United States Senate Committee on Finance – Tax Working Group for Savings and Investment

Considerations for Tax Qualified Retirement Savings

April 14, 2015

As the Senate Finance Committee considers additional steps to help Americans save for retirement within the context of its work on comprehensive tax reform, the Principal Financial Group® is pleased to offer insight based on our work with thousands of small- and medium-sized business retirement plan clients and millions of their employees.

As a leading provider of retirement plans and a global investment management leader, the Principal Financial Group provides comments based on more than 70 years in the retirement industry and our experience with small- to medium-sized employers and their employees. We currently provide retirement services to more than 43,000 retirement plans and 4.2 million employee participants, including more than 38,000 retirement plans of small businesses[1] and their 1.6 million participants.

Our Defined Contribution System has been successful in helping millions of Americans save for retirement. On their own, DC plan assets now represent more than one-quarter of all U.S. retirement assets. When combined with estimated Individual Retirement Account assets, much of which originated from DC plans, these accounts represent more than half of all U.S. retirement assets.[2]

And while DC plans were impacted by the recession just as everything else in our economy, they have shown incredible resilience with participation rates, deferral rates and company contributions now being equal to or higher than they were before the recession. Nearly half of all plans have now adopted an automatic enrollment feature and more plan sponsors are defaulting participants at deferral rates higher than 3 percent. Over half of these plans automatically increase default deferral percentages in subsequent years.[3]

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[1] Retirement plans of small business defined as those with less than 500 participants.
[2] Defined Contribution Plan Participants' Activities, First Half 2013 (November 2013) – ICI Research Report.
[3] PSCA's 56th Annual Survey of Profit Sharing and 401(k) Plans.

But more can be done. We must find ways to enhance our current voluntary retirement system to provide even greater financial security to American workers in retirement. More Americans need access to worksite retirement plans. Those who do have access to plans need to save more. More near-retirees and retirees should consider securing guaranteed income from their account balances. In order to accomplish these goals, necessary enhancements must focus on expanding workplace retirement plan coverage to more Americans, increasing both participation and savings levels in these plans and encouraging plan sponsors to offer and participants to secure guaranteed income for their retirement.

Just as critical, current tax incentives for retirement programs should be preserved. The incentives are successfully encouraging Americans to save for retirement and employers to establish plans. Reducing or removing incentives would very likely decrease savings and reduce the number of employer-sponsored plans, which would have a detrimental impact on overall retirement security for Americans and the economy as a whole.

Current Retirement Tax Incentives Should Be Preserved

The Principal® knows from experience that retirement tax deferrals have been and continue to be a key incentive in helping millions of Americans save for retirement and are critical to improving retirement outcomes for Americans. Being able to show participants that a pre-tax deferral has a much less dramatic impact on their take-home pay than they expect is a critical—and often convincing—key message during the enrollment process and while encouraging annual increases.

Recent surveys validate that American workers strongly support current incentives and deeply oppose cuts:

- Forty-five percent of workers say they would stop or reduce contributions to worksite retirement plans if they could no longer do so on a pre-tax basis. [4]
- Lower income workers ($35,000 or less) would be much more likely to stop contributing if the tax incentives were removed. Twenty-four percent with incomes less than $35,000 said they would stop contributing compared to 11 percent for incomes of $35,000 to $74,000 and 17 percent of incomes over $75,000.[4]
- More than 80 percent of defined contribution-owning households view the immediate tax savings from their retirement plans as a big incentive to contribute, and 83 percent oppose reducing the amount that individuals can contribute. Even modest-income households making less than $30,000 opposed reductions (73 percent).[5]
- Nearly one-quarter of employers feel proposals that lower current tax deferrals on retirement savings (20/20 proposal or tax exclusion limitation) believe 40 percent or more of their employees would be likely to decrease or eliminate their plan contributions if enacted. [6]

[4] Employee Benefit Research Institute 2013 Retirement Confidence Survey.
[5] America's Commitment to Retirement Security: Investor Attitudes and Actions, ICI 2013.
[6] Attitudes of Employee Benefits Decision Makers Toward Retirement Tax Proposals, American Benefits Institute, December 2012

- One-third of employers would drop or consider dropping their plan if the 20/20 proposal or the tax exclusion limitation were enacted.[7]

Retirement plan tax deferrals are not tax forgiveness and the budgetary scoring process should be changed to account for future tax revenue. The current tax incentives for retirement savings have been mischaracterized as expenditures when in fact they are and will continue to be a revenue source for the government. The federal government eventually collects significant tax revenue on distributions from tax-deferred retirement savings. When workers withdraw money from their retirement accounts, they generally pay ordinary income taxes not only on the original savings but also on the potential accumulated, compounded earnings – earnings they wouldn't have if workers hadn't been incented to save in the first place. The return on this investment to the government is significant.

Our analysis of a typical, middle-income worker shows that over the course of a 40-year career, for every $1 of taxes deferred, the federal government collects at least $4 in tax revenue when the contributions and earnings are withdrawn[8] (see Appendix I).

With $12.6 trillion[9] currently saved in worksite retirement defined contribution plans and IRAs, the government will be collecting significant tax revenue for many years to come. Congress should consider changing the laws governing the budgetary scoring process to use more dynamic metrics when it comes to retirement tax deferrals to recognize this future stream of revenue.

Cutting tax incentives would harm middle to lower income workers and pre-retirees. Non-discrimination rules and safe harbors carefully balance the benefits in 401(k) plans between higher- and lower-paid workers, ensuring that benefits are very progressively distributed. As a result, the tax incentives for retirement savings flow overwhelmingly (89 percent) to taxpayers whose income is under $200,000[10].

Among the more than 4 million workers who participate in plans serviced by The Principal, 43 percent of those who saved the maximum tax deferred amount make less than $110,000 and two-thirds of them are age 50 or older. Reductions in tax incentives would have a negative impact on the very people Congress is trying to protect: **non-highly compensated workers** and **pre-retirees**.

As for Individual Retirement Accounts (IRAs), the vast majority of contributions to IRAs (95%) come from rollovers from employer-sponsored retirement plans[11]. Concerns regarding $1 million balances in IRAs should be tempered with the knowledge that this is likely the result of an entire career spent saving and

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[7] Attitudes of Employee Benefits Decision Makers Toward Retirement Tax Proposals, American Benefits Institute, December 2012

[6]Analysis by the Principal Financial Group. See Appendix I for assumptions used.

[9] Investment Company Institute news release, "Retirement Assets Total $23.0 Trillion in First Quarter 2014," June 25, 2014.

[10] *Estimated Benefits of Tax Expenditure Estimates for Defined Contribution Plan Participants and Retirees with Account Balances*, prepared for The American Society of Pension Professionals and Actuaries (ASPPA), 2011.

[11] 2013 Cerulli & Associates

investing in an employer-sponsored retirement plan, and that taxes will be paid on these balances at withdrawal.

As life expectancy and healthcare costs continue to rise, experts suggest that retirees need approximately 80 percent of their pre-retirement income in order to maintain the same standard of living in retirement. For many in middle management, this target is difficult to achieve by simply relying on qualified plans alone. Nonqualified deferred compensation serves an important role in assisting workers in their effort to reach an adequate level of retirement savings. A 2014 survey of our NQDC clients indicates average annual employee deferrals of $27,087 and average account balances of $153,696. These valuable employee plans not only bridge the retirement savings gap, but also serve as a critical employee retention tool for small and mid-size employers throughout the country. Nonqualified deferred compensation tends to be revenue neutral from a tax perspective, with employers unable to take deductions for compensation deferred into NQDC plans until the amounts are actually distributed to the participant.

Reducing retirement incentives means reducing sources of long term capital. Today, trillions of dollars from worksite retirement plans and IRAs are being invested in our capital markets and support the overall growth of our economy. Any changes made to restrict or lessen tax deferrals for retirement savings could have severe long-term implications. Specifically, in 2012 we estimate that approximately 33.4 percent of the value of the US stock market was attributed to contributions which came from DC plans and IRAs[12]. Reducing retirement incentives means reducing sources of long term capital, which ultimately means lower GDP growth rates at the very time that we need long term capital to support higher economic growth for all Americans.

Move Beyond Preserving the System to Enhancing the System

Congress can help expand financial security for Americans by building on the current employer-sponsored system. By removing barriers to new retirement plan formation and encouraging plan designs that increase participation and savings, Congress can help more Americans have access to retirement plans and encourage them to save more effectively.

The Principal recommends the following steps:

Simplify rules, plan designs and regulations to make it easier for employers to offer and plan sponsors to operate retirement plans. Survey results from the *Principal Financial Group Retirement Readiness Survey*[13] found nearly half of plan sponsors felt easing reporting requirements (47 percent) and compliance burdens (42 percent) would help with plan operations. More than half of plan sponsors (52 percent) said allowing all employees to defer up to Internal Revenue Service limits would make it easier for employers to operate their plans.

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[12] Principal analysis shows 2012 U.S. equity holdings in DC plans and IRAs at $6.24 trillion, representing 33.4% of total 2012 US stock market assets ($18.688 trillon).

[13] The *2011 Principal Financial Group Retirement Readiness Survey* commissioned by Principal Financial Group conducted by Harris Interactive online. Data was gathered May 17-June 17, 2011 from 1,305 employers.

The same study found more than half of employers (53 percent) not offering a retirement plan are unaware of the start-up tax credit given to employers who start a DC/401(k) plan. Yet, more than a third (35 percent) said the credit would be a strong incentive when considering whether to offer a DC/401(k) plan.

To make it easier to establish and operate retirement plans and improve plan design, we recommend new rules to reduce bureaucracy and administrative requirements for small businesses and for plans that adopt safe harbor and automatic enrollment designs. Title II- Private Pension Reform of Senator Hatch's Secure Annuities for Employee (SAFE) Act provides a roadmap to accomplish these goals, including a "Starter" deferral-only safe harbor plan, an enhanced employer start-up credit and many simplification measures.

Promote adequate savings levels and encourage use of plan design features that increase participation and savings. Congress can help encourage redesigned automatic enrollment features that promote savings. Plan sponsors should be incented to set automatic enrollment at deferral rates higher than 3 percent and to employ automatic annual deferral increases and employer matches structured to incent higher deferrals.

Automatic contribution arrangement safe harbors should be updated to incorporate single-tier match formulas-- the most commonly used matching design among small employers, as long as the matching rate meets specific requirements.

> *For example, the safe harbor could require the match on deferrals of at least 6% of pay (or more) and a minimum match rate of 50% of pay. This would result in a minimum required employer contribution of 3% of pay and a minimum total contribution of 9% of pay for the participant in the first year of participation. With automatic deferral escalation, participants would soon be in the 10%+ total savings range.*

The 10 percent cap on default deferral and automatic annual deferral increases currently in place in the safe harbor should also be removed.

Address the challenge of retirement income. Many individuals simply do not have a realistic understanding of how much money they need in retirement or how much they can spend before they run out of income from their savings. And while many savers are attracted to the idea of a guaranteed income stream in retirement, few actually use their accumulated DC balances to purchase products like income annuities before or at retirement.

To help change how employees think about saving for their futures, we advocate broader use of retirement income illustrations on benefit statements to drive home how long savings are estimated to last in retirement. We have asked the Department of Labor to address employer concerns about potential liability and encourage the use of these illustrations as a best practice by providing regulatory guidance on how the illustrations are estimates, not guarantees, therefore alleviating fiduciary concerns for plan sponsors.

To encourage broader adoption of guaranteed income products by plan sponsors and use by participants, new safe harbors should be established that alleviate fiduciary concerns related to the selection of an annuity provider and encourage plan sponsors to voluntarily provide education about income annuities in the workplace. Guaranteed income products should also be incorporated into Qualified Default Investment Alternative (QDIA) protections when offered as a diversified asset allocation default.

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About the Principal Financial Group

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[14] "The Principal Financial Group" and "The Principal" are registered service marks of Principal Financial Services, Inc., a member of the Principal Financial Group.
[15] As of June 30, 2014.

Appendix I
Worker Savings and Tax Implication Analysis
From the Principal Financial Group[16]

The following estimation is based on an average, middle income worker who would have access to a 401(k) plan with match throughout their entire working career*.

$74,348	Current amount of taxes the government would have received if the employee had not been allowed to defer 7% annually with 3% employer match ($265,529 x 28%).
$328,495	Tax collected on distributions in retirement on a 4.5% draw down rate of the total account balance over a 30 year period ($2,189,970 x **15% tax rate**).
$4.4 to $1	For every $1 of tax deferred, the government will likely get roughly $4.4 in the future ($328,495/$74,348= 4.418).
$437,994	Tax collected on distributions in retirement on a 4.5% draw down rate of total account balance over a 30 year period ($2,189,970 x **20% tax rate**).
$5.9 to $1	For every $1 of tax deferred, the government will get roughly $5.9 in the future ($437,994/$74,348= 5.891).

Source: Internal analysis

This analysis would be considered a conservative estimate of the tax implications of deferred savings. Factors that would increase the ratio include:

- ***A lower marginal tax rate for the worker***. We assumed 28% but could be lower over the workers career on average so would lower the estimates of the current tax amount.
- ***A higher effective tax rate in retirement***. We assumed a 15% and 20% tax rate which could be low considering the likelihood of higher rates in the future.
- ***A higher draw down rate in retirement***. We assumed a 4.5% draw down rate in retirement which would leave a substantial remaining account balance for heirs. This amount remaining would eventually be taxed as well.

*Details and Assumptions:

- Individual begins saving in 401(k) at age 25 and continues to age 65
- Beginning salary of $30,000
- 7% deferral rate and 3% employer match
- Annual salary increase of 3.5%
- Pre-retirement marginal tax rate of 28%
- Post-retirement effective tax rate of 15%
- 7% assumed rate of return

This example is for illustrative purposes only. The assumed rate of return used is hypothetical and does not guarantee any future returns or represent the return of any particular investment option.

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[16] Calculation by Principal Life Insurance Company, a member company of the Principal Financial Group.