PSCA

Tax Reform Impact on DC Plans

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Executive Summary

Introduction:

Will pre-tax contributions to 401(k) plans survive proposals to reform the tax code?
Stay or go, no one knows for sure. The initial White House announcement concerning proposed tax reforms left out almost all detail. Clearly, the initial proposal retains tax preferences for the home mortgage interest and charitable contribution deductions. Just as clearly, no other tax preference received equal billing – including tax preferences for employer-sponsored benefits including 401(k) plans, other retirement savings plans, defined benefit pensions, and medical coverage. White House Press Secretary Sean Spicer suggested all other tax preferences were at risk. However, the Republican tax reform blueprint document pledges to "continue tax incentives for retirement savings." It also says that the House Ways and Means Committee will develop "options for an effective and efficient overall approach to retirement savings." It is not clear whether that language maintains the status quo, limits use to Roth 401(k) contributions, or perhaps it augers for a change consistent with a 2014 Ways and Means Committee proposal to limit pre-tax 401(k) contributions to half of the annual contribution limit ($9,000 of the 2017 limit of $18,000, with the remainder as Roth 401(k)).

And, of course, tax reform itself is not a certainty. Consider that the last major tax reform was over 30 years ago - the Tax Reform Act of 1986 (TRA'86). That law followed over two years of Congressional discussion and debate. One reason for concern is the precedent created by TRA'86 which changed the tax treatment of Individual Retirement Accounts (IRAs) – 63% fewer Americans contributed to an IRA in 1987 when compared to 1986![i]

Pre-tax, after-tax, or Roth? Some historical context.
Prior to 1982, all employee contributions to tax qualified thrift/savings plans and profit sharing plans were made on an after-tax basis. Earnings accumulated tax deferred and were taxed at payout.

The Internal Revenue Service (IRS) had first issued guidance on deferred compensation programs in 1956[ii]. Regulations were first proposed on December 6, 1972[iii]. Section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA, Pub. L. 93-406) froze the status quo so Congress could study the issues. Section 401(k) was added by the Revenue Act of 1978 (TRA'78). However, today's 401(k) could not possibly be what Congress envisioned back in 1978. The Joint Committee on Taxation's (JCT) General Explanation of the Revenue Act of 1978 confirms that tax code section 401(k) was designed to ***discourage*** deferred compensation plans by ***restricting*** highly compensated employee deferrals by applying non-discrimination rules. The explanation states: "… A cash or deferred arrangement will meet these nondiscrimination requirements for qualification for a plan year if … (the actual deferral percentage for the highest paid one-third of all participants does not exceed the deferral percentage for the other eligible employees)…:

(1) by more than 50 percent, or
(2) by more than three percentage points..[iv]

The JCT report for TRA'78 confirmed the intent: "…this requirement prevents a plan from permitting lower-paid participants to elect to take all of their allocated contributions in cash while permitting higher-paid participants to defer the portion of their allocated contributions…" The JCT description also states: ***"Revenue effect: This provision will have a negligible effect upon budget receipts."*** So, Congress never intended widespread adoption of 401(k) plans nor broad based deferrals by non-highly compensated employees. ***Congress had added 401(k) to curtail deferrals and limit budget revenue losses!*** Simply, the stated purpose for adding 401(k) is foreign to today's benefits professionals and today's members of Congress. However, the 401(k) quickly gained widespread use after the IRS issued regulations in November 1981[v] - today there are tens of millions of 401(k) participants holding trillions of dollars in assets.

After those regulations took effect, most employers elected to add 401(k) features to the after-tax contribution provisions in existing thrift/savings and profit sharing plans – generally giving individuals a choice between contributing on a pre-tax basis or an after-tax basis. TRA'86 changed the non-discrimination rules to reduce the attractiveness of offering a choice, and many employers completed the transition to pre-tax 401(k) by prospectively eliminating the opportunity to contribute on an after-tax basis.

Roth 401(k) provisions were added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, Pub. L. 107–16). Roth 401(k) provisions were initially added as a temporary feature – available starting January 1, 2006 but the provision was to "sunset" on December 31, 2010. Roth was added as a "revenue raiser" to offset cuts in marginal income tax rates and other tax expenditures.[vi]

Early adoption of Roth 401(k) provisions was modest because of the "sunset" provisions. Where added, Roth was typically offered as a choice alongside existing pre-tax provisions.

The Pension Protection Act of 2006 (PPA'2006, Pub. L. 109–280) removed the "sunset" feature so that Roth 401(k) contributions became available indefinitely. No separate pricetag for this change is available, however, in a 10-year budget window process, any shift from pre-tax 401(k) contributions to Roth 401(k) contributions would be a "revenue raiser." Once the "sunset" was removed, more employers added Roth features.

Summary of Findings:

Availability of Roth
Three-fourths of respondents to the survey currently offer a Roth feature to employees with thirty percent reporting 10-20 percent of eligible employees making Roth contributions and a quarter reporting contributions by 5-10 percent of eligible employees. Sixty percent of employers who don't currently offer a Roth feature have evaluated offering it and chose not to. Of those not offering Roth, 80 percent are concerned with the cost and administrative complexity of adding Roth.

Potential Impact on Employers of Changing Tax status of Plans
Eighty-five percent of plans are likely to, or would definitely continue offering a plan if Congress decreases pre-tax savings limits. This drops to 70 percent of plans if Congress changes the laws to Roth only.

More than half of employers promote the pre-tax nature of plans to encourage savings to a high degree and more than half strongly agree with the statement that they rely on the organization's 401(k) or 403(b) plan to attract and retain employees.

Conclusion:

Today, Congress is considering options to again raise revenue to offset the cost of reducing marginal income tax rates. Tax-qualified retirement plans are a target because they receive the second largest "tax expenditure" (loophole) in the federal (and state) income tax code.[vii] More than **90 percent of respondents indicated** that they strongly or somewhat agree that eliminating or **reducing pre-tax contributions to retirement savings plans is a bad idea**. More than **90 percent of respondents** also indicated that they generally believe that policymakers should allow **employers maximum discretion to design their plans** to meet the needs of their employees.

Much depends on the specifics of any tax reform proposal designed to shift pre-tax 401(k) deferrals to Roth 401(k) contributions, and the period of time employers have to reconsider plan design and implement changes.

The majority of respondents indicated that maintaining the current savings limits is important. However, the majority also indicated that they would adjust to new regulations and continue offering plans.

Demographics

Table 1: Respondent Demographics by Employer Size (Number of Total Employees)

	Plan Size (# of Participants)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Number of Plans	69	94	117	80	83	443
Percentage of Plans	15.6%	21.2%	26.4%	18.1%	18.7%	100.0%

Table 2: Respondents by Industry Type

Industry	**Number of Plans**	**Percentage of Plans**
Construction	13	2.9%
Durable Goods Manufacturing	52	11.7%
Engineering	11	2.5%
Financial	115	26.0%
Healthcare	25	5.6%
Insurance	22	5.0%
Non-durable Goods Manufacturing	27	6.1%
Non-Profit Organization	33	7.4%
Real Estate	5	1.1%
Retail Trade	24	5.4%
Services	57	12.9%
Technology or Telecommunications	7	1.6%
Transportation	14	3.2%
Utility or Energy	10	2.3%
Wholesale Distribution	13	2.9%
Other	15	3.4%
Total	**443**	**100.0%**

Availability and Usage of Roth

Table 3: Percentage of Respondents that Offer a Roth Feature to Employees

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Percentage of Plans	79.7%	76.3%	73.5%	76.3%	75.9%	76.0%

Table 4: Percentage of Participants that Make Roth Contributions, when Permitted

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
0 - 5%	19.2%	30.4%	38.1%	24.6%	26.2%	28.8%
5 - 10%	15.4%	20.3%	22.6%	31.6%	32.8%	24.5%
10 - 20%	28.8%	31.9%	25.0%	28.1%	29.5%	28.5%
20–50%	26.9%	15.9%	14.3%	14.0%	11.5%	16.1%
More than 50%	9.6%	1.4%	0.0%	1.8%	0.0%	2.2%
Total	99.9%	99.9%	100.0%	100.1%	100.0%	100.1%

Table 5: Percentage of Employers Not Currently Offering Roth that Evaluated and Rejected adding it in the Past

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Percentage of Plans	42.9%	54.5%	51.6%	57.9%	89.5%	59.0%

Table 6: Degree of Concern Employers Have About the Cost and Administrative Complexity of Adding Roth, if Mandated

	Plan Size (Number of Total Employees)					
	1-49*	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Very Concerned	42.9%	31.8%	32.3%	10.5%	35.0%	30.2%
Moderately Concerned	28.6%	31.8%	25.8%	36.8%	25.0%	29.2%
Slightly Concerned	7.1%	18.2%	19.4%	36.8%	20.0%	20.8%
Not Concerned	21.4%	13.6%	12.9%	15.8%	20.0%	16.0%
Unsure	0.0%	4.5%	9.7%	0.0%	0.0%	3.8%
Total	100.0%	99.9%	100.1%	99.9%	100.0%	100.0%

*Small sample size.

Potential Impact of Tax Reform

Table 7: Likelihood Employer would Continue to Offer the Plan if Congress Decreased the Pre-tax Savings Limit

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Definitely Continue	53.6%	53.2%	50.0%	51.3%	69.9%	55.2%
Likely Continue	18.8%	35.1%	33.6%	35.0%	24.1%	30.1%
Might Continue	15.9%	7.4%	6.9%	7.5%	2.4%	7.7%
Unlikely to Continue	5.8%	2.1%	3.4%	1.3%	0.0%	2.5%
Definitely Terminate	2.9%	0.0%	0.0%	0.0%	0.0%	0.5%
Unsure	2.9%	2.1%	6.0%	5.0%	3.6%	4.1%
Total	99.9%	99.9%	99.9%	100.1%	100.0%	100.1%

Table 8: Likelihood Employer Would Continue to Offer the Plan if Congress Changed the Laws to Roth Only

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Definitely Continue	42.6%	36.6%	38.5%	39.2%	54.2%	41.8%
Likely Continue	13.2%	37.6%	31.6%	31.6%	27.7%	29.3%
Might Continue	22.1%	15.1%	16.2%	13.9%	13.3%	15.9%
Unlikely to Continue	14.7%	4.3%	5.1%	2.5%	1.2%	5.2%
Definitely Terminate	4.4%	0.0%	0.9%	0.0%	0.0%	0.9%
Unsure	2.9%	6.5%	7.7%	12.7%	3.6%	6.8%
Total	99.9%	100.1%	100.0%	99.9%	100.0%	99.9%

Table 9: Degree to Which Employers Promote the pre-tax Nature of Contributions to the Plan

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
High Degree	46.4%	50.5%	56.4%	57.0%	52.4%	53.0%
Somewhat High Degree	26.1%	29.0%	24.8%	21.5%	26.8%	25.7%
Moderate Degree	21.7%	16.1%	15.4%	16.5%	15.9%	16.8%
Somewhat Low Degree	1.4%	3.2%	0.9%	1.3%	4.9%	2.3%
Low Degree	4.3%	1.1%	2.6%	3.8%	0.0%	2.3%
Total	99.9%	99.9%	100.1%	100.1%	100.0%	100.1%

Opinions on the Impact of Changes to the DC System

Table 10: Percentage of Respondents that Agree with the Statement: Eliminating or reducing pre-tax employee contributions to 401(k) or 403(b) retirement savings plans is a bad idea.

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Strongly Agree	76.8%	83.0%	83.8%	86.3%	91.6%	84.4%
Somewhat Agree	11.6%	9.6%	8.5%	11.3%	6.0%	9.3%
Somewhat Disagree	1.4%	3.2%	3.4%	2.5%	1.2%	2.5%
Strongly Disagree	8.7%	4.3%	4.3%	0.0%	1.2%	3.6%
No opinion	1.4%	0.0%	0.0%	0.0%	0.0%	0.2%
Total	99.9%	100.1%	100.0%	100.1%	100.0%	100.0%

Table 11: Percentage of Respondents that Agree with the Statement: Eliminating or reducing the pre-tax benefits of 401(k) or 403(b) retirement savings plans will discourage employee savings in workplace retirement plans.

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Strongly Agree	72.5%	79.8%	79.5%	76.3%	73.5%	76.7%
Somewhat Agree	14.5%	10.6%	15.4%	21.3%	22.9%	16.7%
Somewhat Disagree	2.9%	6.4%	1.7%	1.3%	3.6%	3.2%
Strongly Disagree	7.2%	2.1%	3.4%	0.0%	0.0%	2.5%
No opinion	2.9%	1.1%	0.0%	1.3%	0.0%	0.9%
Total	100.0%	100.0%	100.0%	100.2%	100.0%	100.0%

Table 12: Percentage of Respondents that Agree with the Statement: Our organization relies on the 401(k) or 403(b) retirement savings plan to attract and retain employees.

	Plan Size (Number of Total Employees)					
	1-49	**50-199**	**200-999**	**1,000-1,499**	**5,000+**	**All Plans**
Strongly Agree	59.4%	44.7%	54.7%	62.5%	60.2%	55.8%
Somewhat Agree	27.5%	40.4%	30.8%	30.0%	33.7%	32.7%
Somewhat Disagree	4.3%	4.3%	4.3%	1.3%	0.0%	2.9%
Strongly Disagree	0.0%	0.0%	0.9%	1.3%	1.2%	0.7%
No opinion	8.7%	10.6%	9.4%	5.0%	4.8%	7.9%
Total	99.9%	100.0%	100.1%	100.1%	99.9%	100.0%

Table 13: Percentage of Respondents that Agree with the Statement: I favor maintaining the current pre-tax employee contribution and overall savings limits of 401(k) or 403(b) plans.

	Plan Size (Number of Total Employees)					
	1-49	50-199	200-999	1,000-1,499	5,000+	All Plans
Strongly Agree	79.7%	85.1%	86.3%	88.8%	85.5%	85.3%
Somewhat Agree	13.0%	8.5%	8.5%	3.8%	12.0%	9.0%
Somewhat Disagree	2.9%	4.3%	2.6%	5.0%	1.2%	3.2%
Strongly Disagree	1.4%	1.1%	1.7%	0.0%	0.0%	0.9%
No opinion	2.9%	1.1%	0.9%	2.5%	1.2%	1.6%
Total	99.9%	100.1%	100.0%	100.1%	99.9%	100.0%

Table 14: Percentage of Respondents that Agree with the Statement: I believe future pre-tax savings limits on 401(k) and 403(b) retirement plan savings should continue to be indexed to inflation.

	Plan Size (Number of Total Employees)					
	1-49	50-199	200-999	1,000-1,499	5,000+	All Plans
Strongly Agree	81.2%	85.1%	80.3%	78.8%	81.9%	81.5%
Somewhat Agree	7.2%	9.6%	13.7%	17.5%	14.5%	12.6%
Somewhat Disagree	5.8%	3.2%	0.9%	0.0%	0.0%	1.8%
Strongly Disagree	1.4%	0.0%	1.7%	0.0%	0.0%	0.7%
No opinion	4.3%	2.1%	3.4%	3.8%	3.6%	3.4%
Total	99.9%	100.0%	100.0%	100.1%	100.0%	100.0%

Table 15: Percentage of Respondents that Agree with the Statement: I generally believe policy makers should allow employers maximum discretion to design 401(k) and 403(b) plans to meet their business objectives and the needs of their employees.

	Plan Size (Number of Total Employees)					
	1-49	50-199	200-999	1,000-1,499	5,000+	All Plans
Strongly Agree	87.0%	68.8%	75.2%	72.5%	78.0%	75.7%
Somewhat Agree	8.7%	19.4%	17.9%	16.3%	14.6%	15.9%
Somewhat Disagree	1.4%	2.2%	0.0%	10.0%	1.2%	2.7%
Strongly Disagree	0.0%	1.1%	0.9%	0.0%	0.0%	0.5%
No opinion	2.9%	8.6%	6.0%	1.3%	6.1%	5.2%
Total	100.0%	100.1%	100.0%	100.1%	99.9%	100.0%