ASPPA
WORKING FOR AMERICA'S RETIREMENT

Testimony Presented to the Senate Committee on Finance

Kick-Off for Tax Reform: Tackling the Tax Code
August 3, 2006

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Committee on Finance hearing, "Kick-Off for Tax Reform: Tackling the Tax Code." For the reasons stated below, we believe that certain savings recommendations made by the President's Advisory Panel on Federal Tax Reform (Advisory Panel) on November 1, 2005, would be devastating to the retirement security of millions of American workers.

ASPPA is a national organization of approximately 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system.

The ASPPA Pension Education & Research Foundation (ASPPA PERF) report entitled "Savings Under Tax Reform: What Is The Cost to Retirement Savings?[1]" (Report) examines several possible tax reforms and their impact on retirement savings. We ask that the Report be included as an attachment to this testimony.

The Advisory Panel's Recommendations

"Save at Work" Accounts

The Advisory Panel set forth two savings proposals for fundamental tax reform: the "Simplified Income Tax" and the "Growth and Investment Tax." Both plans would eliminate all employer-sponsored defined contribution plans [e.g., 401(k), 403(b), 457, SIMPLE plans, etc.] and replace them with a "Save at Work" account. In addition, a significant and controversial aspect of the Growth and Investment Tax plan would have contributions to the Save at Work account made on an after-tax basis, although distributions would be tax-free (similar to today's Roth accounts).

With a Save at Work account, without an upfront tax deduction, many workers currently saving in their 401(k) will choose not to save. In its report, the Advisory Panel admitted that it was able to finance lower tax rates on taxpayers with the highest incomes by eliminating the pre-tax deduction for retirement plan contributions. ASPPA believes that it is unacceptable to lower tax rates for higher income individuals by sacrificing the savings tax incentives for American workers.

America is not inherently a nation of savers. Even today, about a third of workers are not saving for retirement and many who are saving have retirement accounts that are inadequate to fund a comfortable retirement. Further, demographic shifts illustrate a growing retiree problem: approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.

Our nation's existing income tax system provides incentives for long-term retirement savings that has encouraged a significant number of Americans of modest means to save for retirement. In fact, the current employment-based retirement plan system, which has made middle-income Americans significant investors in the stock market[2], has been a major contributing force to the "ownership society" to which the President often refers.

Simply put, employer-sponsored retirement plans have been the only effective means to get low- to moderate-income workers to save. According to the Employee Benefits Research Institute, low- to moderate-income workers are almost 20 times more likely to save when covered by a workplace retirement plan. Of workers who earned $30,000 to $50,000 and were covered by an employer sponsored 401(k)-type plan, 77.7 percent actually saved in the plan, while only 4 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account[3]. This stunning disparity cannot be overlooked when evaluating our nation's savings policy. In large part, the difference is due to the convenience of payroll deductions, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer.

Certainly, no one is suggesting that the employer-based retirement plan system is perfect. Coverage rates still need to be improved. In 2003, only 64.9 percent of full-time workers were employed by a firm sponsoring a qualified retirement plan[4]. The lack of coverage is most acute among small business employees who comprise the overwhelming majority of our nation's workers. In 2003, at firms with less than 25 employees, only 31.4 percent of full-time workers had access to an employer-sponsored qualified retirement plan[5].

The failure to achieve universal coverage, however, should not be an excuse to abandon a system that so successfully encourages savings, particular by those workers who otherwise are not likely to save. Improvements to the system can be made. From 1994 to 2003, the percentage of full-time workers at small businesses with less than 25 employees that sponsored a qualified retirement plan increased from 26.5 percent to 31.4 percent.[6] In many respects, this substantial increase in retirement plan coverage for small business employees is due to positive legislation enacted by Congress specifically designed to increase the number of small business retirement plans.[7]

When it comes to encouraging savings, the employer-sponsored retirement plan system has a proven track record. It is not surprising that one study showed that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy as households not covered by a plan. As a result, any examination of our nation's savings policy must include consideration of new ways to expand coverage under the employer-sponsored retirement plan system.

"Save for Retirement" and "Save for Family" Accounts

The Advisory Panel's Simplified Income Tax and the Growth and Investment Tax Plans proposals would also eliminate IRAs and other savings vehicles (e.g., education IRAs, section 529 plans) and replace them with "Save for Retirement" and "Save for Family" accounts that would allow for annual contributions up to $10,000 each. Combined, these accounts would allow a couple owning a small business to save $40,000 for retirement on a tax-preferred basis (compared to $10,000 under current law). ASPPA is concerned that many small business owners will forego adopting a workplace retirement plan for their employees if they can save that much on their own on a tax-preferred basis.

ASPPA encourages the Committee to examine the crucial role played by the employer-sponsored retirement plan system in promoting savings by low- to moderate-income American workers. We implore the Committee to be wary of any proposed tax incentives for after-tax investments that will potentially lessen the attractiveness of savings in a tax-qualified retirement plan. This is especially true in the context of small businesses, whose costs for maintaining a retirement plan are much greater on a per-employee basis than for larger firms. As the tax incentives for nonqualified investments become more favorable on a relative basis, ASPPA is concerned that many small business owners, faced with higher costs for maintaining a retirement plan, will instead forego the plan and invest on their own, leaving their workers without a meaningful opportunity to save.

Not all savings are alike. Through the special incentives afforded the qualified retirement plan system, Congress has always acknowledged, unlike the Advisory Panel, the importance of encouraging long-term retirement savings by our nation's workers. These plans are designed to ensure that savings will be available for retirement by restricting distributions and/or penalties for early withdrawal. The Panel's recommendations for tax incentives for nonqualified short-term investments, however, run counter to that message. The zero capital gains and dividends tax rate for lower-income taxpayers that goes into effect for 2008 is a perfect example. The tax incentive of a zero capital gains rate is economically equivalent to a tax-deductible contribution to an IRA or 401(k) plan. Given that, why would workers contribute on a long-term basis to an IRA or 401 (k) plan when they can get the same tax break outside of a plan and always have access to their money?[8] Without the savings discipline implicit in an IRA or 401 (k) plan, how likely is it that savings in short-term nonqualified investment vehicles will be there for retirement? These are important questions the subcommittee should consider when formulating our nation's savings policy.

In considering our nation's savings policy, high priority must be placed in encouraging greater savings by low- to moderate-income workers. With increasing pressure on the solvency and continued viability of the Social Security system, it is this sector of Americans whose future economic security is most at risk. The empirical evidence clearly suggests that further strengthening our employer-based retirement plan system will most effectively and efficiently achieve that objective.

Dividends and Capital Gains Tax Exemption

Of equal concern to ASPPA is the Advisory Panel recommendation that 100 percent of the dividends paid by US corporations and 75 percent of their investments, including mutual funds in US corporations, be exempt from tax. This essentially means that investments made outside of a qualified plan could have an effective tax rate of less than 4 percent. Further, unlike retirement plan savings, these investments will not be subject to the distribution restrictions that help ensure that the funds are available for retirement. If investments outside of a qualified plan are taxed at an effective rate of less than 4 percent, for many small business owners, it will no longer make financial sense for them to adopt a retirement plan for themselves and their workers.

The reduction or elimination of tax rates for capital gains and dividends threatens small business retirement plan coverage. Small employers hesitate to offer retirement plans for several reasons, including administrative complexity and cost, and the unpredictability of their financial condition. These hurdles are offset partly by the knowledge that the small business owner cannot maximize personal retirement savings without providing a plan for workers as well. Any changes that allow small business owners to meet their personal retirement savings goals for themselves only, such as through a reduction or elimination of the tax on capital gains and dividends, would inevitably threaten the future of the plans they provide their workers.

While opponents argue that these small business owners implement plans for their employees in order to remain competitive, it has been the longstanding experience of ASPPA members that profit-maximizing small business owners rarely adopt retirement plans due to employee pressure. The small business has usually operated successfully without a retirement plan for some time. Rather, the retirement security of the small business owner is the motivating factor for implementing a retirement plan, and the owner is typically happy to provide retirement benefits for workers if it makes financial sense from his or her personal perspective.

Also, because small businesses have fewer employees, the cost of maintaining the plan on a per-employee basis is higher as compared to larger firms. Costs are further heightened by ERISA-mandated nondiscrimination rules that generally mandate contributions (e.g., matching contributions) be made on behalf of employees in order for the small business owner(s) to save in the plan.[9] For small businesses with less than 25 employees, the cost to the owner of these mandatory contributions (plus administrative costs) will typically be at least 30 cents for every dollar that he or she wants to save in the plan. Effectively from the small business owner's perspective, these costs are like a tax that must be paid in order for the owner to participate in the plan.

When capital gains and dividends were taxed at ordinary income rates, it always made sense for small business owners to save through a workplace retirement plan because the upfront deduction provides a greater financial incentive, notwithstanding the 30 percent cost for mandatory contributions for employees. That advantage, however, went away somewhat with the current 15 percent rate on capital gains and dividends and goes away dramatically if tax rates on capital gains and dividends are further reduced. Budget legislation recently passed in Congress now extends the current 15 percent rate on capital gains and dividends through 2010.

As noted earlier, although the Saver's Credit provides added incentive for lower-income individuals to save in a qualified retirement plan, there will literally be millions of American workers who will now have no real incentive to lock up their savings for retirement. It is true that many workers will be provided matching contributions by their employer, which will act as an incentive to invest in the plan. The matching contributions, however, may not be enough of an incentive for some workers, or workers may choose to invest outside of the plan once they have taken full advantage of the matching contribution.[10] Further, many employers do not offer matching contributions at all. Finally, there are tens of millions of working Americans who are still not covered by a workplace retirement plan and only have an IRA as an option. How many of these workers will choose to save on a long-term basis in an IRA where there is absolutely no tax incentive to do so?

ASPPA is very concerned that the permanent extension of the current reduced tax rates for capital gains and dividends, or any further reductions in such rates, will lead to reduced long-term savings. If long-term savings no longer enjoy a special tax advantage, low- to moderate-income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these "savings" will be spent well before retirement, thereby threatening their future economic security.

Conclusion

As Congress evaluates the Advisory Panel's savings proposals, ASPPA asks that any reform to the federal tax system accommodate sound retirement policy. Sound retirement policy suggests that the most efficient and effective tax system must continue to provide sufficient incentives to employers to establish and maintain plans for their workers. The 401(k) has been a great success story introducing tens of millions of Americans to the benefit of saving. It is critical that we "Don't Take Away America's 401(k)."

A sound national savings policy must abide by the following three principles:

- Priority must be given to promoting increased savings by low- to moderate-income workers. These are the Americans who save the least and whose future financial security is most at risk.
- A national savings policy should favor long-term retirement savings with distribution restrictions to help ensure that working families have some needed savings when they reach retirement.
- Recognition must be given to the critical role played by the employer-sponsored retirement plan system in achieving the first two principles. Workplace retirement plans have been, by far, the most effective way to encourage long-term savings by low- to moderate-income workers.

As an alternative to promote savings, ASPPA supports a recent proposal by Senators Gordon Smith (R-OR) and Kent Conrad (D-ND) giving American workers access to an employer-based retirement savings program, specifically a payroll-deduction IRA, where they are not already covered by a qualified retirement plan. We believe that this essential legislative proposal, coupled with an expanded Saver's Credit, will likely persuade more employers, particularly small businesses, to offer a qualified retirement plan to their workers. It should also greatly improve the retirement savings rates of lower-income workers.

The policy implications of reduced long-term retirement savings by working Americans could be substantial, particularly given potential limitations of Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings. ASPPA stands ready to work closely with the members of this subcommittee and Congress to make sure this does not happen.

[1] The Report and its Executive Summary can be found at **http://router.asppa.org:8765/cs.html?charset=iso-8859-1&url=http%3A//www.asppa.org/pdf_files/govpdffiles/2005-05-17-report.pdf&qt=tax+reform&col=aspa&n=6&la=en**.

[2] As of July 2003, an estimated 36.4 million US households, or almost 70 percent of all US households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, US Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

[3] Employee Benefits Research Institute (EBRI, based on 2003 data). It should be noted that this disparity exists notwithstanding likely eligibility for the Saver's Credit.

[4] Congressional Research Service (September 10, 2004), Pension Sponsorship and Participation: Summary of Recent Trends.

[5] Id.

[6] Id.

[7] For example, the Small Business Job Protection Act of 1996 created the SIMPLE plan, a simplified retirement plan for small businesses with lower administrative costs. The Economic Growth and Tax Relief Reconciliation Act of 2001 included, among other things, a tax credit for the start-up costs for establishing a new small business retirement plan.

[8] It is true that the Saver's Credit provides an added tax incentive to American workers to save in an IRA or 401(k) plan. However, there are literally millions of American households that would be eligible for the zero capital gains and dividends tax rate that are not eligible for the Saver's Credit. The Saver's Credit is equal to 10 percent of contributions to an IRA or 401(k) plan up to $2,000 for married taxpayers with adjusted gross income between $32,500 and $50,000. The zero capital gains and dividend tax rate is available for married taxpayers with taxable income up to $58,100 and whose adjusted gross income could be well in excess of that in light of the standard deduction and personal exemptions. In addition, many working families have no tax liability. Since the Saver's Credit is not refundable, it offers no incentive to these families.

[9] In fact, there is a special nondiscrimination rule that is applicable only to small business retirement plans called the top heavy rule that often mandates that a small business must make a retirement plan contribution on behalf of lower-paid workers equal to 3 percent of their compensation. See IRC Section 416.

[10] For example, if an employer matches up to 3 percent of pay, a worker may choose to save just up to 3 percent of pay to take advantage of the match and then do any further saving outside of the plan.