JOINT COMMITTEE ON TAXATION
January 28, 2016
JCX-4-16

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FINANCE HEARING ON HELPING AMERICANS PREPARE FOR RETIREMENT: INCREASING ACCESS, PARTICIPATION AND COVERAGE IN RETIREMENT SAVINGS PLANS[1]

JANUARY 28, 2016

My name is Thomas A. Barthold. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning retirement saving.

Tax subsidies for retirement savings are designed to encourage employers to offer retirement plans to their employees and to encourage individuals to contribute to plans available in the workplace, as well as to IRAs. These subsidies have led to the widespread availability of employer-sponsored retirement plans and to the accumulation of significant amounts in those plans and in IRAs.

Nonetheless, concern about the adequacy of savings to provide income security during retirement is a frequent topic of public discussion and of congressional attention. Costs associated with sponsoring a retirement plan may discourage some employers, particularly small employers, from establishing a plan. In addition, even employees with access to a workplace plan may not take full advantage of it, and savings intended for retirement may be used for other purposes (referred to as "leakage") and not replaced.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Finance Hearing on Helping Americans Prepare for Retirement: Increasing Access, Participation and Coverage in Retirement Savings Plans* (JCX-4-16), January 28, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

The Joint Committee staff has prepared a detailed review[2] of –

- Present law related to employer-sponsored tax-favored retirement plans and individual retirement arrangements;
- Economic issues relating to retirement plans;
- Data relating to retirement savings; and
- Summaries of selected legislative proposals relating to tax-favored retirement savings.

In connection with the work last year of the bipartisan Finance Committee Tax Working Groups, the report issued by the Savings & Investment Working Group focused on the area of private retirement savings and identified three key goals for policy makers: (1) increasing access to tax-deferred retirement savings; (2) increasing participation and levels of savings; and (3) discouraging leakage while promoting lifetime income.[3]

In the slides that follow I review those goals identified by the Working Group report and review various legislative proposals relating to each of those goals.

[2] Joint Committee on Taxation, *Present Law and Background Relating to Tax-Favored Retirement Saving and Certain Related Legislative Proposals* (JCX-3-16), January 26, 2016.

[3] The Working Group report is available at http://www.finance.senate.gov/imo/media/doc/The%20Savings%20&%20Investment%20Bipartisan%20Tax%20Working%20Group%20Report.pdf.

Employer-Sponsored Tax-Favored Defined Contribution Plans

- Defined Contribution Plans
  - Benefits based on individual accounts for employees, consisting of employer and employee contributions and earnings
  - Employee benefits from investment gain and bears risk of investment loss
- Types of Defined Contribution Plans
  - Qualified retirement plans, including section 401(k) plans
  - Section 403(b) plans for charities and public schools
  - Section 457(b) plans for State and local governments

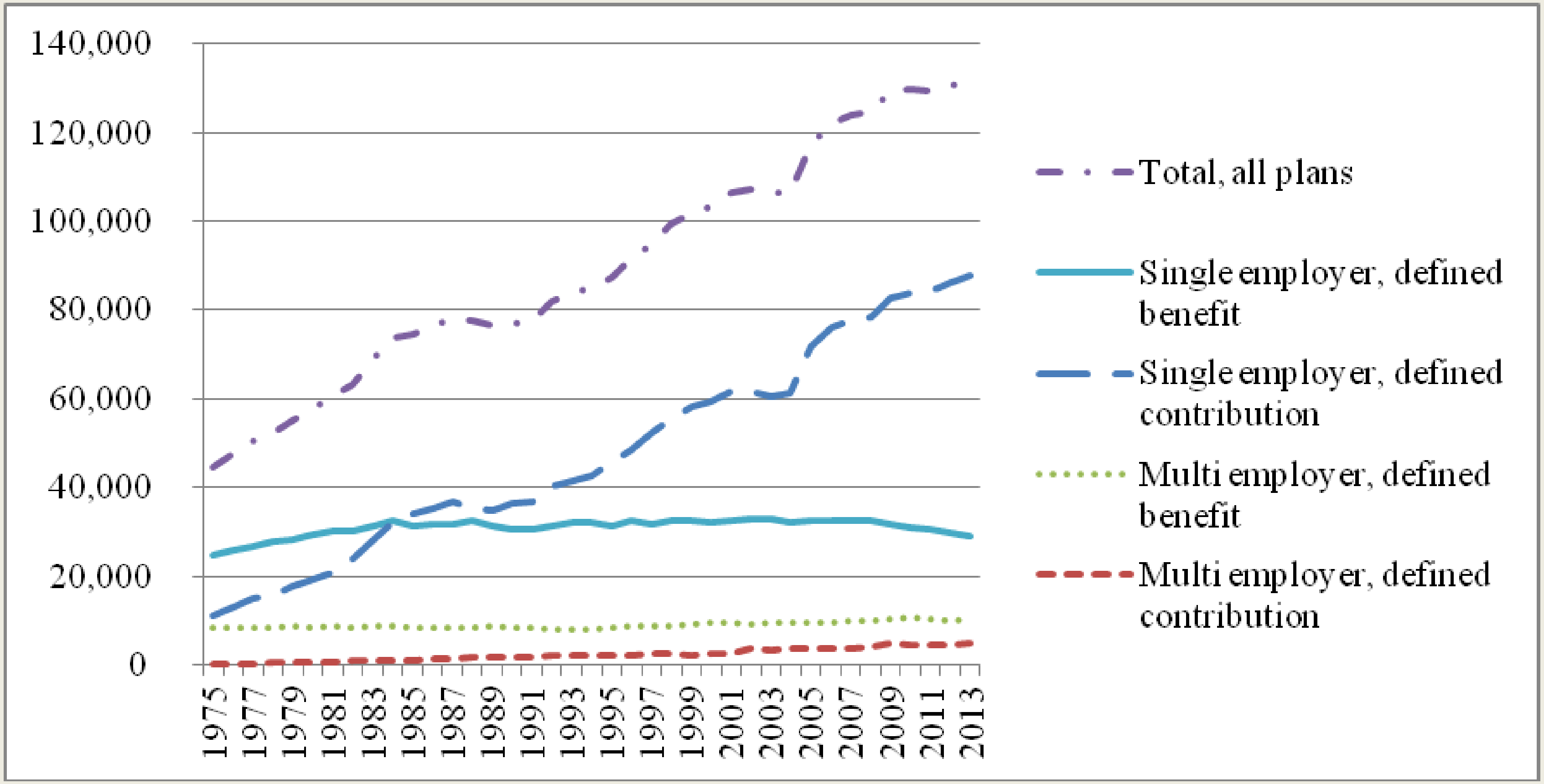
Employer-Sponsored Tax-Favored Defined Contribution Plans (cont'd)

- Types of contributions to defined contribution plans
  - Employee elective deferrals
    - Employee elects plan contribution in lieu of taxable current pay
    - "Automatic enrollment" - deferrals begin automatically at a specified default rate unless the employee elects out or elects a different rate
    - Employee deferrals may be pretax ("traditional") or after-tax Roth
  - Matching employer contributions
    - Contribution must be conditioned on employee making an elective deferral (traditional or Roth) or can be conditioned on after-tax employee contributions
  - Nonelective employer contributions
    - Employer decides the amount of the contribution, not based on employee contribution
  - After-tax employee contributions – generally elective, not a common plan feature

Individual Retirement Arrangements (IRAs)

- Individual savings vehicles rather than employer-sponsored
- Account-based arrangements, like defined contribution plans
- Individual benefits from investment gain and bears risk of investment loss
- Some employer-sponsored plans funded using IRAs
  - Simplified employee pension (“SEP”) plan
  - SIMPLE IRA plan

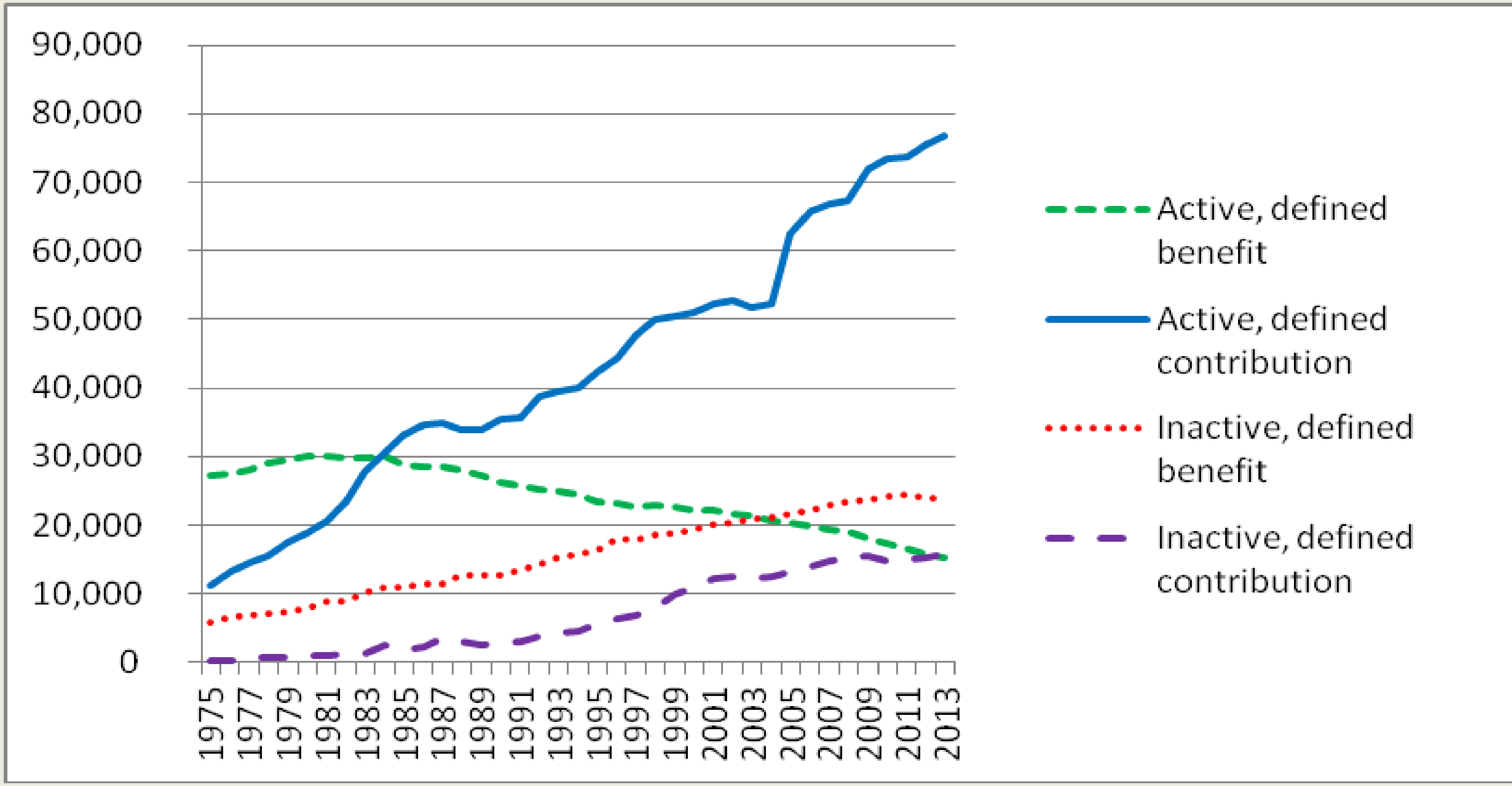
Private Sector Plan Participants by Type of Plan 1975-2013 (thousands)



Source: Form 5500 filings with the U.S. Department of Labor.

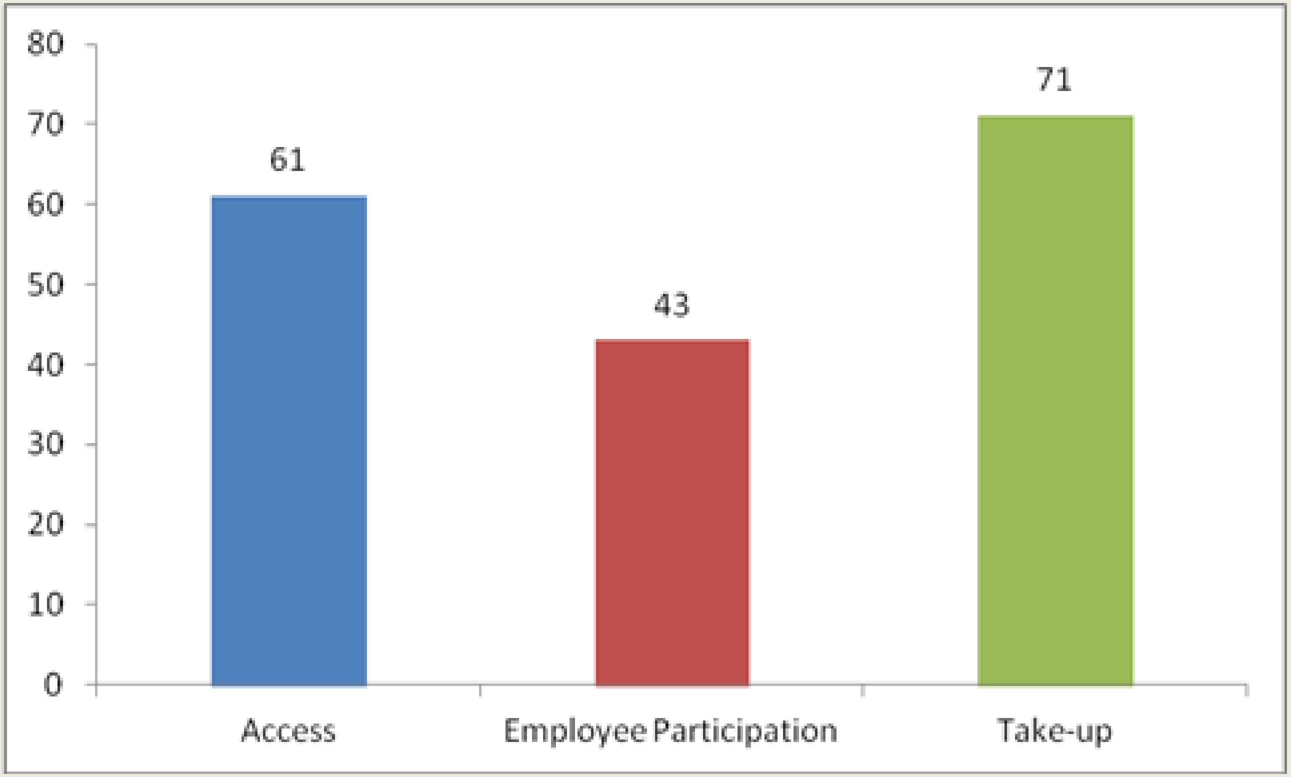
Note: The term "Participants" refers to active, retired, and separated vested participants not yet in pay status. The number of participants also includes double counting of workers in more than one plan. For Form 5500 Short Form filers, this number may also include deceased participants whose beneficiaries are receiving or are entitled to receive benefits. Excludes plans covering only one participant.

Private Sector Plan Participants by Active or Inactive Status and Type of Plan 1975-2013 (thousands)



Source: Form 5500 Filings with the U.S. Department of Labor.

Access, Employee Participation, and Take-up Rates for Defined Contribution Plans in the Private Sector (percentage)



Source: Bureau of Labor Statistics, National Compensation Survey Data, 2015.
Note: All workers=100 percent

Impediments to Retirement Saving

- Lack of access to workplace plans; costs associated with sponsoring a retirement plan may discourage some employers, particularly small employers, from establishing a plan
- Plan may cover only some employees and low participation rates (no contributions or insufficient contributions) by employees who are covered
- Use of savings before retirement without replacement by rollovers or additional contributions ("leakage") and lack of "lifetime income" options

Tax-Favored Retirement Savings – Key Policy Goals*

- Increasing access to retirement plans
- Increasing participation and contribution levels
- Discouraging leakage and promoting lifetime income

*These policy goals and the legislative proposals herein were discussed in the report issued in July 2015 by the bipartisan Finance Committee Tax Working Group Savings & Investment, available at http://www.finance.senate.gov/imo/media/doc/The%20Savings%20&%20Investment%20Bipartisan%20Tax%20Working%20Group%20Report.pdf.

Increasing Access to Plans: Multiple-Employer Plans

- Present-law multiple-employer plans
  - A multiple-employer plan is a single plan maintained for employees of unrelated employers; offers opportunity for centralized administration and lower costs
  - Common interest requirement
    - DOL indicates participating employers must share some connection (sometimes referred to as a common interest). Otherwise, the arrangement is treated as a collection of plans, each covering the employees of a particular employer.
    - The common interests are "*genuine economic or representational interests unrelated to the provision of benefits . . .*"
  - Violation with respect to one employer ("one bad apple")
    - A violation of Code requirements with respect to one employer (such as failure to cover a nondiscriminatory group of that employer's employees) may cause disqualification of entire plan
    - ERISA violation with respect to part of plan could create ERISA liability for all employers

Increasing Access to Plans: Multiple-Employer Plans (cont'd)

- Proposals on multiple-employer (or "pooled employer") plans – S.1270, sec. 207; S.1970, secs. 2-3; S.1979, secs. 201-202
  - No common interest among participating employers required; limited to defined contribution plans
  - "Designated plan provider" (S.1270) or "pooled plan provider" (S. 1979)
    - Professional service provider designated under the terms of the plan to perform all administrative duties reasonably necessary to ensure that plan meets qualification requirements and each participating employer meets its responsibilities.
    - Provider required to register with IRS or DOL and subject to credentialing/oversight.
    - May have fiduciary liability to the extent not delegated under the proposal to a participating employer.
  - Solution for "one bad apple"
    - Each employer bears fiduciary responsibility for the selection and monitoring of the pooled plan provider and for the investment of assets attributable to the employer's employees if not delegated to another fiduciary, but not for plan assets as a whole.
    - The failure of a Code requirement with respect to the portion of the plan covering employees of a particular employer causes disqualification of only that portion of the plan, which may be spun off from the plan.

Increasing Access to Plans: Start-up Costs

- Present-law credit for small employer pension plan start-up costs
  - Nonrefundable tax credit for administrative costs of a small employer for adopting/administering a new qualified retirement plan, SIMPLE IRA plan, or SEP
  - Credit limited to lesser of $500 per year or 50% of qualified start-up costs and only allowed for 3 years
  - Plan must cover at least one lower-paid employee
  - Small employer – no more than 100 employees
  - No requirement to continue plan (or continue at same level) in post-credit period
  - To date, take up for this credit has been very weak. Total value of the credit is often in the range of half a million dollars annually.

Increasing Access to Plans: Start-up Costs (cont'd)

- Proposals to expand the present-law credit for plan start-up costs
  - S. 1270, sec. 202 – Retains credit as 50% of costs, but increases maximum credit to the greater of $500 or lesser of (1) $250 x number of nonhigh participants or (2) $5,000
  - President's FY 2016 budget proposal – Qualified costs are expanded to include employer contributions and maximum credit is increased to $1,500 ($2,000 if new plan includes automatic enrollment); credit of $500 for existing plan that adds automatic enrollment.

Increasing Access to Plans:

New 401(k) Automatic Enrollment Safe Harbors and Related Credit

- Existing automatic enrollment safe harbor for nondiscrimination testing
  - Present-law safe harbor requires default rate of not less than 3% but not more than 10% for first year, then requires escalation of minimum default rate to 4%, 5%, and 6% in subsequent years but not above 10%; 6% deferral needed for full required safe harbor employer match
  - Related safe harbor for matching contributions limits matches to 6%
- S.1270, sec. 220; S.1970, sec. 4 - Secure deferral arrangements
  - Requires automatic enrollment with higher default percentages (minimum default rate of between 6% and 10% for first year, increasing to 8% and 10% in subsequent years, with no maximum rate); 10% deferral needed for full required safe harbor employer match
  - Related safe harbor for matching contributions allows matches up to 10% (rather than 6% maximum under present law)
- Credit for small employer (up to 100 employees) maintaining a secure deferral arrangement
  - S.1270, sec. 220 - Credit for three years of 10% of the matching and nonelective contributions made for nonhighs, subject to an annual credit cap of $10,000
  - S.1970, sec. 5 – Credit for a nonhigh employee's first five years of participation for matching contributions up to 2% of compensation, with no annual credit cap

Increasing Participation and Contribution Levels: Coverage for Long-Term, Part-Time Workers

- Present-law minimum participation rules under the Code and ERISA allow employees to be excluded until earning a "year of service," generally 1,000 hours worked in a 12-month period, and reaching age 21. A parallel rule applies under section 401(k).
- Proposals require a 401(k) plan to allow "long-term part-time" employees to contribute to the plan – H.R. 2117, sec. 103; President's FY 2016 Budget Proposal
  - Long-term part-time defined as at least 500 hours of service annually for three years
  - Age 21 exclusion still permitted
  - Employer contributions not required, but, if made, years of service with at least 500 hours count towards vesting
  - Flexibility provided on how long-term part-time employees treated in nondiscrimination testing

Increasing Participation and Contribution Levels: Present-Law Saver's Credit

- A nonrefundable tax credit for eligible taxpayers who make elective deferrals (or voluntary after-tax contributions) to tax-favored retirement plans or contributions to IRAs
- Only contributions up to $2,000 taken into account
- Tax credit limited to a specified percentage (50%, 20%, or 10%) of contributions, depending on taxpayer's adjusted gross income (for 2016, ranging from $37,000 to $61,500 for joint filers; $18,500 to $30,750 for single)
- Tax credit is in addition to any deduction or exclusion for contributions
- Credit is available to individuals who are 18 or older, other than full-time students or individuals claimed as a dependent on another taxpayer's return
- Credit reduced for distributions from plans or IRAs during a specified period

Increasing Participation and Contribution Levels: Expansion of Saver's Credit

- H.R. 2117, sec. 105
  - Credit is 50% of eligible contributions up to $500 for each eligible individual with AGI not exceeding an indexed dollar amount (initially $65,000 for joint filers ($32,500 for single) with phase-out over next $20,000 ($10,000 single))
  - Credit refundable
  - Doubled (100% of contributions) if taxpayer agrees to have entire credit amount contributed directly to a tax-favored retirement plan
  - $500 contribution amount increases to $1,500 by 2023, indexed thereafter
  - Treated as a pretax contribution (taxable upon distribution), but does not count against contribution limits; treated as employer contribution for nondiscrimination purposes

Discouraging Leakage and Promoting Lifetime Income

- Sources of leakage
  - Exceptions to 10% early distribution tax for withdrawals for special purposes
  - Hardship withdrawals for immediate need for funds
  - Plan loans and inability to repay loan balance may diminish retirement funds
    - On termination of employment, plan terms may accelerate loan repayment and provide for offset of unpaid loan balance against employee's plan account (which includes loan note)
    - Regular 60-day rollover period may not provide sufficient time to restore funds

Discouraging Leakage and Promoting Lifetime Income: Plan Loan Not Repaid

- S. 606, secs. 2 and 4
- Proposal extends the time for rollover of plan loan offset amount until the due date for the return for the year in which the offset occurs
  - Plan loan offset amount - Account balance offset after acceleration of loan repayment under plan terms results in actual rather than deemed distribution
  - As an actual distribution, a plan loan offset amount can be an eligible rollover distribution
    - Under present law, only 60-day rollover available
    - Participant may not know loan offset date or be able to find money within 60 days to rollover
- No debit/credit card-type loans from plans
  - Prevents participant from using plan loans for daily regular purchases and the risk of incurring revolving debt that may not be fully repaid

Discouraging Leakage and Promoting Lifetime Income: Hardship Distributions

- S. 606, sec. 3; S. 1270, sec. 214
- No suspension of deferrals after hardship withdrawal
  - Present law requires a six-month suspension of new elective deferrals following a hardship distribution

Discouraging Leakage and Promoting Lifetime Income: Portability of Lifetime Income Investment

- Lifetime Income
  - Concept - benefits withdrawn in a form that provides payments for entire lifetime, regardless of longevity; includes annuities and other forms, such as structured installment payments
  - Defined benefit plans - must offer annuity benefits
  - Defined contribution plans and IRAs – annuity and other lifetime income options not common; when offered, a lifetime income product may be an investment option under the plan or lifetime income may be a distribution option when benefits commence

Discouraging Leakage and Promoting Lifetime Income: Portability of Lifetime Income Investment (cont'd)

- In order to preserve retirement savings for retirement, present law limits plan distributions before termination of employment ("in-service" distributions).
- If a lifetime income product is discontinued as an investment option under a plan, restrictions on in-service distributions may prevent transfer of the investment to another plan or IRA.
- Participant may be required to liquidate investment and reinvest in different option, losing benefit of lifetime income feature.
- S.1270, sec. 221; President's FY 2016 Budget
  - Allows in-service transfer to another retirement plan or IRA of lifetime income investment when investment options under a plan are changed