AMERICAN RETIREMENT ASSOCIATION
Working for America's Retirement

4245 North Fairfax Drive | Suite 750 | Arlington, VA 22203 • P. 703.516.9300 • F. 703.516.9308

Testimony Submitted by Judy A. Miller
On behalf of the
American Retirement Association

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Corporate Integration
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The American Retirement Association ("ARA") thanks Chairman Hatch, Ranking Member Wyden, and the other members of the Senate Finance Committee for the opportunity to testify regarding the impact of corporate integration on small business qualified retirement plans.

The ARA is an organization of more than 20,000 members nationwide who provide consulting and administrative services to retirement plans that cover millions of American workers and retirees. ARA members are a diverse group of retirement plan professionals of all disciplines, including financial advisers, consultants, administrators, actuaries, accountants, and attorneys. The ARA is the coordinating entity for its four underlying affiliate organizations, the American Society of Pension Professionals and Actuaries ("ASPPA"), the National Association of Plan Advisors ("NAPA"), the National Tax-deferred Savings Association ("NTSA") and the ASPPA College of Pension Actuaries ("ACOPA"). ARA members are diverse but united in a common dedication to America's private retirement system.

A workplace retirement plan is the single most important factor that determines whether or not workers accumulate significant savings for retirement. Data from the Employee Benefits Research Institute shows that workers earning between $30,000 and $50,000 per year are *fifteen times* more likely to save at work than to go out and set up an IRA to save on their own. Because moderate income earners almost exclusively save at work through plans like the 401(k) – the most widely known section of the tax code – it is not surprising that Internal Revenue Service data shows that nearly 80% of participants in 401(k) and other profit sharing plans make less than $100,000 per year, and 43% of participants in these plans make less than $50,000 per year. Simply stated, saving at work, works. That is why it is so critical that businesses, especially small businesses, be encouraged to maintain workplace retirement plans.

The tax incentives for employer-sponsored plans in place today do an efficient and effective job in allowing Americans across the income spectrum to build a secure retirement. These incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Nondiscrimination rules combined with compensation and contribution limits assure that non-highly compensated employees also benefit from these programs. Proposals such as corporate integration that would reduce the incentives for small business owners to save for themselves through a qualified retirement plan will discourage the establishment and maintenance of these retirement plans, and so reduce the availability of workplace retirement savings.

Background

<u>What are the current tax incentives?</u>

Employer contributions made to qualified retirement plans are deductible to the employer when made. Income tax on investment earnings on those contributions is deferred until amounts are distributed from the plan. When a distribution is made to a plan participant, all amounts are subject to ordinary income tax. Employer contributions made on a participant's behalf are not subject to FICA. In addition, individuals with adjusted gross income ("AGI") of less than $30,750, and married couples with AGI of less than $61,500, may qualify for a Saver's Credit ranging from 10% to 50% of the first $2,000 the individual contributes to an IRA or employer-sponsored defined contribution plan.

Limits are placed on contributions to defined contribution plans, and on benefits payable from defined benefit plans:

- Certain defined contribution plans permit employees to contribute on their own behalf by electing to have a certain dollar amount or percentage of compensation withheld from pay and deposited to the plan. These "elective deferrals" are excludable from income for income tax purposes, but FICA is paid on the amounts by both the employer and the employee. For 2016, the maximum elective deferral to a 401(k) or similar plan is $18,000. Employees age 50 or over can also make a "catch-up contribution" of up to $6,000. Elective deferrals to a SIMPLE plan are limited to $12,500, plus a $3,000 catch-up contribution for those age 50 or over.

- If the employer also contributes to a defined contribution plan (such as a 401(k) plan), the maximum contribution for any employee is $53,000. This limit includes any elective deferrals other than catch-up contributions. This means a participant that is age 50 or over, and who makes the full $6,000 catch-up contribution, would have a total limit of $59,000.

- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year's pay or $210,000. If retirement is before age 62, the dollar limit is reduced. Employers can deduct the amount required to fund promised benefits.

- Annual IRA contributions are limited to $5,500, plus "catch-up" contributions of $1,000 for those age 50 or over.

Compensation in excess of $265,000 cannot be considered in calculating contributions or in applying nondiscrimination rules under either defined benefit or defined contribution plans. For example, if a business owner makes $400,000, and the plan provides a dollar for dollar match on the first 3% of pay the participant elects to contribute to the plan, the match for the owner is 3% of $265,000, not 3% of $400,000.

What are the Current Nondiscrimination Rules?

The higher contribution limits for qualified retirement plans – both defined contribution and defined benefit plans – come with coverage and non-discrimination requirements. For example, a small business owner with several employees cannot simply put in a defined contribution plan and contribute $53,000 to his or her account. Other employees who have attained age 21 and completed 1 year of service with at least 1000 hours of work must be taken into consideration, and the employer must be able to demonstrate that benefits provided under the plan do not discriminate in favor of "Highly Compensated Employees" ("HCEs"), which would include the owner.

Generally, contributions or benefits that are proportionate to an individual's compensation are considered fair. Age can also be considered when determining the amount of contributions that can be made on a participant's behalf. A larger contribution (as a percentage of pay) can be made for older employees because the contribution will have less time to earn investment income before the worker reaches retirement age (usually age 65). Safe harbors are also available. For example, if all employees covered by a 401(k) plan are provided with a contribution of 3% of pay that is fully vested, the HCE can make the maximum elective deferral, regardless of how much other employees choose to contribute on their own behalf.

These nondiscrimination rules, coupled with the limit on compensation that can be considered under these arrangements, are designed to insure that qualified employer-sponsored retirement plans do not discriminate in favor of HCEs. *Non-discrimination rules do not apply to other forms of tax-favored retirement savings.* For example:

- IRAs share the incentive of tax deferral. However, if a small business owner makes a personal contribution to an IRA, there is no corresponding obligation to contribute to other employees' IRAs. However, under the current rules, the contribution limit for IRAs is set low enough (and the limit for employer-sponsored plans high enough) to make a qualified retirement plan attractive to a business owner who can afford it.

- Annuities purchased outside of a qualified plan share the benefit of "inside buildup" - the deferral of income tax on investment earnings until distributed from the arrangement – but have no limit on contributions or benefits, and no non-discrimination requirements.

This means the attraction of a qualified retirement plan for a small business owner is heavily dependent on the interaction of non-discrimination rules and the tax incentives for saving through a qualified retirement plan.

Corporate Integration

For purposes of this discussion, we consider a corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities. Taxpayers with a marginal tax rate of less than 35% would not be able to recover any portion of the withholding.

How would corporate integration affect the tax incentives for qualified retirement plans?

The tax incentive for saving through a qualified retirement plan is the deferral of income tax on the contributions made to the plan, and on investment earnings on those contributions, for so long as the funds are held in trust by the plan. Distributions from the plan are then included in ordinary income when payments are made from the plan, usually when the plan participant has retired. Corporate integration would result in taxation of dividends and interest earned by the plan's investments while held in the plan, with the contributions and remaining investment earnings taxed again when the amounts are withdrawn from the plan. The result would be a substantial reduction in the tax incentive to save through a qualified retirement plan relative to current law.

For example, consider a small business owner with $10,000 to contribute to a traditional account in a 401(k) plan. Assume the contribution earns a 5% annual rate of investment return. The initial investment is 50% stocks and 50% bonds, with dividends and interest reinvested in the same type of security. Under current law, the contribution and investment earnings will accumulate tax free until the employee terminates employment and begins to withdraw the account balance. If the accumulation period is 10 years, the account balance attributable to that contribution will have grown to $16,289. In 20 years, the balance would be $26,533. Income tax will be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be $11,728 after 10 years and $19,104 after 20 years.

If the business owner chose not to contribute the $10,000 to the 401(k) plan, but invested the after-tax amount outside of a plan, the initial investment would be $7,200 ($10,000 less $2,800 income tax). Dividends received would be taxed at a 15% rate, and interest at 28%, so the net rate of return on stocks would be 4.25%, and 3.6% on bonds. The balance after 10 years would be $10,586, which is $1,142 less than the after-tax 401(k) plan amount. The balance after 20 years would be $15,579, which is $3,535 less than the after-tax amount from the 401(k) plan after 20 years. In other words, assuming 5% rates of return, the business owner would gain 22.6% over 20 years by investing in the 401(k) plan.

Now assume a corporate integration proposal with mandatory 35% withholding is adopted. Instead of earning 5% per year, net investment return on the amount invested in the 401(k) plan is only 3.25% (65% of 5%). After 10 years with 3.25% rates of return, the $10,000 contribution would accumulate to $13,769. After 20 years, the balance would be $18,958. Income tax will still be paid upon withdrawal. Assuming a marginal rate of 28%, the after-tax balance attributable to that contribution would be $9,914 after 10 years and $13,650 after 20 years.

In other words, corporate integration will have reduced the value of a retirement contribution by 15% after 10 years, and 27% after 20 years. In fact, *corporate integration without recovery of amounts withheld on dividends and interest paid to a qualified retirement plan's trust effectively eliminates the tax incentive for saving through a qualified retirement plan to the extent investment earnings are attributable to dividends and interest.* Assume the $10,000 is not contributed to a 401(k) plan. Income tax at the 28% rate would be paid on that amount, leaving $7,200 to be invested. After 10 years with a net investment earnings rate of 3.25%, the $7,200 would accumulate to $9,914 – the same as the after-tax accumulation in the 401(k) plan. After 20 years, the accumulation outside the plan would be $13,650 – same as the 401(k) plan. Amounts invested outside of a qualified retirement plan are not subject to the restriction for accessing monies in a 401(k) or similar account, so without the tax incentive, investing outside of the 401(k) plan could be more attractive than contributing to the plan.

In theory, with corporate integration dividends could be grossed up to reflect that the corporation no longer has to pay income tax on the dividends. If that were true, the net dividend paid with corporate integration would equal amount of dividend that would have been paid under current law. Assuming this is true, the accumulated balance attributable to the $10,000 contribution to the 401(k) plan would be $15,029 after 10 years and $22,746 after 20 years. Assuming a 28% rate, the after-tax amounts would be $10,821 and $16,377 respectively. The reduction in the value of the contribution as compared to current law would be 7% after 10 years and 14% after 20 years. However, *the tax incentive for saving through a 401(k) plan instead of outside of the plan would still be eliminated.* An investment of $7,200 outside of the plan would also yield $10,821 after 10 years and $16,377 after 20 years.

For simplicity, these examples assume all investment earnings are comprised of interest and dividends on domestic securities. To the extent investment earnings include capital gains, the impact would be lessened.

How would the reduced tax incentive affect small business retirement plans?

The current tax incentives play a critical role in encouraging small business owners to establish and maintain a qualified retirement plan. Because of the nondiscrimination rules, a business owner can only save through the plan if other employees are also benefitting. As a result, a decision to establish and maintain a plan such as a 401(k) plan not only involves taking on fiduciary responsibilities and administrative costs, but often the cost of making contributions for the non-highly compensated employees who participate in the plan. For example, very small employers are often "top heavy", and are required to make contributions of 3% of pay for all eligible non-key employees – whether or not the employees contribute on their own behalf. Other small business owners contribute 3% of pay to satisfy a 401(k) nondiscrimination testing safe harbor. Still others contribute 5% of more to be eligible to apply other nondiscrimination testing approaches. The cost of these contributions can be significant, and the availability of the tax incentives to offset all or part of the cost is critical to the decision to maintain a qualified retirement plan.

Consider the following situation:

> ABC Company has been in operation for 5 years. The owner has some retirement savings in an IRA, but has never taken time to think about retirement. The business has five other employees earning from $35,000 to $75,000, with total payroll of $300,000. The owner takes compensation of $10,000 per month during the year, then takes a year-end bonus of the amount of company profits, which amount to $65,000 for the current year. The owner will pay individual income taxes on the full amount of the profits at a marginal rate of 28%, leaving $46,800 after paying taxes in the amount of $18,200.
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> Before taking the bonus, the owner meets with a retirement plan consultant. The owner is older than most of the other workers, so the consultant recommends a safe harbor 401(k) plan with an additional "cross-tested" contribution. With this type of plan the owner could contribute $50,000 of the profits to the plan on her own behalf. Thanks to the nondiscrimination rules that apply to qualified retirement plans, putting $50,000 of the profits into the 401(k) plan for the owner means the owner must contribute at least 5% of pay for the employees, which is $15,000. So, instead of taking home $46,800 and sending IRS a check for $18,200, the owner will contribute $50,000 to the plan on her own behalf and $15,000 for the employees. A tax credit for the cost of setting up and operating a new plan will help defray any startup and initial operating costs.
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> Under current law, the arrangement makes sense for the small business owner. Instead of sending a check to IRS, she can make a contribution of $15,000 for her employees. The deferral of tax on investment earnings means the amount the owner will have accumulated in after-tax savings in 20 years is similar to what she would have if she paid taxes now on the $65,000, and invested the remainder outside of the qualified plan. If the owner is in the 28% tax bracket at retirement, she will have about $10,000 less from the plan than if she saved outside of the plan, but if she is in a lower tax bracket, she will come out ahead because she chose to set up and contribute to the plan. In short, both the owner and the employees are on the road toward a secure retirement.

How would this scenario change with corporate integration? The deduction for the contribution would still largely cover the costs of the contribution, but the longer term view would lead to a very different conversation. The owner would be advised that if she just paid tax on the $65,000 now and invested the difference without setting up a plan, she would end up with significantly more savings 20 years from now than if she put in the plan, *even if she is down to a 15% marginal rate in retirement.* She would also have more flexibility by holding those savings outside of a qualified plan. If she put the money in a 401(k) plan and needed it before she reached retirement age, she would have to prove hardship, or even go through the formal process of terminating the plan, in order to get to her account. She would also have to pay a 10% penalty if she chose to withdraw it before retirement, death or disability. *In other words, with corporate integration the owner would have less expense, less liability, more flexibility and more long term savings by just saying "no" to setting up a 401(k) plan.*

The following table summarizes the 20-year projections of the value of the owner's contributions based on both 28% and 15% marginal rates at retirement. For purposes of this illustration, it was assumed that with corporate integration, dividends would be increased to absorb the 35% mandatory withholding. *Note that if the owner is in the 28% bracket at retirement, under the proposal she could increase her savings by 30% by not sponsoring a 401(k) plan.*

Figure 1

			Net amount with marginal rate at retirement of	
	Invested Amount	20-year balance	28%	15%
Current law				
401(k) Plan	$50,000	$132,665	$ 95,520	$112,765
Nonqualified acct	$46,800	$101,264	$101,264	$101,264
Proposal				
401(k) Plan	$50,000	$113,728	$ 81,884	$ 96,670
Nonqualified acct	$46,800	$106,450	$106,450	$106,450

The loss of deferral of income tax on dividends and interest with corporate integration would significantly reduce, and for more conservative investors even eliminate, the tax incentive for saving through a qualified retirement plan. Given the costs and obligations that come with sponsoring a qualified retirement plan, the result would be a reduction in the number of plans sponsored by small businesses, and a loss of coverage, and retirement security, for small business employees.

Small business employees would not be the only ones to suffer, however. The lack of deferral of income tax on dividends and interest will reduce the account balances of any participant whose account is invested in an asset that pays interest (or dividends to the extent dividends payable on the investments held by the plan do not increase sufficiently to cover the withholding), and do serious harm to the retirement security of American workers.

Summary

Access to a retirement plan at work is the key to successfully preparing for retirement. Reducing the tax incentives to save through a qualified retirement plan will discourage small business owners from establishing and maintaining qualified retirement plans, and so reduce the availability of workplace savings. A corporate integration proposal under which mandatory 35% withholding would apply to dividends and interest paid on all domestic stocks and bonds, regardless of the tax status of the holder of the securities, including securities held in qualified retirement plans would substantially reduce the tax incentives for these plans, and so discourage plan formation and maintenance.

We thank you for the opportunity to submit these comments. The ARA would be pleased to work with this Committee to assure the tax incentives for qualified retirement plans are maintained or enhanced as this or other proposals move forward.