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Reform School

Consequences of tax reform proposals relating to 401(k) plan contributions

FROM time to time, proposals are made to reform the U.S. retirement system that involve reducing allowable contributions to 401(k) and similar types of plans. Reform proposals may be motivated by policy concerns, such as shifting the demographics of those receiving benefits from the tax expenditure, or may be driven by fiscal concerns, such as reducing the budget deficit. In the first category, advocates, such as William Gale of the Brookings Institution, argue that existing tax deductions providing a relatively greater benefit for employees subject to a higher marginal tax rate should be replaced with a flat rate refundable tax credit that will be deposited directly in the plan participant's retirement savings account. Under this proposal, contribution limits would not change, but employee and employer contributions that generate the credit would be taxable income to the employee.

In contrast, the deficit reduction approach is illustrated by the December 2010 report of the National Commission on Fiscal Responsibility and Reform that recommended reduction of the maximum excludable contribution to a defined contribution plan to the lesser of \$20,000 or 20% of income. This proposal, which covers both the exclusion from taxable income of employee elective deferrals as well as nontaxable employer contributions, is sometimes referred to as the "20/20 cap." If the Joint Select Committee on Deficit Reduction focuses on tax reform, both of these proposals are likely to be considered.

Employer Reaction. Organizations such as the Employee Benefit Research Institute that have attempted to analyze the decisionmaking process of employers in reaction to changes in the current retirement plan incentive structure have concluded that the result will be either modifications to existing plans that reduce the level of employer contributions or outright termination of the plan. Termination is particularly likely in the case of small-plan sponsors that utilize cross-tested plans, since a lower level of employer contributions will not generate enough tax savings to justify continuance of the plan. Even proponents of change admit that the result will be a negative effect on employers' willingness to offer 401(k) plans.

Employee Reaction. If 401(k) plans are made less attractive for higher-income households, Roth options that forgo an immediate deduction but insulate investment earnings from taxation would be more widely used by this group.

The proposals to reduce 401(k) incentives would affect lower-income workers in two ways. First, reduced limits and other restrictions would impede access to retirement plans by such employees, since business owners and other decisionmakers would have less incentive to establish or maintain a qualified retirement plan. In addition, surveys indicate that low-income households have a propensity to act in ways that are not necessarily consistent with optimizing financial outcomes. Thus, members of such households have a tendency to view the tax deductions generated by their contributions to a plan as very important and will reduce or eliminate their plan contributions to the extent that the ability to deduct them is restricted. Thus, while high-income employees are the group most likely to be affected economically by proposals to cut the amount or deductibility of 401(k) contributions, the lowest income categories have the most negative reaction to such proposals and will respond with a savings reduction.

Advisers should be prepared to deal with a smaller universe of 401(k) plans if the current proposals to limit 401(k) contributions and/or deductions are enacted. There would be fewer plans and smaller contributions to those plans that remain.

It can be expected that advisers providing participant-level advice will focus their attention on older workers most of whose career savings remain at relatively high levels. Younger high-income workers who would be disadvantaged by the new system can be expected to allocate assets to Roth accounts, Roth IRAs and tax-advantaged investments outside of a qualified plan. Lower-income workers are likely to have reduced access to 401(k) plans and, even when they do have such access, may be expected to reduce the level of their contributions. As a result, advisers interested in providing broad-based participant-level advice are likely to find reduced opportunities.

³ Testimony of Gale, William G., presented at hearing on Tax Reform Options: Promoting Retirement Security before United States Senate Committee on Finance, September 15, 2011.

⁴ *Id.* at p. 7.

⁵ Testimony of VanDerhei, Jack, Research Director, Employee Benefit Research Institute, presented at hearing on Tax Reform Options: Promoting Retirement Security before United States Senate Committee on Finance, September 15, 2011.