Washington Watch

Understanding the Role of Tax Treatment in the Employer-Provided Retirement System

Reducing tax incentives will result in fewer Americans saving for retirement.

By Ed Ferrigno

The recent report of the National Commission on Fiscal Responsibility and Reform recommends a significant reduction in the limits of the special tax treatment of employer-provided defined contribution plans that permits deferral of income recognition by participants until benefits are distributed, while permitting a current deduction for employer contributions. Under the "Illustrative Tax Plan" proposed by the Commission, the combined annual contributions from employers and employee salary deferrals in a defined contribution plan can not exceed the lesser of $20,000 or 20 percent of a participant's income. Under current law, the section 415(c) annual defined contribution combined limit for employee and employer contributions is $49,000, not including catch-up contributions. The report also includes an alternative recommendation in which the special tax treatment is entirely eliminated. While it is absolutely appropriate for policymakers to examine this and all tax expenditures as part of a comprehensive deficit reduction effort, it is critical that the treatment of employer-provided employer plans and its role in creating retirement income for American workers be fully understood.

Simply put, any erosion of the current tax treatment of employer-provided retirement plans will result in fewer Americans saving for retirement. Low- and moderate-income workers' retirement savings will drop disastrously without the employer-provided system. To the extent that they save, it likely will be in general purpose accounts where access to use savings for current needs will reduce amounts available for retirement.

Absent an attractive tax incentive, a significant majority of employers will not offer a retirement plan to their workers. Contrary to popular belief, employers gain no tax benefit from offering a retirement plan as opposed to merely providing additional deductible cash compensation. In fact, they incur significant additional administrative and compliance costs, and fiduciary exposure, as the result of offering a retirement plan. Management and higher paid employees will be indifferent to whether or not their employer offers an after-tax savings program. In fact, highly-paid employees may find more attractive investment alternatives outside their employer's plan.

According to the Investment Company Institute, total retirement assets were $15.7 trillion on June 30, 2010.[1] Thirteen trillion dollars of that amount is attributable to employer-provided retirement plans. The Bureau of Labor Statistics reports that in March 2010 employer-provided retirement plans were available to 74 percent of full-time and 65 percent of all private sector workers.[2] The Department of Labor Form 5500 analysis for 2007 (latest available data) reports 707,787 private sector retirement plans covering 123 million participants with assets in excess of six trillion dollars.[3]

It is widely recognized that practically no retirement savings occurs outside employer plans or IRAs. In recent Congressional testimony, Jack VanDerhei, Research Director at EBRI, while discussing retirement income adequacy, noted, "If you eliminated the expected retirement income generated by defined benefit pensions, defined contribution plans, and IRAs, the at-risk percentages would be even larger than without Social Security benefits."[4]

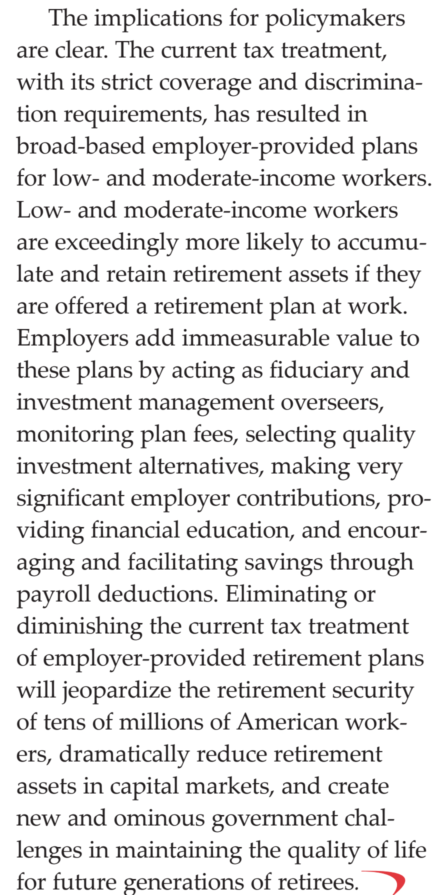
The tax treatment of employer-provided retirement plans, particularly the treatment of salary deferrals under 401(k) and similar plans, is often misunderstood. Critics complain that the tax benefit applies inordinately to those in higher income brackets. Given our progressive income tax regime, that should surprise no one. What most critics do not understand, or sometimes fail to mention, is the significant nondiscrimination and coverage requirements that ensure that tax qualified employer-provided plans provide meaningful and substantial benefit to workers at all income levels. Critics also complain that tax qualified retirement savings merely replace other savings that would be made regardless of any special tax treatment. They are partially correct — a small but not insignificant number of participants will save for retirement without qualified employer-

provided plans. They overwhelmingly will be high-income individuals.

The maximum deferral percentage rate for highly compensated participants, composed of those earning $110,000 or more in 2011, the "top-paid" group, or business owners, is mathematically tied to the average deferrals of nonhighly compensated employees. This often results in the inability of high-income workers and owners to defer the maximum amount permitted under law. To address this problem, plan sponsors undertake significant measures to induce participation in the employer's plan through educational campaigns, offering matching contributions, or providing safe harbor plans that are deemed to meet the nondiscrimination tests if certain vesting and matching or nonelective contributions requirements are satisfied. In PSCA's annual survey of the 2009 plan year, 31 percent of plans reported limiting the deferral rates of highly compensated participants below the statutory limits and 36.9 percent used a safe harbor plan to meet the average deferral percentage test.[5] Vanguard's analysis of 2009 activity of 600 plans and 1.3 million workers reveals that participants earning between $30,000 and $50,000 deferred an average 5.7 percent of salary into a 401(k) type plan, compared to 6.8 percent for all participants.[6]

All tax qualified private sector employer-provided retirement plans, including 401(k), profit sharing, and defined benefit pension plans, must meet broad coverage and nondiscrimination rules that guarantee that the plans are offered to rank and file workers and that benefits are fairly provided. The top-heavy rules that impact small businesses add a second layer of onerous vesting and contribution requirements if 60 percent of plan assets are held by key employees — a very common occurrence in small employer plans. As an additional incentive for lower-paid workers, the Saver's Credit provides a nonrefundable matching income tax credit based on retirement plan contributions.

The tax treatment of employer-provided retirement plans should not be judged by an income distribution analysis but on its effectiveness in providing retirement benefits to working families. In that regard, the evidence is overwhelming that the existence of an employer-provided retirement plan is the preeminent criteria in determining the retirement security of American workers. The Congress Research Service recently reported that in 2007 only 2.6 percent of taxpayers with adjusted gross incomes between $25,000 and $50,000 contributed to a traditional IRA.[7] In comparison, my analysis of the Employee Benefit Research Institute's study of the March 2010 Current Population Survey (for 2009) reveals that 53.4 percent of private sector wage and salary workers age 21–64 earning between $20,000 and $50,000 worked for an employer or union that sponsors a retirement plan and 43.5 percent participated. For all workers (private sector and public) in the same category, 59.4 percent are covered and 50.6 percent participate.[8] While this is not an apples-to-apples comparison, in this analysis low- and moderately-paid workers are 19.5 times more likely to participate in an employer-provided retirement plan than contribute to a traditional IRA.



The implications for policymakers are clear. The current tax treatment, with its strict coverage and discrimination requirements, has resulted in broad-based employer-provided plans for low- and moderate-income workers. Low- and moderate-income workers are exceedingly more likely to accumulate and retain retirement assets if they are offered a retirement plan at work. Employers add immeasurable value to these plans by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making very significant employer contributions, providing financial education, and encouraging and facilitating savings through payroll deductions. Eliminating or diminishing the current tax treatment of employer-provided retirement plans will jeopardize the retirement security of tens of millions of American workers, dramatically reduce retirement assets in capital markets, and create new and ominous government challenges in maintaining the quality of life for future generations of retirees.

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[1] *The U.S. Retirement Market, Second Quarter 2010,* Investment Company Institute, October 2010

[2] *Employee Benefits in the United States*, Bureau of Labor Statistics News Release, July 27, 2010.

[3] *Private Pension Plan Bulletin, Abstract of 2007 Form 5500 Annual Reports*, U.S. Department of Labor Employee Benefits Security Administration, January 2010.

[4] Testimony by Jack VanDerhei, EBRI research director, before the Senate Health, Education, Labor and Pensions Committee, on "The Wobbly Stool: Retirement (In)security in America" (T-166), October 7, 2010.

[5] *53rd Annual Survey Reflecting 2009 Plan Experience*, Profit Sharing/401k Council of America.

[6] *How America Saves 2010 — A Report on Vanguard Defined Contribution Plan Data*, Vanguard, July 2010.

[7] *Ownership of Individual Retirement Accounts (IRAs) and Policy Options for Congress*, Congressional Research Service, November 5, 2010.

[8] *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2009,* Employee Benefit Research Institute Issue Brief 348, October 2010.