401K Specialist

# Are Retirement Plans In Tax Reform Crosshairs?

Terry Dunne

June 22, 2017

Two words may have a profound effect on the retirement industry in coming years: revenue neutrality.

A goal of most tax reform in the U.S. is revenue neutrality. Under the theory of revenue neutrality, tax legislation overall should neither increase federal tax revenue nor increase future federal budget deficits. In its 2017 Tax Policy Outlook, PwC explained the preferred approach today:

"…both President Trump and Congressional tax policymakers have proposed to offset most of the projected revenue loss associated with lowering business and individual tax rates by broadening the tax base to reduce or eliminate certain 'tax expenditures.'"

It notes the Joint Committee on Taxation staff defines expenditures as "revenue losses attributable to the provisions of federal laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

The JCT's January 2017 list of estimated tax expenditures was cause for concern among retirement professionals and legislators who believe improving retirement outcomes is a top national priority.

It indicated that eliminating the tax-favored treatment of qualified workplace retirement plans could generate about $1.1 trillion over five years, and changing the tax treatment of Traditional and Roth IRAs could generate an additional $130 billion over the same period.

It's impossible to know exactly how tax reform may affect qualified retirement plans as a definitive tax bill has yet to be drafted.

However, several proposals have been put forth in recent years that may provide insight into potential outcomes. Here are three options discussed thus far:

January 2017: CBO proposal to limit annual contributions

A January 2017 Congressional Budget Office (CBO) report proposed further limiting annual contributions to retirement plans, "…to $16,000 per year for 401(k)-type plans and $5,000 per year for IRAs, regardless of the person's age. The option would also require that all contributions to employment-based plans— including 457(b) plans—be subject to a single combined limit.

"Total allowable employer and employee contributions to a defined contribution plan would be reduced from $53,000 per year to $47,000. Finally, conversions of traditional IRAs to Roth IRAs would not be permitted for taxpayers whose income is above the top threshold for making Roth contributions."

While the CBO states this option will improve fairness by reducing "the disparity in tax benefits that exists between higher- and lower-income taxpayers," it also recognized the option could cause some lower- and moderate-income taxpayers to save less for retirement. CBO estimates suggested the change could increase revenue by about $92 billion over 10 years.

House of Representatives: A 'Better' Way

The June 2016 tax plan proposed by Speaker Paul Ryan and the House of Representatives would continue current tax incentives for savings while the House Committee on Ways and Means works "to consolidate and reform the multiple different retirement savings provisions in the current tax code to provide effective and efficient incentives for savings and investment."

The savings alternate vehicles under consideration include Universal Savings Accounts (USAs), which are similar to Roth IRAs. Legislation put forth by Senator Jeff Flake of Arizona (S. 323) and Representative Dave Brat of Virginia (H.R. 4094) would give anyone, age 18 or older, an opportunity to contribute up to $5,500 a year, after-tax, to USAs and have any earnings grow tax-free.

Account owners could withdraw both contributions and earnings at any time, for any reason, without penalty.

While current legislation suggests that USAs supplement existing retirement savings vehicles, there has been some discussion of streamlining the options available. On May 1, 2017, a CATO Institute Tax and Budget Bulletin stated,

"The Flake-Brat legislation proposes USAs as an additional vehicle alongside existing saving plans. However, a goal of current Republican tax reform efforts is simplification. As such, policymakers should consider replacing a number of savings vehicles with large USAs. We suggest creating USAs with an annual contribution limit of $10,000 or more, combined with the elimination of traditional IRAs, Roth IRAs, and Coverdell Education Savings Accounts (ESAs)."

While this approach may appeal to younger people, one of the primary drawbacks of is that USAs do not have any of the protections ERISA provides to people saving in qualified retirement plans. Also, there are no assurances that money saved in these accounts will be available for retirement since there are no penalties for withdrawals.

Tax Reform Act of 2014

In 2014, House Ways and Means Committee Chairman David Camp put forth a comprehensive tax overhaul proposal that was not passed into law. The discussion draft included many provisions – such as eliminating income limits on contributions to Roth IRAs, terminating new SEP and SIMPLE plans, and modifying rules regarding qualified plan distributions—that affected workplace retirement plans and IRAs.

In all, the provisions were projected to generate about $228 billion in new tax revenue from 2014 through 2023. However, just three changes accounted for the clear majority of revenue:

- 50/50 contributions: Companies with 100 or more employees that offered 401(k), 403(b), and 457 plans would be required to offer Roth accounts. One-half of allowable annual elective contributions could be made to traditional accounts, and the remainder would go into Roth accounts. The change was projected to generate $144 billion in revenue.
- Freeze COLA: Inflation adjustments for regular and catch-up contributions to SEPs, SIMPLE IRAs, and defined contribution plans (including 401(k), 403(b), and 457 plans) would be suspended until 2024. The change was projected to generate $63 billion in revenue.
- Eliminate Traditional IRAs: "New contributions to Traditional IRAs and non-deductible Traditional IRAs would be prohibited." The change was projected to generate $15 billion in revenue.

Some industry professionals worry that shifting from traditional contributions to Roth contributions could have a negative effect on retirement outcomes. The Employee Benefit Research Institute (EBRI)'s 2011 Retirement Confidence Survey supports those concerns. The vast majority of survey participants—across income groups—indicated that current tax deductibility was an important factor in their savings decisions.

In testimony before the House Ways and Means Committee, EBRI research director Jack VanDerhei, testified:

"EBRI studies have documented that defined contribution plans (and the IRA rollovers they produce) are the component of retirement security that appears to be generating the most non-Social Security retirement wealth for Baby Boomers and Gen Xers. However, the potential increase of at-risk percentages resulting from (1) employer modifications to existing plans, and (2) a substantial portion of low-income households decreasing or eliminating future contributions to savings plans as a reaction to the exclusion of employee contributions for retirement savings plans from taxable income, needs to be analyzed carefully when considering the overall impact of such proposals."

While the prospect of a vastly simplified tax code in the United States is appealing to some individuals and businesses alike, legislators should exercise caution when considering the best course of action for qualified retirement plans.

Louis XIV's finance minister Jean-Baptiste Colbert once wrote, "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."

Impairing the retirement prospects of Americans may result in a lot of hissing.