-and-file workers with a fair share of retirement benefits.

Due to these nondiscrimination rules, for every dollar a small business owner wants to contribute to a qualified plan on his or her own behalf, he or she will generally have to spend a minimum of 30 to 40 cents on behalf of employees. This expenditure represents a combination of the implementation and administrative costs associated with a qualified plan, and the cost of covering the business' workers—a prerequisite to the owner's participation in the plan as required by the qualified plan nondiscrimination rules.

Given this added cost, the relative value of the tax incentives provided under the qualified plan rules is a critical element to the small business owner's decision to establish a retirement plan. Consequently, if a small business owner were able to save an equivalent amount outside of a qualified pension plan in a tax-favored alternative without such added cost, such an alternative would significantly reduce the incentive of the small business owner to incur the responsibilities of contributing to a retirement plan for the small business' workers. An unlimited, uncapped exclusion from taxable income of qualifying dividends (and undistributed after-tax earnings) is just such an attractive alternative. Such a non-plan alternative is made even more attractive when you consider that there are no restrictions on distributions and early-withdrawal penalties as there are with a plan. Further, by not establishing a workplace retirement plan the small business owner could avoid exposure to potential fiduciary liability that he or she would otherwise be subject to with such a plan.

If the Administration's proposal were enacted in its current form, it would not be difficult for the small business owner to generate tax-free investment returns that would be more financially advantageous than investing in a qualified retirement plan. For example, if the Administration's proposal had been effective over the last 15 years, based on our analysis, a simple investment in an S&P 500 index fund would generate on average approximately a 5 percent tax-free annual yield. For many small business owners, during this period they would have been significantly better off investing under the Administration's proposal than through a qualified retirement plan. In effect, from the perspective of the small business owner, the Administration's proposal turns the tax-advantaged qualified retirement plan into a tax-*disadvantaged* plan.

For example, consider a small business with one owner and 5 employees. The owner would like to save the maximum each year to a defined contribution plan—currently $40,000. In order to do that, the qualified plan nondiscrimination rules would require the owner to make roughly $13,000 in contributions on behalf of employees, a cost of 32.5 percent. If the small business owner had invested her annual $40,000 contribution over the last 15 years in an S&P 500 index fund, the owner would have accumulated after-tax savings of

$504,482, assuming a 40 percent tax rate.

Assume instead that the Administration's proposal had been in place over the last 15 years. If the small business owner took the combined $53,000—the $40,000 for herself and the $13,000 for the employees—and gave herself an annual bonus and invested the after-tax amount (approximately $32,000 assuming a 40 percent tax rate) over the same 15-year period in an S&P 500 index fund, the owner would have accumulated after-tax savings of $641,884, over $137,000 more than with the qualified retirement plan, due to the power of the tax free dividends and appreciation under the Administration's proposal. In the real world, a decision to save 21 percent less for retirement is not one many small business owners will make.

The Administration's decision to extend the dividend exclusion proposal to variable annuities makes it even more likely that a small business owner will forego adopting a plan in favor of saving on his or her own. In the above example, the small business owner could take her after-tax bonus and invest it annually in a variable annuity. A variable annuity operates just like a 401(k) plan by offering multiple investment choices and allowing investments to be diversified without current tax consequence. Further, like a 401(k) plan, a variable annuity is only taxed when distributed. However, unlike a 401(k) plan, it is not subject to any limits or nondiscrimination rules. Now, under the Administration's proposal, a substantial portion of the earnings under the variable annuity will be tax free. Thus, by extending the proposal to variable annuities, the Administration not only makes it more financially advantageous for the small business owner to save without a plan, but it also provides the small business owner with the same ability to diversify investments as if the owner had a plan.

In light of this, a significant number of small business owners will likely choose the non-plan option consistent with the Administration's proposal and avoid the necessity of making contributions on behalf of their small business employees. They may offer their employees a 401(k) plan, but such a plan would be funded solely with contributions made by the small business employees with no contributions, like matching contributions, made by the owners, likely reducing the participation rates of many small business workers.

Critics of this view suggest that there are other reasons besides tax incentives for a small business owner to establish a plan, such as the need to compete for employees, which will lead to small business retirement plan coverage. However, ASPPA members who work closely with America's small businesses every day know that the incremental decision to establish a workplace retirement plan by the owner of a small business, which has been operating quite well without a plan, has little to do with competition for employees. Surveys conducted by Employee Benefit Research Institute show that employees of small businesses without a plan would generally prefer wages instead of retirement plan coverage. Thus, the tax incentive carrot to the small business owner is needed in order to bring the small business workers into the savings game.

Tax and Social Policy Concerns

ASPPA recognizes the tax policy arguments underlying the proposition that income should be taxed only once. However, ASPPA also joins the Administration and the Congress in its firm support for the social policy underlying incentives to encourage businesses—and particularly small businesses—to establish and fund qualified retirement savings plans for the workers employed by our nation's small businesses. Ironically, thanks to the tremendous efforts of the Ways and Means Committee significant progress has been made. According to the Congressional Research Service, since 1996 coverage of full-time small business employees at firms with less than 25 employees has increased from 25 to over 33 percent. This translates to millions of small business workers who now are covered by a plan.

Unfortunately, unless the Administration's proposal is modified to include workplace retirement plans, just as was done for variable annuities, the tax policy that supports tax-free qualifying dividends will likely undercut the good social tax policy that incents small business owners to provide retirement coverage for their workers. Failure to modify the proposal that would exclude qualifying dividends from taxable income (or increase basis to reflect after-tax retained earnings) could make the employees of our country's small businesses potential losers.

It is a heavy price to pay for theoretically sound tax policy.

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