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Paul Schott Stevens, PRESIDENT AND CEO

[redacted]

By Electronic Delivery

April 15, 2015

Senator Mike Crapo
Co-chair, Working Group on Savings & Investment
239 Dirksen Senate Office Building
Washington, DC 20510

Senator Sherrod Brown
Co-chair, Working Group on Savings & Investment
713 Hart Senate Office Building
Washington, DC 20510

Re: Investment Company Institute Submission to Senate Finance Committee Working Group on Savings & Investment

Dear Senators Crapo and Brown:

The Investment Company Institute[1] is pleased to provide these comments to the Committee on Finance Working Group on Savings & Investment in connection with the request by Chairman Hatch and Ranking Member Wyden for "input, data, and information" that may be helpful as the Working Group examines "policy trade-offs and available reform options" within its designated area. The Institute strongly supports efforts to promote savings and investment opportunities for American workers. We thank the leadership and members of the Committee on Finance for their past support of bipartisan retirement savings plan improvements, including provisions in the Pension Protection Act of 2006 (PPA) which made permanent the increased contribution limits and catch-up contributions for older workers introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Thanks in no small part to Congress' efforts to promote retirement savings, Americans currently have $24.7 trillion earmarked for retirement, with more than half of that amount

[1] The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $18.1 trillion and serve more than 90 million U.S. shareholders.

in defined contribution (DC) plans and individual retirement accounts (IRAs).[2] About half of DC plan and IRA assets is invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers.

Consideration of policy trade-offs and available reform options must be guided by an assessment of Americans' retirement prospects and the role that the current system plays in helping American workers reach their retirement goals. Accordingly, we provide below an assessment of the current system and the significance of the current retirement savings tax incentives, including the contribution rates, in the system's success. That assessment is followed by a summary of available reform proposals that the Institute believes would serve to strengthen the U.S. retirement system to help even more Americans achieve a secure retirement.

I. It Is Important to Assess Americans' Retirement Prospects and the Role That the Current System Plays in Helping American Workers Reach Their Retirement Goals.

Our statement in connection with the September 16, 2014 hearing in the Committee on Finance titled "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy," described the research and data on savings and retirement preparedness in the United States. Our statement, which is attached, made the following key points:

- **While there is opportunity for improvement, the retirement system is working for millions of American workers.** A wide range of work by government, academic, and industry researchers who have carefully examined Americans' saving and spending patterns, before and after retirement, shows that the American system for retirement saving is working for the majority of American workers and has grown stronger in recent decades. Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and growth in the number of households, retirement assets were more than seven times the level at year-end 2014 than at year-end 1975.[3]

- **The U.S. retirement system relies upon the complementary components of Social Security, homeownership, employer-sponsored retirement plans (both defined benefit (DB) plans and DC plans offered by both private-sector and government employers), IRAs (both contributory and rollover), and other savings.** In retirement, different households will depend on each of these components in differing degrees, subject to overall saving levels, work history, and other factors. For most households, however, employer-sponsored retirement plans

[2] At the end of the fourth quarter of 2014, U.S. retirement assets totaled $24.7 trillion, DC plan assets were $6.8 trillion and IRA assets were $7.4 trillion. *See* Investment Company Institute, "The U.S. Retirement Market, Fourth Quarter 2014" (March 2015), available at www.ici.org/info/ret_14_q4_data.xls.

[3] *See* Figure 4, p. 11 (updated to year-end 2014), in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

are crucial: about eight in 10 near-retiree households have retirement assets (DC plans or IRAs), DB benefits, or both.[4] Thanks to this multi-faceted system, successive generations of American retirees have been better off than previous generations.[5]

- **The significance of Social Security must be considered in any assessment of the U.S. retirement system.** Social Security provides the foundation of retirement security for almost all American workers—for the majority, it may be the largest single income source in retirement[6]—and it replaces significant portions of income for lower-income retirees. In this respect, Social Security replaces 85 percent of average inflation-indexed annual earnings for workers in the lowest lifetime household earnings quintile; 55 percent for workers in the middle lifetime household earnings quintile; and 34 percent for workers in the highest lifetime household earnings quintile.[7] Yet the Social Security system faces a projected long-term

[4] *Ibid* (Figure 13, p. 29, and Figure 14, p. 31). *See also,* updated figure (p. 13) in Statement of the Investment Company Institute, Brian Reid, Chief Economist, Hearing on "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy" Committee on Finance, United States Senate (September 16, 2014); available at www.ici.org/pdf/14_senate_sfc_retirement.pdf and attached.

[5] *See* discussion, pp. 10–14, in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[6] Since 1975, there has been little change in the importance of Social Security benefits in providing retiree income. Social Security benefits continue to serve as the foundation for retirement security in the United States and represent the largest component of retiree income and the predominant income source for lower-income retirees. In 2013, Social Security benefits were 57 percent of total retiree income and 85 percent of income for retirees in the lowest 40 percent of the income distribution. Even for retirees in the highest income quintile, Social Security benefits represented one-third of income in 2013. *See* Figure 4 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2013," *ICI Research Perspective* 20, no. 7 (October 2014); available at www.ici.org/pdf/per20-07.pdf.

[7] Figures represent the mean replacement rates for retired workers in the 1950s birth cohort, assuming the workers claim Social Security benefits at age 65. *See* Exhibit 10 in Congressional Budget Office, *CBO's 2014 Long-Term Projections for Social Security: Additional Information* (December 2014); available at www.cbo.gov/publication/49795.

imbalance.[8] It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.[9]

- **Effective policymaking requires a better understanding of the "coverage gap."** Discussions about pension plan coverage often rely on misleading or incomplete coverage statistics. The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.[10] Efforts to expand coverage will be more successful if policymakers better understand the reasons underlying why specific populations are not participating in retirement savings vehicles.

- **The voluntary employer-provided retirement system is characterized by flexibility, competition, and innovation.** A strength of the voluntary employer-sponsored retirement system is the flexibility built into its design. Combined with competition—among employers to offer attractive benefits packages that include retirement plans and financial services firms to provide services to those plans—this flexibility has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.

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[8] For projections related to these programs, *see* The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (July 2014), Washington, DC: U.S. Government Printing Office, available at www.ssa.gov/OACT/tr/2014/tr2014.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (July 2014), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2014.pdf; Congressional Budget Office, *The 2014 Long-Term Budget Outlook* (July 2014), available at www.cbo.gov/sites/default/files/cbofiles/attachments/45471-Long-TermBudgetOutlook_7-29.pdf; and Social Security Administration, "Detailed Reports on the Financial Outlook for Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds," (2014), available at www.ssa.gov/OACT/tr/index.html.

[9] Regardless of the form they take, changes to Social Security will likely increase the importance of employer-sponsored retirement plans and IRAs to provide for retirement adequacy. If Social Security benefits are cut, future retirees will need to accumulate more retirement resources. If taxes are raised on workers, net earnings will fall, but the amount of earnings that would need to be set aside to supplement Social Security benefits in retirement would remain largely unchanged. To the extent that either the benefit cuts or tax increases are structured to exempt workers with low lifetime earnings, it would place an even heavier burden on those already most dependent on employer-sponsored retirement plans and IRAs. For a discussion of how different methods of cutting Social Security benefits would impact workers with different levels of lifetime income, *see* Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* 9, no. 2 (April 2010): pp. 235–262.

[10] *See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf.

- **Retirement plan sponsors and investors are cost conscious and 401(k) plan assets tend to be concentrated in lower-cost mutual funds.** At year-end 2013, 401(k) plans had $4.2 trillion in assets and more than 60 percent of 401(k) plan assets were invested in mutual funds. Fees paid on mutual funds have trended down over the past two decades—both on mutual funds invested in 401(k) plans and industrywide—and investors tend to concentrate their assets in lower-cost funds.[11]

II. The Current Retirement Tax Incentive Structure Is the Foundation of the U.S. Retirement System's Success.

A crucial component of the success of the U.S. retirement system is the current retirement savings tax incentives, including the contribution limits, that motivate saving and encourage employers to maintain and contribute to employer-sponsored plans. While we understand this Working Group is tasked with considering policy trade-offs and available reform options, Congress should not throw out decades of progress by taking away the ability of American workers to make full use of the retirement vehicles they value so strongly. Consistent with the views of the overwhelming majority of Americans,[12] we urge this Working Group to recommend that Congress maintain the current retirement savings tax incentives, including the contribution limits, and other features that successfully encourage millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement. As more fully described in our September 2014 statement—

- **A deferral of tax is not equivalent to a tax exclusion or a tax deduction.** Exclusions and deductions reduce taxes paid in the year taken, but do not affect taxes in any future year. Tax deferrals—such as the deferral of tax on compensation contributed to an employer-sponsored retirement plan—reduce taxes paid in the year of deferral, but increase taxes paid in the year the income is recognized through distribution or withdrawal from a plan or account.

- **Tax deferral equalizes the incentive to save.** The incentive to save is the after-tax return savers earn on their savings. By effectively taxing all investment income at a zero rate,[13] tax deferral

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[11] *See* Collins, Holden, Chism, and Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013," *ICI Research Perspective* 20, no. 3 (July 2014); available at www.ici.org/pdf/per20-03.pdf.

[12] *See* Figures 2 and 3 in Schrass, Holden, and Bogdan, "American Views on Defined Contribution Plan Saving," *ICI Research Report* (January 2015); available at www.ici.org/pdf/ppr_15_dc_plan_saving.pdf.

[13] For an explanation of why this is the case, *see* discussion in Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at www.ici.org/pdf/ppr_12_tax_benefits.pdf; and Brady, "Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free," *ICI Viewpoints* (September 16, 2013), available at www.ici.org/viewpoints/view_13_deferral_explained. If a taxpayer's marginal tax rates at the time of contribution and the time of distribution are the same, tax deferral is equivalent to taxing investment income at a zero rate. If tax rates are

simply ensures that a dollar of 401(k) contributions earns the same after-tax return regardless of the tax bracket workers are in.

- **The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.** Reducing the incentive for employers to offer plans will lead to fewer employers offering plans. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans. In addition to tax deferral, lower-paid workers covered by a DC plan benefit from the convenience of payroll deduction, the "nudge" of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-sponsored retirement plans.

- **Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.**[14] Proposals to "cap" the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement. In fact, some workers may find that they would be better off simply paying income taxes on their wages and investing in a taxable account.

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lower at the time of distribution, the benefits of tax deferral are increased. If tax rates are higher at the time of distribution, the benefits of tax deferral are reduced.

[14] For a discussion of how such proposals would impact the benefits of tax deferral, *see* Brady, *A 'Modest' Proposal that Isn't: Limiting the Upfront Benefits of Retirement Contributions,* Investment Company Institute (September 2012); available at www.ici.org/viewpoints/view_13_limiting_upfront_benefits. Several proposals intended to limit the up-front benefit of tax-deferred retirement plan contributions have been introduced in recent years. Since fiscal year 2011 (FY2011), the Administration's budget has included a proposal to "cap" the benefits of itemized deductions at 28 percent. Starting with the FY2013 budget, the proposal was expanded so that the 28 percent cap also applied to tax-deferred employee contributions to DC plans and tax-deferred IRA contributions. In his tax reform discussion draft, Ways and Means Committee Chairman Camp (R-MI) included a proposal that would subject tax-deferred employee and employer contributions to DC plans to a 10 percent surtax. Although the 10 percent surtax proposal appears to be much different from the 28 percent cap proposal, the combination of the surtax with a top marginal rate of 25 percent is equivalent to having a top marginal rate of 35 percent and a 25 percent cap. Both the 28 percent cap proposal and the 10 percent surtax proposal are variants of proposals that have been around for some time: turning all deductions and exclusions into flat-rate credits. For example, in 2006, Batchelder, Goldberg, and Orszag proposed to turn all "tax incentives" into refundable 15 percent credits. *See* Batchelder, Goldberg, and Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *New York University Law and Economics Working Papers*, Paper 77 (October 2006), available at lsr.nellco.org/nyu_lewp/77. More recently, Gale, John, and Smith released a similar proposal specifically for retirement contributions. *See* Gale, John, and Smith, "New Ways to Promote Retirement Saving," *AARP Public Policy Institute Research Report* no. 2012-09 (October 2012), available at www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf.

- **Limits on DC retirement plan contributions are already low by historical standards and should not be reduced further.**[15] Adjusted for inflation, the current annual contribution limit to DC plans is less than half the limit originally established by the Employee Retirement Income Security Act of 1974 (ERISA).

- **Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and DB plan benefit accruals are unworkable and would discourage plan formation.**[16] Any proposal to place a dollar cap on individual retirement accumulations would add complexity to our nation's retirement system and would discourage employers from creating retirement plans and workers from participating.

[15] For a discussion of how DC plan contribution limits have changed over time, *see* Brady, *Tax Reforms Should Not Favor DB Plans Over DC Plans,* Investment Company Institute (September 2012); available at www.ici.org/viewpoints/view_13_equal_tax_treatment. Several proposals have been made to reduce contribution limits to DC plans. The National Commission on Fiscal Responsibility and Reform's so-called "20/20 proposal" suggested limiting the combination of employer and employee contributions to DC plans to the lesser of $20,000 annually or 20 percent of compensation. Chairman Camp's tax reform discussion draft would suspend inflation adjustments to DC plan contribution limits and DB plan benefit limits for 10 years. In addition to the 20/20 proposal, many other proposals focus on limiting the tax benefits of DC plans in particular. For example, aforementioned proposals to limit the up-front benefit of deferral only apply to DC plans. The Camp 10 percent surtax proposal would apply only to employee and employer DC plan contributions. The Administration's 28-percent proposal would apply only to employee elective deferrals to DC plans and tax-deferred IRA contributions. Under the 20/20 proposal, the ratio of the DB benefit limit to the DC contribution limit would move from four to one to nearly 10 to one.

[16] The Administration's FY2016 budget proposal (also appearing in prior years' budget proposals) to limit the total amount that an individual could accrue in retirement benefits would make the system more complex, place additional compliance burdens on individuals, and likely cause some employers—particularly small businesses—to terminate their retirement plans. Current law limits on the amount of tax-deferred compensation generally apply to the benefits a worker receives from a single employer. The proposal would place an additional limit on the total value of deferred compensation accumulated by any one individual—inclusive of accrued DB benefits, DC plan account balances, and IRAs.

III. Reform Options Should Build on the Existing System—Not Put It at Risk.

Even with its many current strengths, the U.S. retirement system can be strengthened further to help even more Americans achieve a secure retirement. Attached to this letter, please find a document titled "Retirement Plan Modernization Proposals," describing policies supported by the Institute that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. As summarized below, these reforms would build upon the current system by expanding coverage, participation, and savings rates in DC plans and IRAs; improving the delivery and quality of information and education to plan participants and plan sponsors; enhancing flexibility in determining how and when to tap retirement savings; and eliminating unnecessary burdens in plan administration so that plans can function more effectively.

A. Expand Coverage, Participation, and Savings

Included in the Institute's reform proposals are the following relatively modest changes which would help bring more employers into the system and generate better outcomes for plan participants, importantly without detracting from the system's successful features.

New SIMPLE Plan. Small businesses often face particular challenges in establishing and maintaining retirement plans. While the SIMPLE IRA and other plan options offer a relatively simple solution to plan sponsorship, none of the existing plan options work well for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund. Many small employers want to offer employees the option to contribute to a 401(k) or similar plan, but cannot meet the non-discrimination tests and do not have the capacity to make the required employer contributions associated with the safe harbor 401(k) plan or a SIMPLE plan. For employers whose workforce places less value on compensation paid as retirement benefits as opposed to take-home wages, the required employer contributions discourage the adoption of SIMPLE plans. Creating a new type of SIMPLE plan for small employers would encourage greater plan creation and coverage in smaller workplaces. As described in greater detail in the attached document, the new plan would be modeled on existing SIMPLE plans, but would not require employer contributions. It would have contribution limits above traditional and Roth IRA limits, but below existing SIMPLE plan limits.[17] Such a plan would accommodate any employee who wants to save for retirement, while preserving the incentives for the employer to step up to a SIMPLE IRA or 401(k) plan.

Open MEPs for Small Employers. The Institute also supports easing restrictions on "open" multiple employer plans (or "MEPs"), but targeting the provision to employers with no more than 100 employees—the employer segment most in need of solutions to encourage retirement plan

[17] We note that a conceptually similar provision, referred to as the "starter k" plan, has been proposed by Ranking Member Orrin Hatch (R-UT) in S. 1270, the "Secure Annuities for Employee (SAFE) Retirement Act of 2013."

sponsorship.[18] Allowing small employers to participate in a MEP—regardless of the employer's industry or any other preexisting relationship with other participating employers or the plan sponsor—will reduce administrative and compliance costs and burdens, and ultimately improve the availability of retirement plans to employees of small employers. In addition to administrative and compliance burdens, smaller employers may be challenged by the fiduciary responsibility and liability of selecting and monitoring service providers and plan investment options. By providing a level of liability relief for investment options offered under the plan, small employers would be encouraged to participate in a MEP, while at the same time ensuring that plan participants are protected. Our proposal also includes important safeguards for open MEP arrangements to ensure the legitimacy of the sponsoring entity and that fiduciary standards are met.

Automatic Enrollment Safe Harbors. Studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income and younger workers because these groups are typically less likely to participate in a DC plan where affirmative elections are required.[19] Employers should be encouraged to use automatic enrollment if appropriate for their employee base. Employers may want to enroll their workers at higher levels of savings and escalate the savings more substantially than is perceived appropriate under current law. For plan sponsors that rely on the nondiscrimination testing safe harbor established under the PPA—the qualified automatic contribution arrangement or "QACA"—the 10 percent ceiling is a barrier to escalating automatic contributions to levels that in some cases may be more appropriate for ensuring retirement adequacy. (In fact, even plan sponsors that do not rely on the QACA safe harbor often perceive the rule's 10 percent as a ceiling.) Accordingly, there is broad agreement across the retirement plan community for removing the 10 percent cap on automatic escalation deferral rates for plan participants.

In addition, while the QACA safe harbor has been applauded for encouraging the use of automatic enrollment, many plan sponsors believe that the safe harbor default contribution levels are too low and that higher contribution levels are necessary to ensure a secure retirement for plan participants. Creating a new automatic enrollment safe harbor would give employers another option alongside the QACA safe harbor, with higher minimum default contribution rates and a "stretched" matching contribution formula to encourage participants to contribute at least 10 percent of pay. A

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[18] For a discussion of how pension coverage varies by plan size, *see* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2013," *ICI Research Perspective* 20, no. 6 (October 2014); available at www.ici.org/pdf/per20-06.pdf.

[19] The EBRI/ICI 401(k) Accumulation Projection Model demonstrates the increases in retirement income that can result from automatic enrollment. Replacement rates, modeled after adding automatic enrollment and investing contributions in a target date fund, increase significantly. *See* Holden and VanDerhei, "The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *Investment Company Institute Perspective* 11, no. 2, and *EBRI Issue Brief*, no. 283 (July 2005), available at www.ici.org/pdf/per11-02.pdf and www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf. Furthermore, studies find that adopting an automatic enrollment feature has a particularly strong impact on improving participation rates among low-income and younger workers. *See, e.g.*, Utkus and Young, *How America Saves, 2014: A report on Vanguard 2013 defined contribution plan data*, Vanguard Center for Retirement Research (2014), available at https://institutional.vanguard.com/iam/pdf/HAS14.pdf.

tax credit might also be included to encourage small employers to adopt the new automatic enrollment safe harbor. Another incentive to adopt the new safe harbor could be the option to apply a three-year cliff vesting period to employer matching contributions. The Institute believes that these changes would give employers more flexibility to design their plans to meet the needs of their particular workforces and ultimately increase participation and savings rates.

Index IRA Catch-up Contributions. Another modest change to improve savings rates described in our proposals would be to index IRA catch-up contribution limits for inflation. Since their creation in 1974, IRAs have played a vital role in building retirement security for workers without access to a retirement plan at work, for small business owners, and for non-working spouses. Like contribution limits for workplace plans, the general contribution limit for IRAs is indexed so that its value is not eroded over time. The catch-up contribution limit for 401(k), 403(b) and 457(b) plans also are all inflation indexed, but the catch-up contribution limit for IRAs—which was last adjusted to $1,000 per year in 2006—is not. We believe the catch-up contribution limit for IRAs should be indexed for inflation for the same reason—so that workers' ability to save for their future is not eroded by increases in the cost of living.

B. Help Participants Make Informed Decisions

Policymakers, plan sponsors, and service providers strive to improve the ability of American workers to make sound decisions about retirement savings and investing. Congress was instrumental in encouraging rules that improved disclosure of 401(k) plan fees and associated investment information. Our proposals recommend that Congress go further by promoting electronic delivery of plan information, interactive educational tools, and materials to help American workers understand their savings options.

E-delivery. Allowing plans to make e-delivery the default method for communicating with participants (but allowing participants to opt for paper) will enhance the effectiveness of ERISA communications and produce cost savings for the economy and plans that decide to opt for e-delivery. Under our proposal, any document that is required by ERISA or the Internal Revenue Code to be furnished to a participant, beneficiary or other individual (a "recipient") may be furnished electronically under a number of alternative methods:

- Direct delivery of the document to the recipient's email address;
- Posting on a continuously available website, if the recipient is notified that the document is available; or
- Any other electronic means reasonably calculated to ensure actual receipt.

The proposal includes robust safeguards for participants who prefer to receive documents in paper form. Recipients must be informed of the right to request delivery in paper format, and a recipient

who requests delivery of a paper document would be entitled to receive it. Any electronically furnished document must be presented in a manner that is consistent with the style, format, and content requirements applicable to the particular document taking into account the electronic form of the document, and the system must incorporate measures reasonably designed to protect personal information.

Consolidate Notices. Over the years, the number of notices that must be provided to participants and beneficiaries has exploded. When ERISA was enacted in 1974, Congress intended that one document—the summary plan description—would be the notice that informed participants of their rights and obligations. Since then, a large number of additional notices have been imposed on retirement plans under ERISA and the Internal Revenue Code—now numbering more than 30 that apply just to retirement plans. These include various safe harbor notices, the qualified default investment alternative (QDIA) notice, and fee disclosures for participant-directed plans. Many of these notices must be provided upon enrollment and annually thereafter, although the specific timing requirements vary according to applicable regulations. In implementing these rules, the Departments of Labor (DOL) and the Treasury have explicitly or implicitly discouraged combining these notices, even though together the notices provide interrelated information about a 401(k) plan's features. This discourages an integrated communication approach, complicates plan administration, and inundates participants with information. Particularly with technical materials, more is often less, and the proliferation of notices, sent at different times, may serve to confuse many participants and cause many notices to be overlooked. We propose permitting plans to use a single notice (which could be referred to as the "Quick Start" notice) that would combine the information currently required under various separate rules, including the QDIA notice, participant fee disclosures, 401(k) safe harbor notice, automatic contribution arrangement notices, and investment advice notices. The proposal also would eliminate certain redundant or irrelevant notices, such as the summary annual report and deferred vested pension statement.

Expand Access to Education and Information on Investing and Retirement Income Planning. DOL's Interpretive Bulletin 96-1 (IB 96-1) currently provides important guidance on the provision of investment-related education and information to participants and beneficiaries in participant-directed individual account plans. Persons who provide only information covered by IB 96-1 are deemed not to be "fiduciaries" under ERISA and therefore are not exposed to liability for the provision of investment information. IB 96-1 has resulted in plan sponsors and service providers providing investment education and information to participants and beneficiaries to assist them in making more informed decisions with respect to their individual accounts.

We believe this guidance should be codified and updated in a tailored way (as described below) to provide greater certainty regarding the types of investment education and information that may be provided to plan sponsors and participants and to expand the types of information (*e.g.*, distribution and retirement income information) that may be provided. Our proposed provision would amend ERISA as follows:

- To clarify that information, materials, and tools that inform a participant or beneficiary about distribution options and income in retirement shall not be considered investment advice for purposes of ERISA section 3(21)(A)(ii) nor a "recommendation" for purposes of 29 C.F.R. § 2510.3-21 (or any successor regulation).

- To allow service providers to provide investment education and information to plan sponsors and other fiduciaries (*e.g.*, plan committees). Service providers should be permitted to provide investment education and information to plan sponsors and other fiduciaries of qualified defined contribution and defined benefit plans, as well as other funded employee benefit programs such as VEBAs, without such communications being deemed fiduciary investment advice under ERISA.

- To clarify that the educational information and materials described in IB 96-1 (as modified by this proposal) may be provided to owners of IRAs, Archer MSAs, HSAs, and Coverdell educational savings accounts.

Target Date Fund Benchmarks. We also support a proposal to change current DOL rules for how performance information for target date funds must be compared to a benchmark, in order to simplify and make these benchmark comparisons more understandable to participants.

Support Flexible Approaches to Illustrating Lifetime Income. In the context of proposals intended to help plan participants and retirees determine how much retirement income they can generate from a 401(k), IRA, and other savings, allowing flexibility in designing such tools is important. Information on how an account balance might translate into a regular stream of income in retirement is useful and helps workers see if their retirement savings is on track. While this information is not currently required, some plan providers successfully include estimates of what monthly income the participant might receive from the account at retirement. Any legislation should allow current best practice to continue.

The Institute has recommended certain changes to the Lifetime Income Disclosure Act, as introduced in prior Congresses,[20] to ensure the needed flexibility. The attached appendix to our Retirement Plan Modernization Proposals explains that any amendment to ERISA to require plans to give participants lifetime income estimates should:

- Allow plans the option to project future contributions and investment experience of the account to give participants, especially those far from retirement, a more realistic estimate of monthly income.

[20] *See, e.g.*, S. 1145 (113th Congress), introduced by Senators Isakson, Murphy, Warren, Scott, and Nelson.

- Not specify a single method but rather allow plans to express the estimate as an annuity payment, a percentage of the account balance designed to spread payments over the participant's life, a life expectancy calculation based on IRS minimum distribution rules, or other appropriate method. This recognizes, as the Departments of Treasury and Labor have acknowledged,[21] that there is no single way to obtain a lifetime income stream from a retirement account.

- Require certain explanations to help participants understand the information.

- Not freeze innovation and evolution of best practice disclosure. Letting this competitive market evolve will better serve the interests of plan participants—the users of this information—than codifying a single approach at this time.

All retirement income products and strategies involve tradeoffs and consideration of an individual's personal circumstances, such as the amount of annuitized income to be received from Social Security,[22] other assets or income, health status and life expectancy, the need or desire for emergency financial reserves, specific goals in retirement, and the need to provide for other family members. As a matter of public policy then, it is important to ensure a level playing field for all products and services.[23]

C. Permit Greater Flexibility for Participants

Two of our reform proposals would provide individuals with more flexibility to manage their retirement savings in a way that best meets their own individual needs. First, the Institute's proposal would amend the Internal Revenue Code to increase the required beginning age for "required minimum distributions" (RMDs) from 70½ to at least 75, to reflect changing patterns of retirement

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[21] *See, e.g.,* Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, Department of the Treasury and Department of Labor, 75 Fed. Reg. 5253 (Feb. 2, 2010).

[22] *See* discussion of Social Security replacement rates and how the role of Social Security varies by income and wealth on page 3, *supra.*

[23] In terms of generating income in retirement, we support maintaining a level playing field for different approaches to drawing down assets. As explained in the attached appendix to our Retirement Plan Modernization Proposals, no one financial product is best suited to address all of the risks that individuals can potentially face in retirement, and more than one financial product enables individuals to secure a lifetime stream of payments. Proposals to provide an exclusion from gross income for a specified portion of lifetime annuity payments received from a qualified retirement plan (and in some bills, from a taxable account), would artificially elevate one financial product over other products and strategies that can play an important role in managing assets in retirement. It is also important that similar products should receive similar tax treatment, and thus proposals providing special tax treatment to insurance products with investment features should extend to similar non-insurance products or draw-down strategies designed to spread income over retirement.

savings and increases to life expectancy.[24] Second, we support removing unnecessary administrative burdens on hardship distributions.

While retirement assets generally should be held for use in retirement, policymakers have recognized that allowing pre-retirement distributions for critical financial needs actually encourages savings because workers know that they can access their savings in an emergency. Current IRS regulations impose a number of unnecessary administrative burdens on hardship distributions, which complicate plan administration. Our proposal would remove these restrictions by allowing earnings on contributions to be withdrawn in a hardship distribution; allowing hardship withdrawals from all employer contributions to a profit-sharing plan or stock bonus plan (including safe harbor contributions, qualified nonelective contributions, and qualified matching contributions); and eliminating the IRS safe harbor rule restricting employees from making contributions for six months after a hardship distribution. These restrictions are unnecessary to discourage hardship distributions because the Internal Revenue Code already applies a 10 percent penalty for any hardship distribution before age 59½.

D. Improve Plan Administration

Finally, several improvements can be made to the way plans are administered, and our proposals include three that would go a long way toward easing the complicated administrative burdens that have accumulated over the years as the legal landscape has changed. As described in greater detail in our attached Retirement Plan Modernization Proposals, we believe that the following changes would improve plan administration and therefore reduce the compliance costs associated with plan sponsorship. First, we support proposals to expand the IRS compliance program to better address common errors that are relatively easy to fix, such as allowing plans to self-correct plan loan errors and missed RMD payments and expanding the compliance program to IRAs. Second, our proposal would fix a problematic aspect of current 403(b) regulations that, in some situations, can prevent a 403(b) plan from terminating. Third, the proposal would modify the plan amendment rules to apply a more reasonable schedule of deadlines for adopting plan amendments, but would not relieve a plan from operating in compliance with any statutory or regulatory deadlines.

* * *

[24] First added to the Internal Revenue Code in 1962, Congress has since applied the RMD rule to virtually all tax-advantaged retirement accounts, but has never reexamined the required beginning age to reflect changing patterns of retirement savings or increases to life expectancy. According to the Social Security Administration's Period Life Expectancy Table, the life expectancy of a person aged 65 in 2013 is about five years longer for men and four and a half years longer for women than it was in 1962 (when the 70½ rule was first added). *See* Table V.A3. Period Life Expectancy in *2014 OASDI Trustees Report,* Social Security Administration; available at www.ssa.gov/oact/TR/2014/lr5a3.html#hist.

We commend this Working Group for its willingness to examine research, data, and information in an effort to better assess Americans' retirement prospects and the role that the current system plays in helping American workers reach their retirement goals and to determine what reform options can best strengthen the U.S. retirement system. The Institute believes that a careful examination of the facts will lead this Working Group to recommend that the Finance Committee continue its support for policies that protect the tax incentives for retirement savings, and adopt reform options that build upon and improve the current system, which will serve to help even more American workers achieve a secure retirement.

Sincerely,



Paul Schott Stevens
President & CEO
Investment Company Institute

Attachments

cc: Senator Richard Burr
Senator Benjamin Cardin
Senator Bob Casey
Senator Dean Heller
Senator Johnny Isakson
Senator Robert Menendez
Senator Tim Scott
Senator Mark Warner

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Statement of the Investment Company Institute
Brian Reid, Chief Economist
Hearing on "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy"
Committee on Finance
United States Senate

September 16, 2014

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing in the U.S. Senate Committee on Finance titled "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy." The Institute strongly supports efforts to promote retirement security for American workers. We thank Chairman Wyden and Ranking Member Hatch for their past support of bipartisan retirement savings plan improvements, including provisions in the Pension Protection Act of 2006 (PPA) which made permanent the increased contribution limits and catch-up contributions for older workers introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Thanks in no small part to Congress' efforts to promote retirement savings, Americans currently have $23.0 trillion earmarked for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).[2] About half of DC plan and IRA assets is invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers.

The Institute has devoted years of research and considerable resources to making and communicating an accurate assessment of America's retirement system.[3] We are concerned that those

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $17.1 trillion and serve more than 90 million shareholders.

[2] At the end of the first quarter of 2014, U.S. retirement assets totaled $23.0 trillion, DC plan assets were $6.0 trillion and IRA assets were $6.6 trillion. *See* Investment Company Institute, "The U.S. Retirement Market, First Quarter 2014" (June 2014), available at www.ici.org/info/ret_14_q1_data.xls.

[3] One of the major roles the Institute serves is as a source for statistical data on the investment company industry. With a research department comprising more than 40 people, including seven PhD-level economists, the Institute conducts public policy research on fund industry trends, shareholder characteristics, the industry's role in U.S. and international financial markets, and the retirement market. For example, the Institute publishes reports focusing on the overall U.S. retirement market, fees and expenses, and the behavior of defined contribution (DC) plan participants and IRA investors. In its research on mutual fund investors, IRA owners, and 401(k) plan participants, the Institute conducts periodic household surveys that connect directly with savers.

who attempt to paint the current system as "broken" all too often proceed by isolating one component of the system or by focusing solely on account balances. But that is not how Americans plan and prepare for retirement. The U.S. retirement system relies upon the complementary components of Social Security, homeownership, employer-sponsored retirement plans (both defined benefit (DB) plans and DC plans offered by both private-sector and government employers), IRAs (both contributory and rollover), and other savings.

In retirement, different households will depend on each of these components in differing degrees, subject to overall saving levels, work history, and other factors. For most households, however, employer-sponsored retirement plans are crucial: about 8 in 10 near-retiree households have retirement assets (DC plans or IRAs), DB benefits, or both.[4] Thanks to this multi-faceted system, successive generations of American retirees have been better off than previous generations.[5]

Even with its many successes, the U.S. retirement system can be strengthened further to help even more Americans achieve a secure retirement. The Institute supports policies that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. These reforms would build upon the strengths of the current system. Unfortunately, many critics do not appear interested in building upon our current voluntary system—they want to tear it down, often relying upon selective information and overheated rhetoric to support their efforts. Claims that Americans are facing "pension poverty," for example, are not used to bolster tax incentives for savings, but, rather, are cited to justify efforts to scrap the current system, limit or eliminate tax incentives, or create new and untested schemes that would take control over retirement preparedness away from Americans and their employers. As our research demonstrates, Americans do not want to lose that control, and employer-sponsored plans play an important role in preparing workers for retirement.

We commend this Committee for its willingness to look at the research and understand the facts in an effort to better assess Americans' retirement prospects and the role that the current system plays in helping American workers reach their retirement goals. The Institute believes that a careful examination of the facts will lead this Committee to continue its support for policies that protect the tax incentives for retirement savings, improve the system, and help even more American workers achieve a secure retirement.

SUMMARY OF KEY POINTS

We have summarized the key points of our testimony below.

1. **While there is opportunity for improvement, the retirement system is working for millions of American workers**. A wide range of work by government, academic, and industry researchers who have carefully examined Americans' saving and spending patterns, before and after

[4] *See* Figure 13, p. 29, and Figure 14, p. 31, in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

[5] *Ibid* (discussion, pp. 10–14).

retirement, shows that the American system for retirement saving is working for the majority of American workers and has grown stronger in recent decades.

- ***Americans' retirement resources are best thought of as a pyramid.*** The pyramid has five layers (Social Security, homeownership, employer-sponsored retirement plans, IRAs, and other assets), and the importance of each layer varies across households.

- ***Effective policymaking requires a better understanding of the "coverage gap."*** Discussions about pension plan coverage often rely on misleading or incomplete coverage statistics. The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage. Efforts to expand coverage will be more successful if policymakers better understand the reasons underlying why specific populations are not participating in retirement savings vehicles.

- ***The voluntary employer-provided retirement system is characterized by flexibility, competition, and innovation.*** A strength of the voluntary employer-sponsored retirement system is the flexibility built into its design. Combined with competition—among employers to offer attractive benefits packages that include retirement plans and financial services firms to provide services to those plans—this flexibility has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.

- ***Retirement plan sponsors and investors are cost conscious and 401(k) plan assets tend to be concentrated in lower-cost mutual funds.*** At year-end 2013, 401(k) plans had $4.2 trillion in assets and more than 60 percent of 401(k) plan assets were invested in mutual funds. Fees paid on mutual funds have trended down over the past two decades—both on mutual funds invested in 401(k) plans and industrywide—and investors tend to concentrate their assets in lower-cost funds.

2. **A deferral of tax is not equivalent to a tax exclusion or a tax deduction.** Exclusions and deductions reduce taxes paid in the year taken, but do not affect taxes in any future year. Tax deferrals—such as the deferral of tax on compensation contributed to an employer-sponsored retirement plan—reduce taxes paid in the year of deferral, but increase taxes paid in the year the income is recognized through distribution or withdrawal from a plan or account.

    - ***Tax deferral equalizes the incentive to save.*** The incentive to save is the after-tax return savers earn on their savings. By effectively taxing all investment income at a zero rate, tax deferral simply ensures that a dollar of 401(k) contributions earns the same after-tax return regardless of the tax bracket workers are in.

3. **Vast majorities of U.S. households appreciate the tax treatment of DC plans and want to preserve the key features of DC plans.** Household survey data indicate that DC account–

owning households appreciate the tax advantages and investment features of DC plans. The tax incentives for retirement savings are vitally important in encouraging employers to create retirement plans and encouraging workers to participate. A vast majority of U.S. households, whether they have DC plans or IRAs, or not, reject the suggestion that DC plan contribution limits should be reduced. Reducing the tax incentives for retirement savings through employer plans or IRAs would undermine this system's foundation and put at risk our nation's progress on retirement security.

4. **Changes in retirement policy should build on the existing system—not put it at risk.** We urge this Committee to continue its leadership in pursuing policies to build on the strengths and successes of the U.S. retirement system. Any improvements, however, should preserve the tax incentives and other features that successfully encourage millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement.

    - ***The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.*** Reducing the incentive for employers to offer plans will lead to fewer employers offering plans. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans. In addition to tax deferral, lower-paid workers covered by a DC plan benefit from the convenience of payroll deduction, the "nudge" of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-sponsored retirement plans.

    - ***Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.*** Proposals to "cap" the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement. In fact, some workers may find that they would be better off simply paying income taxes on their wages and investing in a taxable account.

    - ***Limits on DC retirement plan contributions are already low by historical standards and should not be reduced further.*** Adjusted for inflation, the current annual contribution limit to DC plans is less than half the limit originally established by the Employee Retirement Income Security Act of 1974 (ERISA).

    - ***Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and DB plan benefit accruals are unworkable and would discourage plan formation.*** Any proposal to place a dollar cap on individual retirement accumulations would add complexity to our nation's retirement system and would discourage employers from creating retirement plans and workers from participating.

I. THE U.S. RETIREMENT SYSTEM IS HELPING MILLIONS OF AMERICANS ACHIEVE A SECURE RETIREMENT

Retirement policy discussions often start from the premise that retirees' pension income has fallen over time. Contrary to this conventional wisdom, private-sector pension income has become more prevalent and more substantial—not less prevalent or less substantial—over time. Since the enactment of ERISA, increasing numbers of retirees receive benefits from private-sector pension plans (DB and DC) and receive more in benefits from these plans:

- Data from the Current Population Survey (CPS) show the share of retirees receiving private-sector pension income increased by more than 60 percent between 1975 and 1991, and has remained fairly stable since.[6]

- Among those receiving income from private-sector pensions, the median amount of inflation-adjusted income—which had remained fairly flat between 1975 and 1991—has increased nearly 40 percent between 1991 and 2012.[7]

Other evidence also points to retirees becoming better off over time.

- Poverty rates for people aged 65 or older have fallen over time. In 1966, the elderly poverty rate was nearly 30 percent. In 2012, it was 9 percent—and the elderly had the lowest poverty rate among all age groups.[8]

- Academic analysis has found that successive generations have reached retirement wealthier than the last.[9]

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[6] *See* Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2012," *ICI Research Perspective* 19, no. 8 (October 2013), available at www.ici.org/pdf/per19-08.pdf.

[7] *Ibid* (Figure 7 and Table 19 in the supplemental tables). The increase in pension income since ERISA is likely understated because the survey data used to analyze retiree income do not fully capture payments from DC plans and IRAs. *See also* Figure 20 and discussion, pp. 20–22, in Sabelhaus and Schrass, "The Evolving Role of IRAs in U.S. Retirement Planning," *Investment Company Institute Perspective* 15, no. 3 (November 2009), available at www.ici.org/pdf/per15-03.pdf.

[8] *See* U.S. Census Bureau, "Living in Near Poverty in the United States: 1966–2012," *Current Population Reports,* available at www.census.gov/prod/2014pubs/p60-248.pdf. In 2012, the poverty rate for individuals aged 18 to 64 was 14 percent, while it was 22 percent for those younger than 18. For historical time series, *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 6, p. 14.

[9] *See* Haveman, Holden, Wolfe, and Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf.

- Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and population growth, retirement assets were nearly seven times the level at year-end 2013 than at year-end 1975.[10]

These statistics speak to the impact of the combined changes implemented over many years, with the increased generosity of Social Security benefits, the enactment of ERISA in 1974, the creation of the 401(k) plan in 1978,[11] EGTRRA in 2001, PPA in 2006, and other measures. A crucial foundation of this success is the voluntary employer-sponsored retirement plan system, built around the laws and regulations that allow deferral of tax on compensation set aside for retirement. Rules allowing tax-deferred compensation date back to the origin of the income tax,[12] and play a crucial role in encouraging employers to establish and maintain retirement plans for their workers. While it is important to consider how the retirement system can be improved still further, Congress should *not* throw out decades of progress by taking away the ability of American workers to make full use of the retirement vehicles they value so highly.

II. THE COMPOSITION OF RESOURCES RELIED UPON IN RETIREMENT DIFFERS FROM HOUSEHOLD TO HOUSEHOLD

Assessing whether or not workers are saving enough for retirement requires a standard by which to judge savings adequacy. Retirement savings adequacy is typically defined as a relative, rather than an absolute, standard: savings would be judged to be adequate if the savings allowed retired households to maintain the standard of living they enjoyed while working. Another complicating factor in judging adequacy is that the focus on dedicated retirement savings typically occurs later in a working career. Younger households typically have other savings goals that compete with retirement savings, such as funding education, purchasing a home, and building a rainy-day fund. Importantly, this life-cycle pattern of savings observed in the data is consistent with rational economic behavior. Because of this change in focus over the life cycle, it is difficult to assess retirement preparedness for households that are not in or near retirement.

In assessing whether American workers are saving enough for retirement, it is also important to understand the different resources that most people will draw from in retirement and the role that each resource plays. The traditional analogy is that retirement resources are like a three-legged stool. This analogy implies that everyone should have resources divided equally among Social Security, employer-sponsored pension plans, and private savings. This is not, nor has it ever been, an accurate picture of

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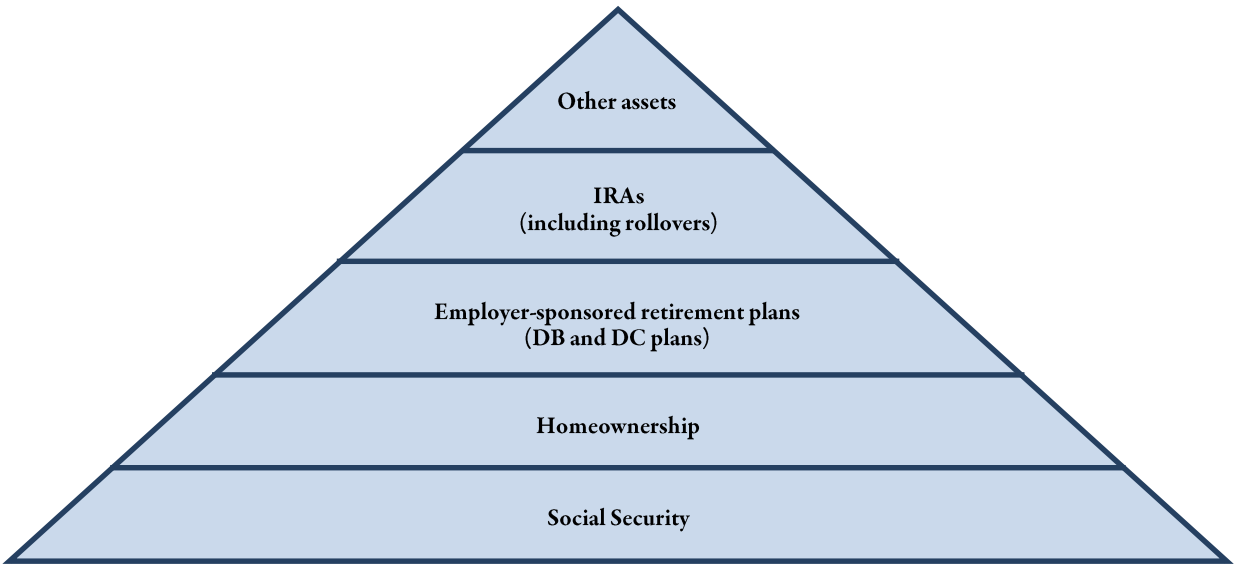
[10] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 4, p. 11 (updated to year-end 2013).

[11] Although Congress added section 401(k) to the Internal Revenue Code with the Revenue Act of 1978, it was not until November 10, 1981 that the Internal Revenue Service (IRS) formally described the rules for these plans. *See* discussion pp. 1–4 in Holden, Brady, and Hadley, "401(k) Plans: A 25-Year Retrospective," *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

[12] The modern federal income tax was established in 1913. The deferral of tax on contributions to profit-sharing plans was codified in the Revenue Act of 1921, and deferral of tax on contributions to DB plans was added in the Revenue Act of 1926. The earlier statutory text is vague as to what forms of compensation represent current income, so it is not clear how deferred compensation was treated before these laws were enacted.

Americans' retirement resources. A pyramid is a better representation of retirement resources (*see* figure below). The retirement resource pyramid has five basic components: Social Security; homeownership; employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans); IRAs (including rollovers); and other assets.[13] The composition of the retirement resource pyramid—that is, the extent to which a household relies on any given resource—will differ from household to household.

Retirement Resource Pyramid



Source: Investment Company Institute; *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System* (December 2012)

It is possible to estimate the retirement resource pyramid for U.S. households, but doing so requires measuring the value of a household's future stream of Social Security and DB plan benefits. Gustman, Steinmeier, and Tabatabai (2009) undertook this exercise using data from the Health and Retirement Study (HRS).[14] The analysis focuses on households approaching retirement—in this case, households with a member born between 1948 and 1953 (aged 57 to 62 in 2010). Their analysis is used

[13] These assets can be financial assets—including bank deposits and stocks, bonds, and mutual funds owned outside of employer-sponsored retirement plans and IRAs—and nonfinancial assets—including business equity, nonresidential property, second homes, vehicles, and consumer durables (long-lived goods such as household appliances and furniture). Assets in this category tend to be owned more frequently by higher-income households. For a more complete discussion of the retirement resource pyramid, *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012).

[14] *See* Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *University of Michigan Retirement Research Center Working Paper* 2009-206 (October 2009). The paper used 2006 HRS data, and the authors provided updated data from the 2010 HRS, which are presented in the figure.

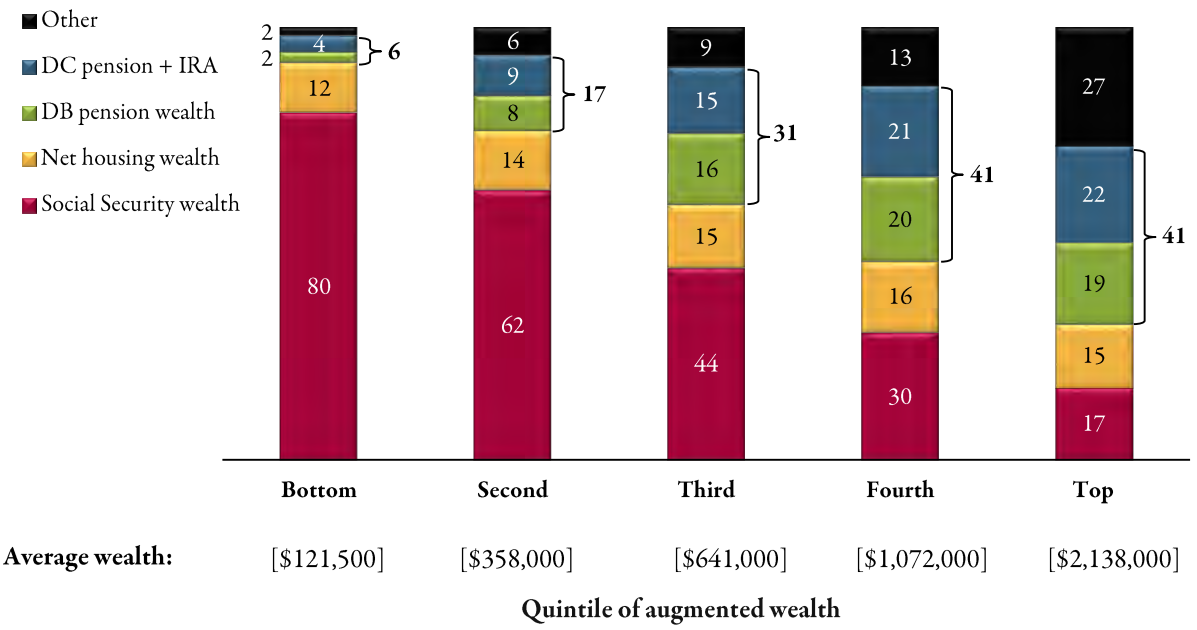
to estimate the components of the retirement resource pyramid for these households, with households grouped by their augmented wealth (*see* figure below). Reflecting the progressive benefit formula, households approaching retirement in the lowest augmented wealth quintile (the lowest 20 percent of households approaching retirement ranked by augmented wealth) rely heavily on Social Security benefits. In 2010, Social Security comprised 80 percent of total augmented wealth for households approaching retirement who were in the lowest augmented wealth quintile. Although Social Security typically replaces a high percentage of earnings for these households, many also had equity in their homes, accumulated retirement benefits, and other assets.

In comparison with those with lower augmented wealth, households approaching retirement in the middle of the augmented wealth distribution rely more heavily on resources other than Social Security. Social Security comprised a large portion of total augmented wealth (44 percent) for households approaching retirement in the middle of the augmented wealth distribution (*see* figure below). For this group, equity in their homes made up 15 percent of augmented wealth and the combination of employer-sponsored DB and DC retirement plans and IRAs comprised another 31 percent of augmented wealth. These households in the middle of the augmented wealth distribution are reliant on a mix of resources in retirement: some from Social Security, but more than half from employer-sponsored retirement plans and IRAs, equity in their homes, and other assets.

The highest augmented wealth quintile of households approaching retirement relies relatively little on Social Security, reflecting the fact that Social Security benefits typically replace a much smaller share of lifetime earnings for this group. For these households, employer-sponsored retirement plans, IRAs, and other assets are more important. For households approaching retirement in the top augmented wealth quintile, Social Security comprised only 17 percent of total augmented wealth (*see* figure below). For this group, 22 percent of total augmented wealth was composed of employer-sponsored DC plans and IRAs, 19 percent from DB plans, 15 percent from equity in their homes, and 27 percent from other assets.

Retirement Resource Pyramid Varies with Wealth

Percentage of wealth by wealth quintile, households with at least one member age 57 to 62, excludes top and bottom one percent, 2010



Source: Investment Company Institute tabulation derived from an updated Table 3 of Gustman, Steinmeier, and Tabatabai (2009) using Health and Retirement Study (HRS) data

A. Social Security

Although often ignored in retirement policy discussions, the United States already has a mandatory retirement plan: Social Security. Social Security stands at the base of the retirement resource pyramid, providing households across all levels of earnings with inflation-indexed income for life. For most households, Social Security is one of their most valuable resources.

When Social Security was signed into law in 1935, it was intended to replace a modest portion of income. Changes to the system since its inception—in particular, two periods of expansion, first in the 1950s and then again in the 1970s—increased benefits substantially, especially for those with low lifetime earnings.[15] Described as a "cornerstone" for U.S. retirement security at its beginning, Social Security has transformed into a comprehensive government-provided pension for workers with lower lifetime earnings and a strong foundation for retirement security for those with higher lifetime earnings.

The expansion of benefits has not come without costs. In 1937, the OASDI tax rate was 2.0 percent on up to $3,000 of wages and salary (equivalent to about $49,000 in constant 2014 dollars).

[15] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 17–20.

Today, Social Security mandates contributions for American workers of 12.4 percent of wages and salary from the first dollar they earn up to the maximum annual earnings covered by the system, *i.e.*, $117,000 in 2014.[16]

Social Security benefits are designed to be progressive; that is, the benefits represent a higher proportion of pre-retirement earnings for workers with lower lifetime earnings than for workers with higher lifetime earnings. For example, for the cohort of individuals born in the 1940s, Congressional Budget Office (CBO) analysis shows that Social Security benefits are projected to replace 77 percent of average indexed earnings for the typical individual in the bottom 20 percent of individuals ranked by lifetime earnings.[17] The replacement rate drops to 51 percent for the second quintile, and then declines more slowly as lifetime earnings increase. Social Security benefits are projected to replace a considerable fraction of indexed earnings—32 percent—for even the top 20 percent of earners.

These statistics, however, understate the generosity of Social Security benefits, as illustrated in a recent paper by Pang and Schieber.[18] The replacement rate measures used by both the CBO and the Social Security Administration (SSA) measure Social Security benefits as a percentage of wage-indexed earnings. If a worker is seeking to maintain their standard of living in retirement, inflation-indexed, not wage-indexed, earnings represent a better metric of success. Because wages have grown more quickly than inflation over time, Social Security benefits replace a higher percentage of inflation-indexed earnings. To illustrate the impact, Pang and Schieber calculate replacement rates for workers born in 1949 and retiring at age 65 in 2014.[19] Measured as a percentage of wage-indexed earnings, Social Security benefit replacement rates are 77 percent for very low earners, 42 percent for medium earners, and 28 percent for maximum earners (*see* figure below). Using inflation-indexed earnings, the replacement rates are 87 percent, 47 percent, and 31 percent, respectively.

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[16] *See* Social Security Administration, "Contribution and Benefit Base Determination," available at www.ssa.gov/oact/cola/cbbdet.html. For historical tax rates, *see* www.ssa.gov/oact/progdata/taxRates.html. For the historical earnings base, *see* www.ssa.gov/oact/COLA/cbb.html. OASDI taxes as a percentage of earnings increased to 3.0 percent by 1950, to 6.0 percent by 1960, to 8.4 percent by 1970, to 10.16 percent by 1980, and reached the current 12.4 percent rate in 1990.

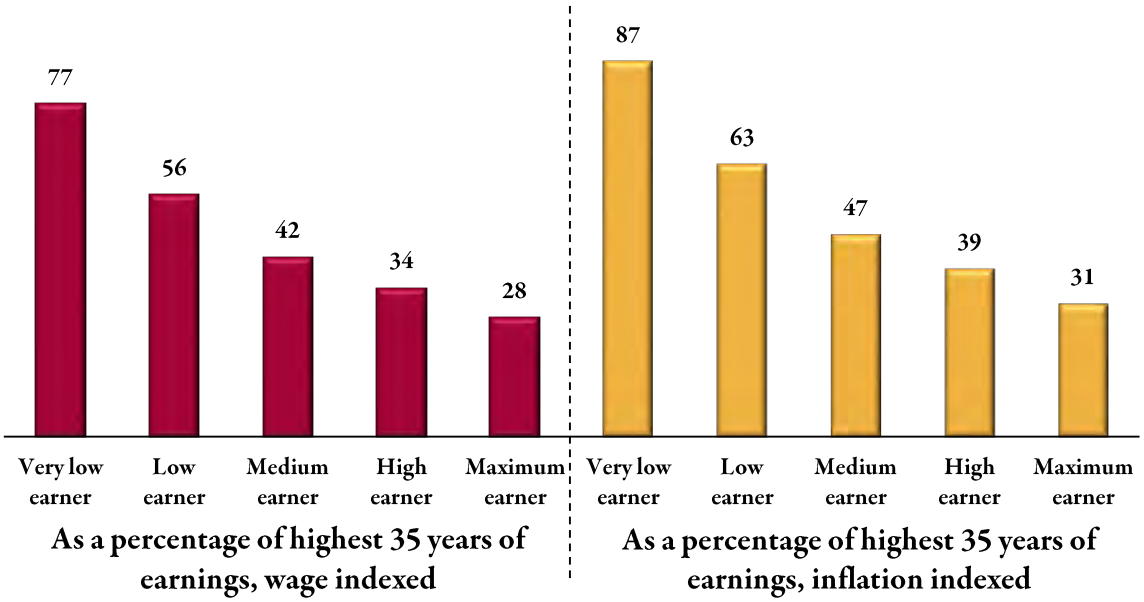
[17] *See* Congressional Budget Office, *The 2013 Long-Term Projections for Social Security: Additional Information* (October 2013), available at www.cbo.gov/publication/44972. These are an update of the estimates in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 9, p. 19. *See also* Investment Company Institute, *2014 Investment Company Fact Book*, available at www.icifactbook.org.

[18] *See* Exhibit 3 in Pang and Schieber, "Why American Workers' Retirement Income Security Prospects Look so Bleak: A Review of Recent Assessments," *Working Paper* (May 31, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2433193.

[19] *Ibid.* The authors used wage profiles developed by SSA for five hypothetical workers with different levels of lifetime earnings.

Social Security Benefits Are More Generous to Workers with Low Lifetime Earnings

Alternative replacement rates for estimated Social Security benefits for SSA hypothetical workers born in 1949, retiring at age 65 in 2014



Source: Pang and Schieber (2014)

Because of the progressive benefit formula, Social Security benefits comprise a higher share of lower-earning households' retirement income. In addition, although this resource typically is not included in measures of household wealth, if it were to be counted as an asset, the value of future Social Security benefits would comprise a higher share of assets in such an augmented balance sheet for those households (as discussed above). In contrast, to maintain their standard of living in retirement, higher-earning households have a greater need to supplement Social Security benefits.

B. Homeownership

A second resource available to the vast majority of retired households is the home in which they live.[20] Homeownership increases with age and is high across all income groups among near-retiree households. Households who own homes often have no or low mortgage debt by the time they reach retirement age. Households do not have to sell their homes to benefit from them in retirement; they simply have to live in them. Homeownership is like having an annuity that provides rent, as the home provides a place to live that otherwise would have to be rented.

[20] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 22–26.

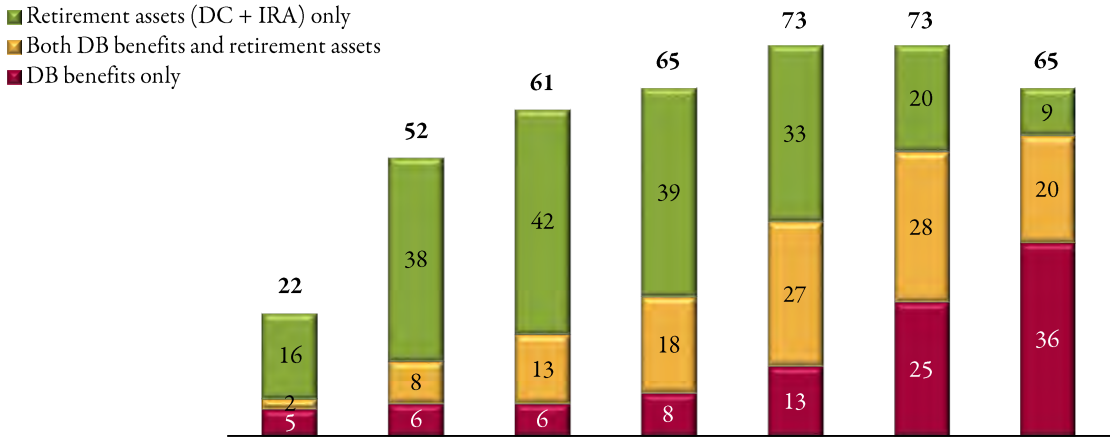
C. Employer-Sponsored Retirement Plans and IRAs

The next two layers of the retirement resource pyramid consist of accumulations in employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans) and IRAs (both contributory and those resulting from rollovers from employer-sponsored plans). Near-retiree households across all income groups have these retirement benefits, but employer-sponsored retirement plans and IRAs typically provide a larger share of resources for higher-income households, for whom Social Security benefits provide a smaller share.

The share of households with retirement accumulations—that is, with benefits accrued in a DB plan or assets in a DC plan or IRA—follows a life-cycle pattern. Based on data from the 2013 Survey of Consumer Finances (SCF), conducted by the U.S. Federal Reserve Board, the share of households with retirement accumulations increases from 22 percent of households younger than 25, to 61 percent of households aged 35 to 44, to 73 percent of households aged 65 to 74 (*see* figure below). Similarly, among those with a DC plan or IRA, median retirement assets increase from $2,300 for households younger than 25, to $42,700 for households aged 35 to 44, to $149,000 for households aged 65 to 74.

Share of Households with DB, DC, or IRA Increases with Age, as Do Retirement Assets

Households by age of household head, 2013



	Younger than 25	25 to 34	35 to 44	45 to 54	55 to 64	65 to 74	75 or older
	Age of head of household						
Median retirement assets:	$2,300	$13,500	$42,700	$87,000	$104,000	$149,000	$69,000

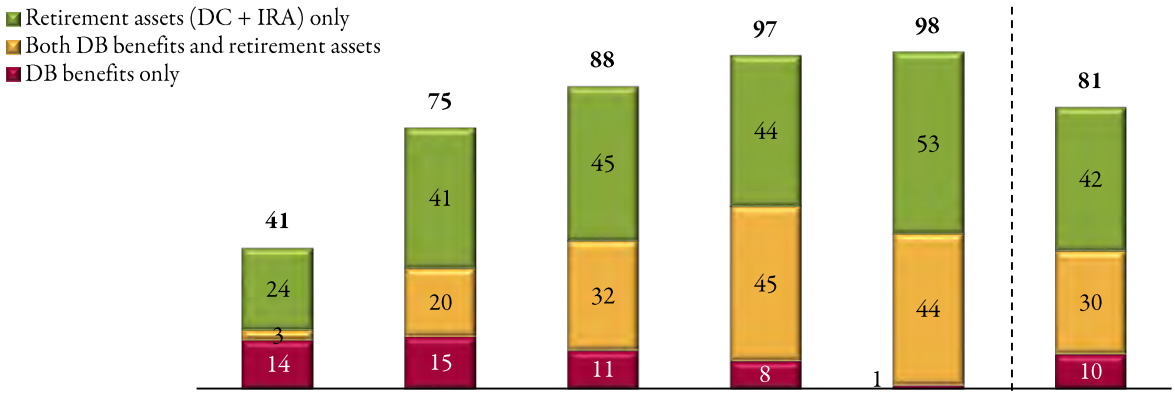
Note: Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.
Source: ICI tabulations of the Survey of Consumer Finances

The figure above analyzed the incidence of retirement accumulations by age of household across all households to highlight the life-cycle pattern of focus on saving for retirement. The next figure looks more closely at households who are still working and are getting close to retirement. Focusing on these near-retiree households—that is, working households aged 55 to 64—81 percent have retirement

accumulations and, among those with DC plans or IRAs, median retirement assets are $107,000 (*see* figure below). Pre-retirees across all income groups have retirement accumulations, including 41 percent of near-retiree households with income less than $30,000 and 75 percent of near-retiree households with income of $30,000 to $54,999. For the top 60 percent of households by income, over 90 percent have retirement accumulations.

Near-Retiree Households Across All Income Groups Have Retirement Assets, DB Plan Benefits, or Both

Households with working head aged 55 to 64, by household income, 2013



	Less than $30,000	$30,000 to $54,999	$55,000 to $79,999	$80,000 to $149,999	$150,000 or more	All
Percentage of households:	16%	24%	16%	26%	18%	100%
Median retirement assets:	$10,300	$35,000	$88,000	$129,000	$425,000	$107,000

Note: Near-retiree households are households with a working head aged 55 to 64 in 2013, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.
Source: ICI tabulations of the Survey of Consumer Finances

As with Social Security benefits, assets specifically earmarked for retirement have increased significantly over time. In 1975, aggregate retirement assets, including assets in DB plans, represented about $27,700 per household in constant 2013 dollars. By year-end 2013, that figure stood at about $185,700—6.7 times the level in 1975.[21]

[21] *See* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 4, p. 11 (updated to year-end 2013).

III. EFFECTIVE POLICYMAKING REQUIRES A BETTER UNDERSTANDING OF THE "COVERAGE GAP"

While the current retirement laws and policies are working well and are helping tens of millions of American workers accumulate savings and generate retirement income, some argue that the system is a failure in that not all Americans have access to an employer-sponsored retirement plan. This perceived failure is referred to as the so-called "coverage gap." The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.[22] Discussions about coverage, however, often rely on misleading or incomplete coverage statistics. Household surveys, such as the Current Population Survey (CPS), typically show lower rates of pension coverage than surveys of business establishments, such as the National Compensation Survey (NCS). For example, the CPS data show that 57 percent of all full-time private-sector wage and salary workers had pension coverage in 2012.[23] The March 2014 NCS, on the other hand, shows that 65 percent of all private-industry workers and 74 percent of all full-time private-industry workers have access to a pension.[24]

Even if one uses the CPS data for analysis, however, looking below the aggregate statistics paints a significantly different picture. Of the 80.6 million workers who report that their employer does not sponsor a pension plan in 2012, 18.2 million are either federal workers, state and local workers, self-employed, or work without pay.[25] This leaves 62.5 million private-sector wage and salary employees who report that their employer does not sponsor a retirement plan. Yet this still overstates the number on which to focus. Of these, 6.1 million are under 21 and 3.3 million are aged 65 or older. This leaves 53.1 million private-sector wage and salary employees aged 21 to 64 who report that their employer does not

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[22] *See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013), available at www.ici.org/pdf/per19-06.pdf. Current Population Survey (CPS) data for 2012 indicate that 50 percent of private-sector wage and salary workers were employed by firms that sponsored retirement plans (including both DB and DC plans). However, access to retirement plans is not random. Limiting the analysis to full-time, full-year workers aged 30 to 64, access to retirement plans increases to 60 percent. If the analysis is narrowed further to the groups of workers most likely to be focused on saving for retirement—workers aged 30 or older with at least moderate levels of earnings and all but the lowest earning workers aged 45 or older—then 69 percent work for employers that sponsor retirement plans. In addition, some in this group without access to plans at their own employers have access to plans through their spouses' employers. Taking into account access through spouses, 74 percent of workers who are likely to be focused on saving for retirement have access to employer-provided retirement plans, and 93 percent participate in the plans offered.

[23] *Ibid* (Figure 3). Pension coverage includes DB and/or DC plans.

[24] *See* Table 1 in U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in the United States – March 2014," News Release USDL-14-1348 (July 25, 2014), available at www.bls.gov/news.release/pdf/ebs2.pdf. Pension coverage includes DB and/or DC plans.

[25] This includes 1.0 million federal government workers and 4.2 million state and local government workers who reported that their employers did not sponsor retirement plans (and possibly gave an inaccurate response to the survey). Another 13.0 million workers without an employer-sponsored retirement plan were self-employed and approximately 149,000 reported that they worked without compensation of any type. Self-employed workers are excluded because, being their own employer, they can access an employer-provided plan by exercising their option to establish a plan. *See* Figure 5 in Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013).

sponsor a pension plan.[26] Of these, 21.7 million are part-time, part-year workers[27] and 7.6 million are full-time, full-year workers aged 21 to 29 (*see* figure below).[28] This leaves 23.8 million full-time, full-year private-sector wage and salary workers aged 30 to 64 who report that their employer does not sponsor a pension plan. Of these, 7.6 million earn less than $26,000 a year[29] and 3.8 million earn $26,000 to $44,999 a year and are aged 30 to 44.[30] The result is 12.4 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan. But 2.2 million of these have a spouse whose employer sponsors a plan. The final result is 10.2 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan through their own employer or a spouse.

[26] *Ibid* (Figure 5).

[27] Most part-time, part-year workers have low income and high replacement rates from Social Security. They are unlikely to save for retirement in the current year if they work full-time or year-round in other years. *Ibid* (Figure 6).

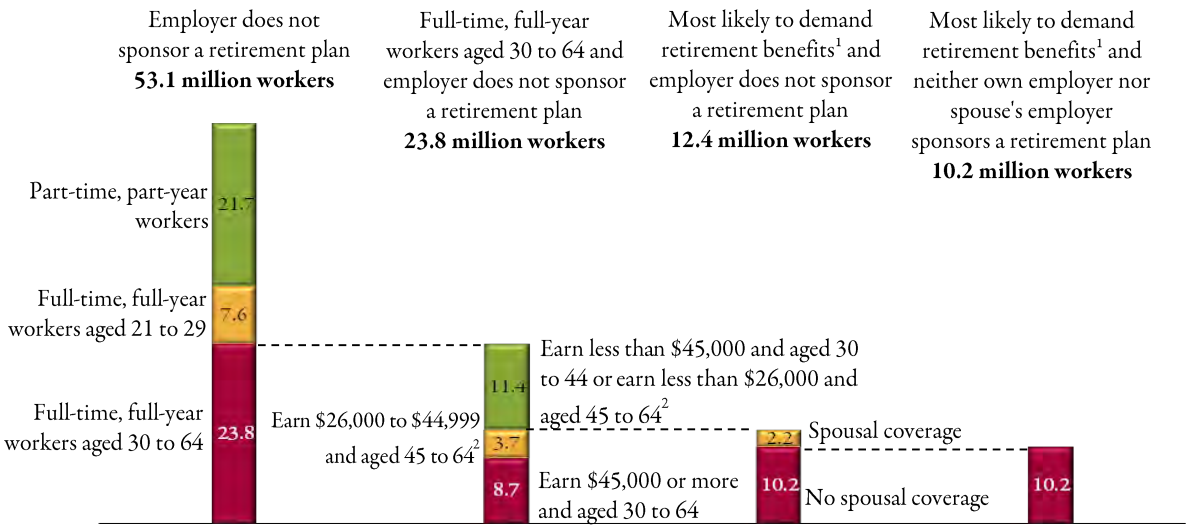
[28] Few in this age group save primarily for retirement. Workers age 21 to 29 save primarily for education, the purchase of a home, or for precautionary reasons. *Ibid* (*see* ICI tabulations from the 2010 Survey of Consumer Finances, Figure 1, p. 4).

[29] The primary concern for workers earning less than $26,000 per year is they do not have enough to spend on food, clothing and shelter. In fact, many are eligible for government income assistance so that they will be able to spend more than what they earn on these items. If these workers consistently have low earnings throughout their careers, Social Security will replace a high percentage of their lifetime earnings. *Ibid* (*see* Tables 41 and 42 in Brady and Bogdan "Supplemental Tables for Who Gets Retirement Plans and Why, 2012," available at www.ici.org/info/per19-06_data.xls).

[30] Workers age 30 to 44 who earn between $26,000 and $44,999 a year may have the ability to save, but have other saving priorities, such as starting a household and having children. Given that they get a substantial replacement rate from Social Security, they are likely to delay saving for retirement until later in life–perhaps after age 44. *Ibid* (Tables 41 and 42).

A Closer Look at Workers Who Are Not Covered by an Employer Plan

Millions of private-sector wage and salary workers aged 21 to 64, 2012



[1] Full-time, full-year workers who earn $45,000 or more and are aged 30 to 64 or earn $26,000 to $44,999 and are aged 45 to 64.

[2]Among full-time, full-year workers aged 35 to 44, $26,000 represents the top earnings of the 20th percentile of annual earnings and $45,000 represents the top earnings for the 50th percentile of annual earnings.

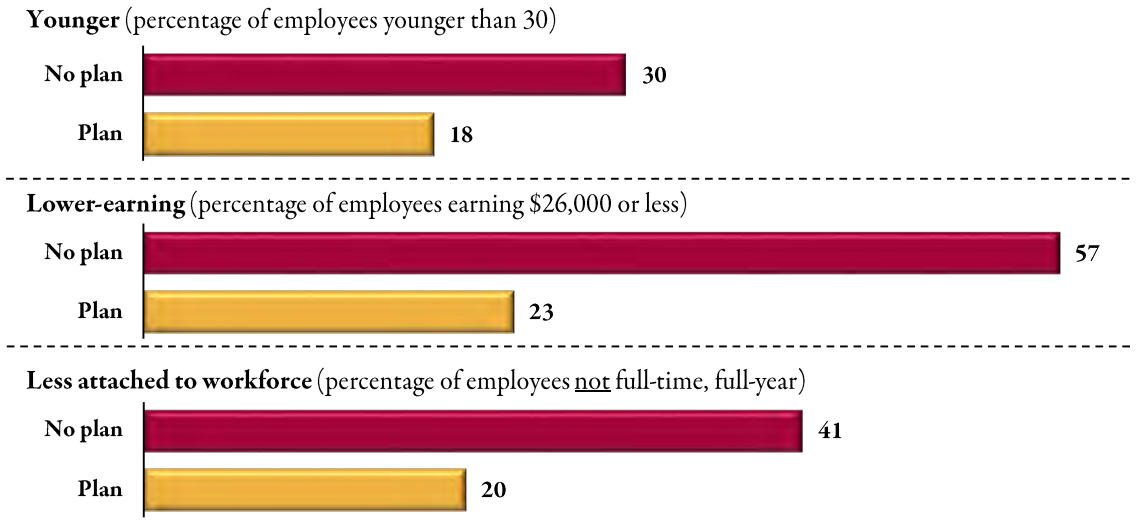
Note: Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of March 2013 Current Population Survey; *see* Brady and Bogdan, "Who Gets Retirement Plan and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013)

Access to retirement plans at work is not randomly distributed throughout the workforce. Differences in workforce composition appear to be a primary cause for the lower rate at which small employers sponsor retirement plans.[31] As a group, the characteristics of small-firm employees differ substantially from the characteristics of large-firm employees. Nevertheless, workers at small firms that sponsor plans are very similar to workers at large firms that sponsor plans, and workers at small firms that do not sponsor plans are very similar to workers at large firms that do not sponsor plans. In particular, employees who work for firms that do not sponsor retirement plans are more likely to be younger, have lower earnings, and have less attachment to the workforce (*see* figure below). For example, among employers that do not sponsor retirement plans, 30 percent of their employees are younger than 30, 57 percent of their employees are low earners, and 41 percent of their employees are not full-time, full-year. In contrast, among employers that do sponsor retirement plans, only 18 percent of their employees are young, only 23 percent are low earners, and only 20 percent are not full-time, full-year.

[31]*See* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013).

Companies That Don't Offer Pension Plans Have Workforces That Are:



Source: Investment Company Institute tabulations of March 2013 Current Population Survey; *see* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* (October 2013)

It is also important to remember that households with earned income have access to IRAs to save for retirement on a tax-advantaged basis. For example, Congress designed the traditional IRA with two goals in mind: (1) to create a contributory retirement account for workers, and (2) to provide a rollover vehicle to preserve assets accumulated in employer-sponsored retirement plans (both DB and DC). Although a small share of individuals contributes to traditional IRAs in any given year,[32] the majority of those who contribute make repeat contributions in succeeding years.[33] In addition, many of those IRA investors contributing to traditional IRAs contribute at the limit.[34]

Many more workers will have access to an employer-sponsored retirement plan at some point during their working careers and will reach retirement with work-related retirement benefits than is implied by looking at a snapshot of coverage among all workers at any point in time. Data from the SCF show that accrued benefits and asset accumulations in employer-sponsored retirement plans and IRAs

[32] A number of factors may account for this relatively low contribution rate. Two of the major determinants of individuals' decisions to contribute to traditional IRAs are their assessment of their need for additional retirement savings and their ability to deduct contributions from their taxable income. Individuals who are covered by retirement plans at work may find that they can meet their saving needs through those plans. In addition, coverage by such plans may curtail their eligibility to make tax-deductible contributions. For lower-income households, Social Security replaces a much higher fraction of pre-retirement earnings, which may reduce their need for additional retirement savings. Furthermore, there is some evidence that confusion about IRA rules may prevent some individuals from contributing. *See* Holden and Bass, "The IRA Investor Profile: Traditional IRA Investors' Activity, 2007–2012," *ICI Research Report* (March 2014), available at www.ici.org/pdf/rpt_14_ira_traditional.pdf.

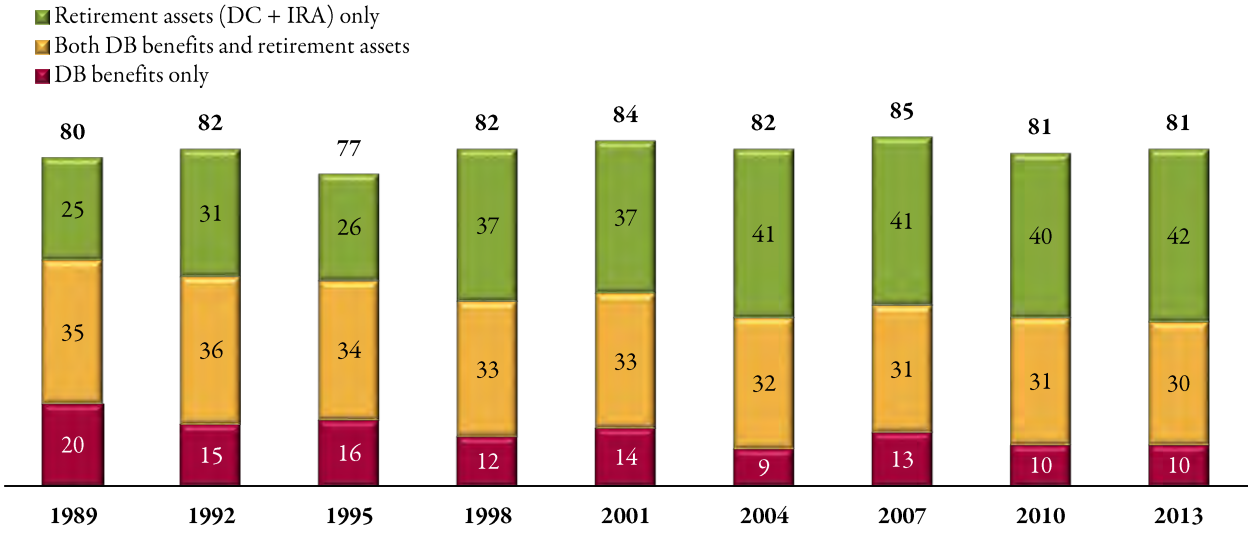
[33] *Ibid.*

[34] *Ibid.*

constituted a resource for about 80 percent of near-retiree households in 2013 (*see* figure below).[35] For the past two decades about 80 percent of near-retiree households—those with a working head of household aged 55 to 64 in the year indicated—have consistently accrued DB, DC, or both types of retirement plan benefit (from private-sector employer and government employer plans), or IRAs (rollover and contributory). Despite the fact that DC plans have grown relative to DB plans among private-sector employers, the portion of near-retiree households with retirement accumulations has remained stable. What has changed is the composition of those retirement accumulations: in 1989, 55 percent of near-retiree households had DB benefits and 60 percent had retirement assets (DC plans or IRAs, or both), compared with 2013, when 40 percent of near-retiree households had DB benefits and 72 percent had retirement assets.

Vast Majority of Near-Retiree Households Have Accrued Pension Benefits

Percentage of near-retiree households, 1989–2013



Note: Near-retiree households are households with a working head aged 55 to 64 in the year indicated, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of the 1989–2013 Survey of Consumer Finances

[35] Update of tabulations in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 13, p. 29.

IV. THE VOLUNTARY EMPLOYER-SPONSORED RETIREMENT SYSTEM IS CHARACTERIZED BY FLEXIBILITY, COMPETITION, AND INNOVATION

A strength of the voluntary employer-provided retirement system is the flexibility built into its design. This flexibility has allowed a tremendous amount of innovation to take place over the past few decades, due to the combined efforts of employers, employees, and plan service providers. Some of these innovations—for example, making contributions through regular payroll deduction, which provides convenience and stability, or employer matching contributions, designed to further incentivize employee participation—are now taken for granted as standard plan features. Another important improvement has been automatic enrollment to increase plan participation.[36] Another change, auto-escalation, gradually increases the share of pay contributed each pay period until it reaches a desired goal. Further, target date funds also have become increasingly popular both as a default and as an employee choice and have been successful in ensuring that investors have a diversified portfolio that rebalances to be more focused on income and less focused on growth over time.[37]

It is important to remember that the employer-sponsored retirement system is premised on its voluntary and flexible nature; employers can choose to provide retirement plans to their employees tailored to their specific needs—but they are not required to do so. The current tax structure—including allowing the deferral of tax on compensation contributed to employer-sponsored retirement plans—provides a strong and effective incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that provide significant benefits to American workers of all income levels. Untoward changes in the retirement tax incentives would require each employer to reevaluate and potentially redesign its retirement plan offerings and could prompt them to consider eliminating their plans entirely.

A. 401(k) Plan Assets Tend to Be Concentrated in Lower-Cost Mutual Funds

Employers design and offer 401(k) plans to attract and retain qualified workers, and financial companies compete to provide services to the plans. Competition and a growing asset base have contributed to the success of 401(k) plans by reducing investment costs, which results in cost-effective investing for 401(k) participants. In this respect, Institute research shows that the costs 401(k) plan participants have incurred for investing in long-term mutual funds have trended down over the past decade. For example, in 2000, 401(k) plan participants incurred expenses of 0.77 percent of the 401(k)

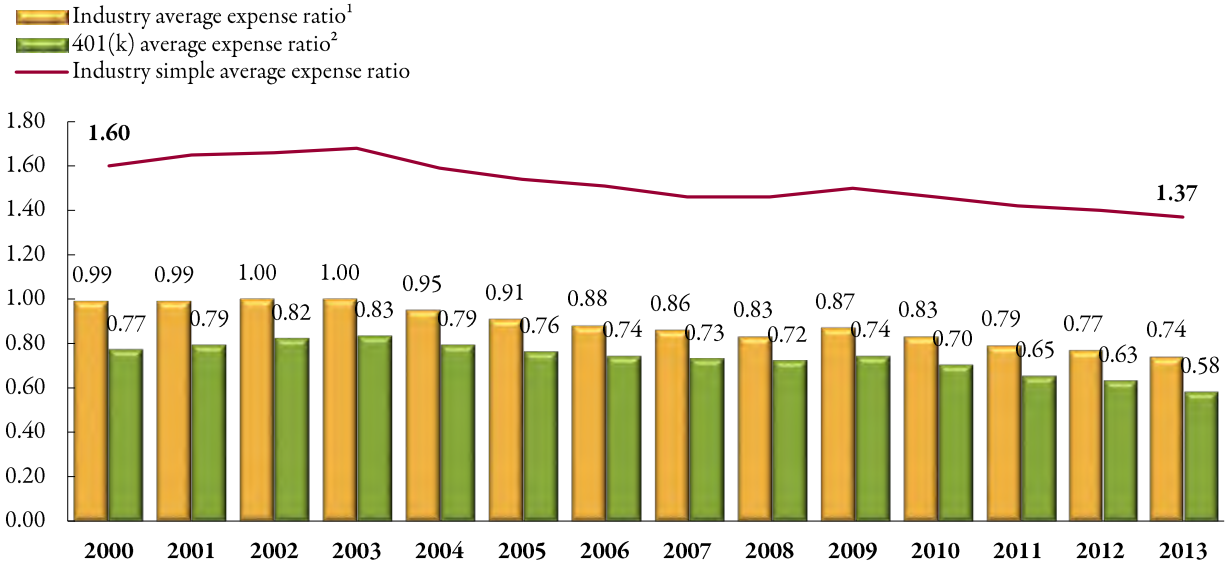
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[36] The EBRI/ICI 401(k) Accumulation Projection Model demonstrates the increases in retirement income that can result from automatic enrollment. Replacement rates, modeled after adding automatic enrollment and investing contributions in a target date fund, increase significantly. *See* Holden and VanDerhei, "The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *Investment Company Institute Perspective* 11, no. 2, and *EBRI Issue Brief*, no. 283 (July 2005), available at www.ici.org/pdf/per11-02.pdf and www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf. Furthermore, studies find that adopting an automatic enrollment feature has a particularly strong impact on improving participation rates among low-income and younger workers. *See, e.g.*, Utkus and Young, *How America Saves, 2014: A report on Vanguard 2013 defined contribution plan data*, Vanguard Center for Retirement Research (2014), available at https://institutional.vanguard.com/iam/pdf/HAS14.pdf.

[37] *See* Charlson, "Diversification Pays Off for Target-Date Funds," *Morningstar Advisor* (January 17, 2013).

assets they held in equity funds (*see* figure below).[38] By 2013, that had fallen to 0.58 percent, a 25 percent decline.[39] The expenses 401(k) plan participants incurred for investing in hybrid and bond funds also fell from 2000 to 2013, by 19 percent and 21 percent, respectively.[40] It is also significant that participants in 401(k) plans tend to pay lower fees than fund investors overall. The 0.58 percent paid by 401(k) investors in equity funds is lower than the expenses paid by all equity fund investors (0.74 percent) and less than half the simple average expense ratio on equity funds offered for sale in the United States (1.37 percent). The experience of hybrid and bond fund investors is similar.

401(k) Mutual Fund Investors Concentrate Their Assets in Lower-Cost Equity Funds
Percent, 2000–2013



[1]The industry average expense ratio is measured as an asset-weighted average.
[2]The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.
Note: Data exclude mutual funds available as investment choices in variable annuities.
Sources: Investment Company Institute and Lipper; *see* Collins, Holden, Chism, and Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013," *ICI Research Perspective* (July 2014)

B. American Workers Show Strong Support for the Defined Contribution Retirement Plan System

Given this progress in building nest eggs for American workers, it is no surprise that Americans highly value their DC plans and the features typically associated with them. A fall 2013 household

[38] *See* Collins, Holden, Chism, and Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013," *ICI Research Perspective* 20, no. 3 (July 2014), available at www.ici.org/pdf/per20-03.pdf.

[39] *Ibid* (Figure 6, p. 12).

[40] *Ibid* (Figure 6, p. 12).

survey demonstrated American households' strong support for key features of DC plans, including DC plans' tax benefit, and their appreciation for the investment opportunity these plans provide.[41]

- **Americans overwhelmingly support preserving the tax incentives for retirement saving.** Eighty-six percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated. Eighty-three percent opposed any reduction in employee contribution limits.[42]

- **Vast majorities of American households oppose altering key features of DC plans.** Eighty-six percent of all U.S. households disagreed with the idea that individuals should not be permitted to make investment decisions in their DC accounts.[43]

- **Investors like choice and control of investments.** Ninety-six percent of all DC account–owning households agreed that it was important to have choice in, and control of, the investment options in their DC plans. Eighty-six percent said their plan offers a good lineup of investment options.[44]

- **Most households have positive attitudes toward the 401(k) system.** Sixty-six percent of all U.S. households surveyed in fall 2013 had favorable impressions of 401(k) and similar plan accounts, similar to the support shown in surveys taken in the prior four years.[45] More than three-quarters of households expressed confidence that DC plan accounts could help participants reach their retirement goals.[46]

ICI's household surveys during the past five years find that despite the experience of a recent bear market and a broad economic downturn, Americans remain committed to saving for retirement and value the characteristics, such as the tax benefits and individual choice and control that come with DC plans.

V. TAX-DEFERRED COMPENSATION IS NOT TAX-FREE COMPENSATION

Discussion and policy proposals surrounding tax incentives for retirement often proceed from premise that compensation that is saved for retirement is similar to an exclusion or deduction, or in other words "tax-free." That premise is false. The tax code allows workers to *defer* taxation on compensation that is set aside for retirement in a qualified employer plan or in an IRA. With a deferral, taxes are collected in the year the worker receives the compensation (through a plan distribution or an

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[41] *See* Burham, Bogdan, and Schrass, "Americans' Views on Defined Contribution Saving," *ICI Research Report* (January 2014), available at www.ici.org/pdf/ppr_14_dc_plan_saving.pdf. The survey included 3,021 U.S. adults interviewed in November 2013 and December 2013. Survey results were weighted to be representative of U.S. households.

[42] *Ibid* (Figure 3, p. 9).

[43] *Ibid* (Figure 3, p. 9).

[44] *Ibid* (Figure 2, p.7).

[45] *Ibid* (Figure 1, p. 5).

[46] *Ibid* (Figure 5, p. 13).

IRA withdrawal), rather than in the year the compensation is earned. When a distribution is taken, taxes are paid on both the original deferred compensation and the earnings on those deferrals from the plan or IRA.

A deferral of tax is *neither* a tax deduction *nor* a tax exclusion. Tax deductions (such as the deduction of mortgage interest expense) and tax exclusions (such as the exclusion of employer-paid health insurance premiums from taxable compensation) reduce taxes paid in the year taken, but do not affect taxes in any future year. In contrast, setting aside a portion of compensation until retirement reduces taxes paid in the year the compensation is earned, but *increases* taxes paid in the year the compensation is received.

The simple calculations used to quantify the tax benefits and revenue costs of tax exclusions and tax deductions accordingly do not apply to tax deferrals. Unlike a deduction or an exclusion, the benefits an individual receives from deferring tax on compensation cannot be calculated by simply multiplying the amount of compensation deferred by the individual's marginal tax rate. This is because the tax benefit is not the up-front deduction.[47]

Instead, the benefits of deferral depend on many factors, with the most important factor being the length of time a contribution remains invested (which in turn is generally driven by the saver's age at the time of the contribution). The dollar value of the tax benefit also will depend on an individual's marginal tax rate, but that relationship is complex. In fact, under current law, controlling for the length of deferral, there already is little difference in the dollar value of the tax benefit generated by a $1,000 retirement contribution among individuals in the top five federal income tax brackets (with marginal tax rates of 25, 28, 33, 35, and 39.6 percent).[48]

A. Proposals to Limit the Up-Front Benefit of Tax Deferral Are Misguided

Because a *tax deferral* is neither a *tax deduction* nor a *tax exclusion,* it should not be included in proposals that limit the tax benefit of deductions and exclusions. In particular, because the tax benefit of a deferral is not the up-front tax savings, proposals that limit the up-front tax savings change the tax treatment substantially. Capping the up-front tax savings on retirement contributions would arbitrarily penalize workers, substantially reducing the tax benefits for those closest to retirement.

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[47] As a rough approximation, the benefits of tax deferral are equivalent to facing a zero rate of tax on investment income. In the absence of deferral, an individual saving for retirement would first pay tax on her compensation, contribute the after-tax amount to a taxable investment account, and then pay taxes on investment returns each year. Other than tax on unrealized capital gains, no tax would be paid when account balances were withdrawn. Tax deferral changes the tax treatment at three different points in time: no tax is paid up front; no tax is paid on investment returns during the deferral period; and both contributions and investment returns are taxed upon withdrawal. If there is no change in an individual's marginal tax rate, the tax paid upon distribution pays back to the government, with interest, the up-front reduction in taxes. The remaining difference represents the tax benefit of deferral: tax-free investment income on the portion of the initial contributions that would have been contributed to a taxable account. *See* Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at: www.ici.org/pdf/ppr_12_tax_benefits.pdf.

[48] *Ibid.*

Several proposals intended to limit the up-front benefit of tax-deferred retirement plan contributions have been introduced in recent years. Since fiscal year 2011 (FY2011), the Administration's budget has included a proposal to "cap" the benefits of itemized deductions at 28 percent. Starting with the FY2013 budget, the proposal was expanded so that the 28 percent cap also applied to tax-deferred employee contributions to DC plans and tax-deferred IRA contributions. In his tax reform discussion draft, Ways and Means Committee Chairman Camp (R-MI) included a proposal that would subject tax-deferred employee and employer contributions to DC plans to a 10 percent surtax. Although the 10 percent surtax proposal appears to be much different from the 28 percent cap proposal, the combination of the surtax with a top marginal rate of 25 percent is equivalent to having a top marginal rate of 35 percent and a 25 percent cap. Both the 28 percent cap proposal and the 10 percent surtax proposal are variants of proposals that have been around for some time: turning all deductions and exclusions into flat-rate credits. For example, in 2006, Batchelder, Goldberg, and Orszag proposed to turn all "tax incentives" into refundable 15 percent credits.[49] More recently, Gale, John, and Smith released a similar proposal specifically for retirement contributions.[50]

The idea of limiting the tax benefits of deductions and exclusions, rather than eliminating them altogether, may seem at first glance to be a modest proposal. Under current tax law, a deduction or exclusion generally reduces a taxpayer's income tax by the amount of the item multiplied by the taxpayer's marginal tax rate. For example, an additional $1,000 of mortgage interest deduction would reduce income taxes by $350 for a taxpayer in the 35 percent tax bracket, and by $250 for taxpayer in the 25 percent tax bracket. Under both the Administration's 28 percent cap proposal and the Camp 10 percent surtax proposal, the tax benefit of the mortgage interest deduction would remain unchanged for the 25 percent marginal rate individual, but would be reduced to $280 or $250, respectively, for the 35 percent marginal rate individual.

When applied to tax deferrals, however, the impact of these proposals is anything but modest. These proposals would substantially change the tax treatment of retirement contributions. To implement a cap on the up-front benefit, taxpayers would pay an additional "cap tax" or "surtax" on retirement plan contributions. For example, a taxpayer in the 35 percent bracket would pay a tax on a $1,000 contribution of $70 (7 percent, or 35 percent less 28 percent) under the 28 percent cap proposal, a tax of $100 with a 10 percent surtax, and a tax of $200 (20 percent, or 35 percent less 15 percent) with a 15 percent credit. Taxes paid in retirement would remain unchanged, however, with all distributions from the account subject to tax.[51] Thus, the up-front value of the tax deferral is reduced by the "surtax"

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[49] *See* Batchelder, Goldberg, and Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *New York University Law and Economics Working Papers*, Paper 77 (October 2006), available at lsr.nellco.org/nyu_lewp/77.

[50] *See* Gale, John, and Smith, "New Ways to Promote Retirement Saving," *AARP Public Policy Institute Research Report* no. 2012-09 (October 2012), available at www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf.

[51] This is the case with the 15 percent credit proposal, the Camp 10 percent surtax proposal, and the Administration's FY2013 28 percent cap proposal. Responding to criticism that workers could be made worse off by contributing to a retirement plan, the Administration's FY2014 proposal included a provision for an unspecified basis adjustment. Any basis adjustment that would ensure no worker is made worse off contributing to a retirement plan would be unintuitive, complex,

or "cap tax," but the tax ultimately paid on income from the retirement account is not reduced. In effect, taxpayers would be taxed on contributions made to the retirement account and again as they receive the amounts in the form of distributions.

The additional "surtax" or "cap tax" would create a drag on a saver's return, sharply reducing the benefits of tax deferral. In fact, some workers close to retirement age may find that they would have been better off paying taxes on the wages and investing in a taxable account.[52] For example, a worker invested in stocks would need to hold the investment for 13 years before the benefits of deferral offset the impact of a 10 percent surtax.[53]

Reducing the value of tax-deferred retirement contributions will reduce the incentives for employers to offer DC plans to their employees. Highly paid employees will no longer assign as much value to the opportunity to save in employer-sponsored plans. Some employers likely will find that the benefits their employees receive no longer justify the expense of offering a plan, and may choose to eliminate their plans and use the savings to simply increase cash compensation. It is difficult to predict the size of the effect, but if the 10 percent surtax or 28 percent cap were applied to tax-deferred retirement contributions, this change would undoubtedly reduce the number of employers that voluntarily sponsor a retirement plan.

B. Contribution Limits Already Are Low by Historical Standards

Several proposals have been made to reduce contribution limits to DC plans. The National Commission on Fiscal Responsibility and Reform's so-called "20/20 proposal" suggested limiting the combination of employer and employee contributions to DC plans to the lesser of $20,000 annually or 20 percent of compensation. Chairman Camp's tax reform discussion draft would suspend inflation adjustments to DC plan contribution limits and DB plan benefit limits for 10 years.

Contribution limits are already low by historical standards.[54] As illustrated in the figure below, for 2014, the Internal Revenue Code Section 415(c) limit for total DC plan contributions (employer plus employee) is $52,000. The original limit set under ERISA ($25,000 in 1975; or about $114,000 in today's dollars) was indexed to inflation until 1983, when it was reduced to $30,000 (or about $71,000 in today's dollars) and subsequently frozen. The Tax Reform Act of 1986 delayed reinstating inflation

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burdensome on taxpayers, and difficult for the IRS to enforce. And, in the end, the benefits of tax deferral would still be reduced substantially.

[52] *See* Brady, "A 'Modest' Proposal That Isn't: Limiting the Up-Front Benefits of Retirement Contributions," *ICI Viewpoints* (September 18, 2013), available at www.ici.org/viewpoints/view_13_limiting_upfront_benefits.

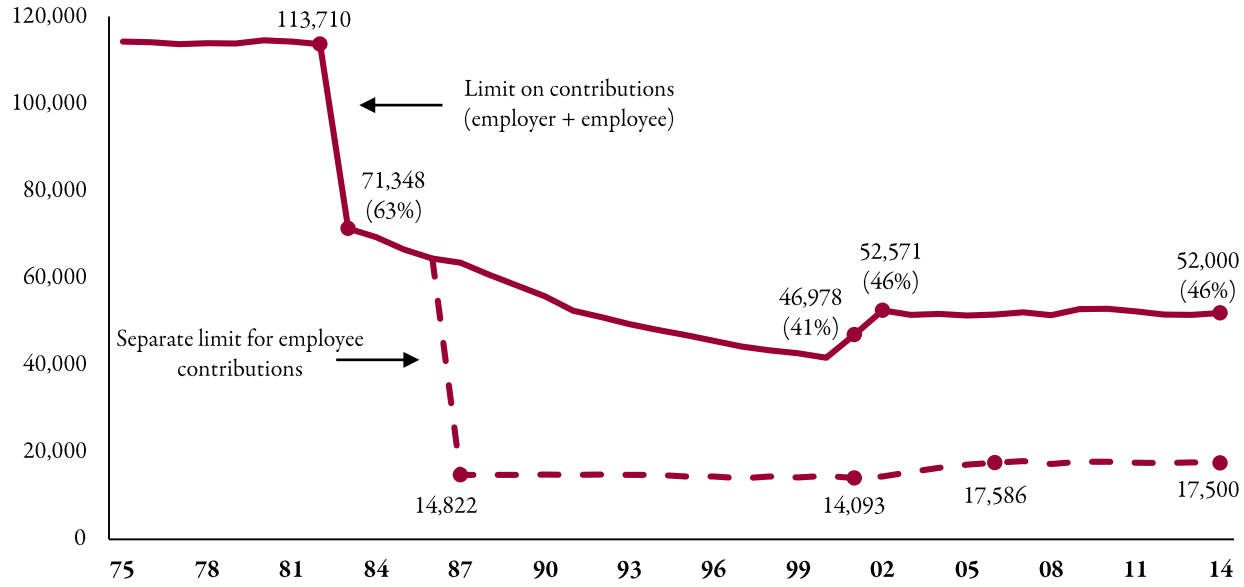
[53] This calculation assumes the up-front benefit is capped at 25 percent and the taxpayer is subject to a 35 percent marginal tax with no change in marginal tax rate over time and is not subject to penalty for early withdrawal. Investments are assumed to earn a 6.0 percent nominal rate of return composed of 3.0 percent long-term capital gains and dividend payments, 0.5 percent short-term capital gains, and 2.5 percent unrealized capital gains.

[54] For a discussion of the history of contribution limits, *see* pp.10–11 in Holden, Brady, and Hadley, "401(k) Plans: A 25-Year Retrospective." *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

adjustment and implemented a $5,000 "round-down" rule. The combined effect was the limit was unchanged until an inflation adjustment increased the limit to $35,000 (or about $47,000 in today's dollars) in 2001. EGTRRA subsequently increased the limit to $40,000 in 2002. The current limit, however, is less than half of the original limit in inflation-adjusted dollars. In addition, the Tax Reform Act of 1986 instituted a separate limit on employee contributions, whereas previous law only limited the combination of employer and employee contributions. EGTRRA increased the employee contribution limit in steps from 2002 to 2006, at which point the limit was indexed for inflation.

DC Plan Contribution Limits Are Low by Historical Standards

Limit on annual contributions to defined contribution plans, constant 2014 dollars, 1975–2014; percentage of ERISA limit, various years



Source: Investment Company Institute

Proposals to reduce those limits further would represent an unprecedented restriction on the ability of working individuals to defer a portion of their current compensation until retirement. Based on Congressional Budget Office (CBO) inflation assumptions, a 10-year freeze would effectively reduce contribution limits by about 20 percent. A $20,000 limit would be below the original limit set in 1974 in *nominal* dollars.

DC plan contribution limits are particularly important because of the uneven life-cycle pattern of retirement savings. The amount that workers contribute to their 401(k) plans is unlikely to be smooth and steady throughout their career. As a group, younger workers are less focused on retirement savings. They typically invest in other ways, such as funding education, purchasing a home, and raising children. Retirement savings typically ramps up as workers get older, both because earnings typically increase with age and because other expenses, such as childcare and education, decline.

The impact of the life-cycle pattern of retirement savings can be seen in statistics on workers who make the maximum allowable employee contribution to a DC plan.[55] Limit contributors typically are in their prime savings years and have moderate income: 69 percent of limit contributors were aged 45 to 64, and 58 percent had adjusted gross income (AGI) of less than $200,000.[56]

Although contribution limits may impact few workers in any given year, many more workers are affected at some point in their career. Only about 9 percent of workers with elective deferrals contributed the maximum allowed by law in 2010, but the share of workers at the limit increases with age (*see* figure below). For example, only about 2 percent of workers under 35 contribute at the limit, but that percentage increases to 15 percent for workers aged 60 to under 65.

Workers Are More Likely to Contribute at the Limit as They Approach Retirement

Percentage of W-2 workers with elective deferrals who contribute at the 402(g) elective deferral limit, by age, 2010



Source: Internal Revenue Service Statistics of Income Division

As with proposals to "cap" or apply a surtax to the tax benefit of employee contributions, freezing the employee and employer contribution limits or adopting the 20/20 proposal likely would cause some firms that previously offered retirement plans to terminate their plans. Employees affected by a lower effective contribution limit would face reductions in the tax benefits they receive. For some employers, the reduction in tax benefits received by their employees (including employees who currently have contributions in excess of proposed lower limits, or employees closer to retirement age who have

[55] The statistics used in this analysis are from IRS Statistics of Income Division (SOI) tabulations of Form W-2 data, available at www.irs.gov/uac/SOI-Tax-Stats-Individual-Information-Return-Form-W2-Statistics and described in Pierce and Gober, "Wage Income and Elective Retirement Contributions from Form W-2, 2008–2010," *Statistics of Income Bulletin* (Summer 2013): pp. 5–21, Washington, DC: Internal Revenue Service Statistics of Income Division, available at www.irs.gov/pub/irs-soi/13insumbulw2.pdf. The data are from the 2010 tax year, the most recent available. Limits are adjusted for catch-up contributions for workers age 50 or older. Some workers will be prevented from contributing the maximum allowed by law by rules established by their employer's plan. These workers are not included in the statistics for limit contributors.

[56] *Ibid* (Table 2.F.3 and Table 2.G.3 in the data files).

anticipated the prospect of higher contributions later in their careers), would tip the balance, and these firms would decide to no longer offer a plan.

C. Tax Reform Should Not Favor DB Plans over DC Plans

Any comprehensive effort to address fiscal policy or tax reform should maintain one aspect of the current income tax: neutral tax treatment of qualified deferred compensation. Tax-deferred contributions to both DB plans and DC plans are treated equally under the tax code. Employees pay no tax on compensation contributed on their behalf to a qualified retirement plan, and no tax on the investment earnings of a plan while they accrue. Taxes are due only when employees take distributions from a plan. In addition, limits on DC plan contributions are intended to be roughly equivalent to the restrictions on the generosity of DB plans.

Many proposals focus on limiting the tax benefits of DC plans. For example, proposals to limit the up-front benefit of deferral only apply to DC plans. The Camp 10 percent surtax proposal would apply only to employee and employer DC plan contributions. The Administration's 28-percent proposal would apply only to employee elective deferrals to DC plans and tax-deferred IRA contributions. The 20/20 proposal would reduce the DC plan contribution limit, but leave the DB plan benefit limit unchanged. As a result the ratio of the DB benefit limit to the DC contribution limit would move from four to one to nearly ten to one.

Changing the rule only for DC plans means that benefits a worker gets from deferral will depend on how their employer structures their compensation. For example, consider the impact of the 20/20 proposal on two workers who both have an annual salary of $100,000. The first is a private-sector worker who only has access to a DC plan. Under the proposal, the maximum amount of deferred compensation—that is, the combination of elective employee deferrals and employer contributions—would be $20,000. The second is a federal government employee who is covered under the Federal Employee Retirement System (FERS). Under the proposal, this individual could contribute $15,000 to the Thrift Savings Plan (TSP) and receive $5,000 in employer contributions, for a total of $20,000 in contributions. The federal government employee, however, would also be accruing DB pension benefits. For a worker approaching retirement, the additional DB benefit accrued in a year of work represents—depending on the length of service and other factors—an additional $20,000 to $50,000 in deferred compensation.

To maintain the neutrality of the current tax code, any changes to retirement plans should apply equally to DB plans and DC plans. In addition, any changes in the treatment of contributions should not single out employee versus employer contributions.

D. Limiting Accruals of Deferred Compensation Would Add Complexity, Could Cause Small Businesses to Terminate Plans

The Administration's FY2014 budget proposal to limit the total amount that an individual could accrue in retirement benefits would make the system more complex, place additional compliance burdens on individuals, and likely cause some employers—particularly small businesses—to terminate their retirement plans. Current law limits on the amount of tax-deferred compensation generally apply

to the benefits a worker receives from a single employer.[57] The proposal would place an additional limit on the total value of deferred compensation accumulated by any one individual—inclusive of accrued DB benefits, DC plan account balances, and IRAs.

Compliance with the new limit would require additional reporting from employer-sponsored plans to the IRS and place additional compliance burdens on individuals. Some employers, particularly small businesses, may choose no longer to offer a plan to their employees if the business owner or key employees can no longer accrue additional benefits. Such a change would also pose substantial difficulties for individuals as they plan for retirement or strategize about investing through their IRA. Imposition of such a proposal would therefore not only create significant administrative burdens, but would effectively penalize people for being diligent about their planning and saving and for accumulating retirement resources. This outcome is simply incongruent with the Committee's previous thinking and actions in the retirement policy sphere.

E. All Employees Will Be Hurt When Firms Drop Retirement Plans

The impact of the proposals which target DC plans would not be limited to taxpayers in the top three tax brackets (or taxpayers in Chairman Camp's proposed 35 percent tax bracket), or workers with contributions in excess of proposed lower limits. As discussed above, if these proposals are adopted, some firms that currently offer plans likely will decide to terminate their plans. With the loss of plans, lower-paid workers—who were never the intended target of the proposals—would lose the opportunity to save through an employer plan. While they receive substantial tax benefits from contributing, low- and moderate-income workers likely benefit as much or more from the non-tax features of employer-sponsored retirement plans. For example, these workers may value more highly the convenience of payroll deduction, the economies of scale that reduce the cost of investing, and the professional investment management offered through employer plans. There is also evidence that workers with moderate and high income are willing to accept lower cash wages in exchange for retirement benefits, whereas lower-income workers are not.[58] Thus, employer contributions are more likely to represent an increase in total compensation for lower-income workers, rather than a shift in the form of compensation. The loss of such contributions if employers drop their plans would be detrimental to the retirement security of lower-income workers.

F. Tax Deferral Equalizes the Incentive to Save

A criticism often leveled against tax deferral is that it provides an "upside-down" incentive to save. That is, it is argued that tax deferral results in higher-income workers having a larger incentive to save than lower-income workers.

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[57] If an employer has multiple DB plans, the DB plan benefit limit would apply to all benefits accrued from the employer. Similarly, if an employer has multiple DC plans, the DC plan contribution limit would apply to all (employer and employee) contributions to plans sponsored by the employer. The lone exception to this rule is the limit on elective employee deferrals to 401(k)-type plans, which applies to the taxpayer rather than to the benefits received from a single employer.

[58] *See* Toder and Smith, "Do Low-Income Workers Benefit from 401(k) Plans?" *Center for Retirement Research Working Paper* no. 2011-14 (September 2011), available at: crr.bc.edu/wp-content/uploads/2011/10/wp_2011-14_508-1.pdf.

The incentive to save is the after-tax rate of return earned on investments. Normal income tax treatment discourages savings by reducing the after-tax rate of return. Because the tax on investment returns increases with income, the rate of return falls more for higher-income taxpayers.

Far from providing an "upside-down" incentive to save, tax deferral equalizes the incentive to save. The benefit of tax deferral is that it effectively taxes investment income at a zero rate.[59] By removing the difference between the market rate of return and the after-tax rates of return, tax deferral equalizes the incentive to save. That is, for any given investment, a dollar invested in a 401(k) plan will provide the same after-tax rate of return regardless of a worker's tax bracket.

VI. CHANGES IN RETIREMENT POLICY SHOULD BUILD ON EXISTING SYSTEM—NOT PUT IT AT RISK

As the Committee on Finance considers possible changes to the U.S. retirement system, the Institute urges you to focus on the following policy objectives and improvements to ensure that as many American workers as possible are successful in retirement:

- **Continue to prioritize the goal of promoting retirement savings.** Promoting retirement savings must remain one of the nation's top policy priorities.[60] We urge this Committee to continue its leadership in pursuing tax policies to improve our nation's retirement system. As outlined above, the success of the current system has resulted in significant part from our existing and successful tax incentive structure, which works effectively to facilitate retirement plan savings by American workers and families. Even seemingly small changes that at first glance appear to affect only high-income individuals would, as detailed above, severely disrupt the success of the current system.

- **Recognize the significance of Social Security.** Social Security provides the foundation of retirement security for almost all American workers—and for the majority, it may be the largest single income source in retirement. Yet the Social Security system faces a projected long-term

[59] For an explanation of why this is the case, *see* discussion in Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at www.ici.org/pdf/ppr_12_tax_benefits.pdf; and Brady, "Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free," *ICI Viewpoints* (September 16, 2013), available at www.ici.org/viewpoints/view_13_deferral_explained. If a taxpayer's marginal tax rates at the time of contribution and the time of distribution are the same, tax deferral is equivalent to taxing investment income at a zero rate. If tax rates are lower at the time of distribution, the benefits of tax deferral are increased. If tax rates are higher at the time of distribution, the benefits of tax deferral are reduced.

[60] A vast majority (79 percent) of U.S. households surveyed from November 2012 to January 2013 agreed that continuing retirement savings incentives should be a national priority. *See* Figure 12 in Holden and Bass, "America's Commitment to Retirement Security: Investor Attitudes and Actions, 2013," *ICI Research Report* (February 2013), available at www.ici.org/pdf/ppr_13_retir_sec_update.pdf.

imbalance.[61] It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.[62]

- **Foster innovation and growth in the voluntary retirement savings system.** Policymakers, plan sponsors, and service providers strive to improve the ability of American workers to make sound decisions about retirement savings and investing. Congress was instrumental in encouraging rules that improved disclosure of 401(k) plan fees and associated investment information. Now, we urge Congress to go further by promoting electronic delivery of plan information, interactive educational tools, and materials to help American workers understand their savings options. Employers should be encouraged to use automatic enrollment if appropriate for their employee base; employers may want to enroll their workers at higher levels of savings and escalate the savings more substantially than is perceived appropriate under current law. As noted above, studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income and younger workers because these groups are typically less likely to participate in a DC plan where affirmative elections are required.[63]

- **Offer simpler plan features and easier access to multiple employer plans ("MEPs") for small employers**. Small businesses often face particular challenges in establishing and maintaining retirement plans. Special attention should be given to addressing legal requirements that may create obstacles to plan sponsorship among smaller employers. Creating a new type of SIMPLE plan for small employers would encourage greater plan creation and coverage in smaller workplaces. The new plan would be modeled on existing SIMPLE plans, but would not require

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[61] For projections related to these programs, *see* The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (July 2014), Washington, DC: U.S. Government Printing Office, available at www.ssa.gov/OACT/tr/2014/tr2014.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (July 2014), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2014.pdf; Congressional Budget Office, *The 2014 Long-Term Budget Outlook* (July 2014), available at www.cbo.gov/sites/default/files/cbofiles/attachments/45471-Long-TermBudgetOutlook_7-29.pdf; and Social Security Administration, "Detailed Reports on the Financial Outlook for Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds," (2014), available at www.ssa.gov/OACT/tr/index.html.

[62] Regardless of the form they take, changes to Social Security will likely increase the importance of employer-sponsored retirement plans and IRAs to provide for retirement adequacy. If Social Security benefits are cut, future retirees will need to accumulate more retirement resources. If taxes are raised on workers, net earnings will fall, but the amount of earnings that would need to be set aside to supplement Social Security benefits in retirement would remain largely unchanged. To the extent that either the benefit cuts or tax increases are structured to exempt workers with low lifetime earnings, it would place an even heavier burden on those already most dependent on employer-sponsored retirement plans and IRAs. For a discussion of how different methods of cutting Social Security benefits would impact workers with different levels of lifetime income, *see* Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* 9, no. 2 (April 2010): pp. 235–262.

[63] *See* note 36 and accompanying text, *supra.*

employer contributions. It would have contribution limits above traditional and Roth IRA limits, but below existing SIMPLE plan limits.[64] The Institute also supports easing restrictions on "open" MEPs, but targeting the provision to employers with fewer than 100 employees—the employer segment most in need of solutions to encourage retirement plan sponsorship.[65]

- **Support flexible approaches to retirement saving and lifetime income**. Employers have a number of options for savings plans today,[66] but it is important for Congress to recognize that mandating a particular plan or contribution level would not work for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.[67] The voluntary employer-provided retirement system recognizes that employers need the flexibility to design benefit packages that meet the unique needs of their particular workforce in the business' specific competitive environment. This flexibility is also important in the context of proposals intended to assist plan participants and retirees in ensuring that they don't run out of income in retirement or in determining how much retirement income they can generate from a 401(k), IRA, and other savings. All retirement income products and strategies involve tradeoffs and consideration of an individual's personal circumstances, such as the amount of annuitized income to be received from Social Security,[68] other assets or income, health status and life expectancy, the need for emergency reserves, specific goals in retirement, and the need to provide for other family members. As a matter of public policy then, it is important to ensure a level playing field for all products and services.

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The promotion of retirement savings—whether through employer-sponsored retirement plans or IRAs—has long been one of the Committee on Finance's top priorities and legacies. In recent years, the Committee strengthened the private-sector retirement system by raising contribution limits in 2001

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[64] We note that a conceptually similar provision, referred to as the "starter k" plan, has been proposed by Ranking Member Orrin Hatch (R-UT) in S. 1270, the "Secure Annuities for Employee (SAFE) Retirement Act of 2013."

[65] For a discussion of how pension coverage varies by plan size, *see* Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013).

[66] DC plans, traditional DB plans, hybrid plans, and SIMPLE IRAs all are available to meet the varying needs of employers.

[67] *See* Haveman, Holden, Wolfe, and Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), noting that households are more likely to focus on saving for retirement as they get older and as their income increases, and that younger and lower-income households, which are already contributing 12.4 percent of income to Social Security, tend to earmark the balance of their additional saving for liquidity, education, future large purchases, or to purchase homes.

[68] *See* discussion of Social Security replacement rates and how the role of Social Security varies by income and wealth on pages 9–11, *supra*.

(EGTRRA) and making those provisions permanent in 2006 (PPA). We welcome the Committee's continued leadership in pursuing policies to improve our nation's retirement system. But any changes should only build upon a successful system that tens of millions of U.S. households rely on to help them achieve retirement security. Consistent with the views of the overwhelming majority of Americans, we urge this Committee to preserve the current retirement savings tax incentives, including the compensation deferral rates without new caps or other limitations, and allow our successful employer-provided retirement system to flourish.

RETIREMENT PLAN MODERNIZATION PROPOSALS



APRIL 1, 2015

RETIREMENT PLAN MODERNIZATION PROPOSALS

The Investment Company Institute supports the following proposals intended to improve the successful defined contribution plan system and better equip American workers with the tools needed to build a secure retirement. The proposals would expand coverage, participation, and savings rates in defined contribution plans and IRAs; improve the delivery and quality of information and education to plan participants and plan sponsors; enhance flexibility in determining how and when to tap retirement savings; and eliminate unnecessary burdens in plan administration so that plans can function more effectively.

Expand Coverage

1. Establish New Simpler Plan Design 3

2. Expand Usage of Multiple Employer Plans 4

Increase Participation and Savings Rates

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Permit Greater Flexibility for Participants

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10. Simplify Hardship Rules 18

Improve Plan Administration

11. Expand Employee Plans Compliance Resolution System 19

12. Simplify 403(b) Termination 20

13. Reduce Plan Amendment Burdens 22

EXPAND COVERAGE: ESTABLISH NEW SIMPLER PLAN DESIGN

Current Law

Small employers have many different plan options to choose from: payroll-deduction IRAs, SEP IRAs (which allow only employer contributions), SIMPLE IRAs or SIMPLE 401(k) plans, as well as full-blown tax-qualified plans such as 401(k), profit-sharing, or defined benefit plans.

One such option—the SIMPLE IRA plan—is, as its name implies, a very simple plan to establish and maintain. It also has attractive employee contribution limits as compared to a regular traditional or Roth IRA ($12,000 vs. $5,500 in 2014). Under Internal Revenue Code ("Code") §408(p), employers with 100 or fewer employees who received at least $5,000 in compensation from the employer in the prior year may establish a SIMPLE IRA plan. The employer may not maintain any other retirement plan while maintaining a SIMPLE IRA plan. The employer can choose to cover all employees or only employees who received at least $5,000 in compensation during any two prior years and are reasonably expected to receive at least $5,000 during the current year. Employees may contribute up to $12,000 in 2014 (plus a $2,500 catch-up contribution for individuals age 50 or older). Employers must either match employee contributions 100 percent up to 3 percent of compensation or make a nonelective contribution of 2 percent of each eligible employee's compensation. All contributions must be fully vested. Each year, employees must receive notice of their rights under the plan, an election form, and a summary description. There is no annual reporting required (such as Form 5500), beyond reporting participation and contributions on an employee's W-2. The IRS provides model forms for establishment of a SIMPLE IRA plan, including a model notice to eligible employees and a model salary reduction agreement (*see* Forms 5304-SIMPLE and 5305-SIMPLE). Many financial institutions offering SIMPLE IRA plans use the IRS forms (although they could instead provide their own plan document). SIMPLE IRA plans generally are subject to Title I of the Employee Retirement Income Security Act ("ERISA"), but have more limited fiduciary obligations than a 401(k) plan for example.

Need for Improvement

While the SIMPLE IRA and many other plan options offer a relatively simple solution to plan sponsorship, none of the existing plan options work well for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund. Many small employers may like to offer employees the option to contribute to a 401(k) or similar plan, but cannot meet the non-discrimination tests and do not have the capacity to make the required employer contributions associated with the safe harbor 401(k) plan or a SIMPLE plan. For employers whose workforce places less value on compensation paid as retirement benefits, the required employer contributions discourage the adoption of SIMPLE plans.

Proposal

We propose a very modest change to current law that would build on the existing framework for SIMPLE plans.[1] In its simplest form, the new plan would work the same as the SIMPLE IRA, except that employer contributions would not be required and the employee deferral limit would be set lower than that for SIMPLE IRAs ($12,000 for 2014), but higher than the regular IRA contribution limit ($5,500 for 2014). To implement this change, Congress could amend Code §408(p) (Simple Retirement Accounts) to add an option with no employer contribution required and lower deferral limits. The IRS would revise certain existing guidance on SIMPLE IRAs (Notice 98-4) to reflect the new option, make any necessary conforming changes to IRS regulations, and revise their model forms to reflect the new option.

The Simpler plan should be an attractive, low-cost option for employers currently reluctant to offer a plan. Because the Simpler plan would be available only to small employers (100 or fewer employees)—the group least likely to currently offer plans—we believe the new option would not detract from the successful 401(k) system. Indeed, as these employers grow and become accustomed to the basic responsibilities of sponsoring a plan, they may be more inclined to step up to offering a 401(k) plan with its higher contribution limits and additional flexibility.

EXPAND COVERAGE: EXPAND USAGE OF MULTIPLE EMPLOYER PLANS

Current Law

Most retirement plans subject to ERISA and the Code are "single employer plans" and are maintained by a single employer for its employees (and other employees of companies within the same "controlled group"). ERISA also allows multiple employers to sponsor a plan, as a sponsor of plan may include "…any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity."

The Department of Labor ("DOL") has issued guidance analyzing when an entity may establish a single ERISA plan that covers multiple employers. Most of the guidance addresses associations, but some addresses other types of organizations (*e.g.*, financial institutions, franchises, employee leasing and professional service organizations). This guidance generally provides that for a single ERISA plan to exist, the employers that participate in the plan must be tied together by a common economic interest or organizational relationship unrelated to the provision of benefits.

[1] The new plan could be structured as either a SIMPLE IRA or a SIMPLE 401(k) plan, but we focus here on SIMPLE IRAs because very few employers that offer SIMPLE plans elect to use the SIMPLE 401(k) format. The draft language includes an amendment to Code section 401(k)(11) to allow for a Simpler plan under the SIMPLE 401(k) format.

To the extent there is no such relationship each participating employer is treated as establishing and maintaining a separate employee benefit plan for its own employees.

In contrast to DOL guidance requiring a common interest or relationship between the participating employers, the Code provides special tax-qualification rules that accommodate plans sponsored by two or more employers that are not in the same controlled group or otherwise related. Under these rules, employers participating in the multiple employer plan are treated as one employer for certain purposes (*e.g.*, minimum participation testing; vesting) and as separate employers for certain other purposes (*e.g.*, nondiscrimination and minimum coverage testing; deduction rules). Current law provides that a violation of the Code's tax-qualification requirements by one participating employer in a multiple employer plan could result in the disqualification of the entire plan for all participating employers. For example, if one participating employer in a multiple employer plan fails to satisfy the top-heavy rules then the multiple employer plan may be disqualified for all of the employers in the plan.

Need for Improvement

Rulings[2] that preclude small employers from banding together to participate in a single retirement plan maintained by a single service provider impact the ability of small employers to gain the same efficiencies that larger employers enjoy. These efficiencies come in the form of reduced compliance and administrative burdens (*e.g.*, a single Form 5500, a single vendor relationship to manage). However, DOL guidance has essentially foreclosed the operation of retirement plans covering groups of unrelated employers under ERISA. In addition, employers are discouraged from joining a multiple employer plan by the Code provision that violations of qualification requirements by one participating employer disqualifies the entire plan.

Allowing small employers to participate in a single, multiple-employer ERISA plan (often referred to as a "MEP")—regardless of the employer's industry or any other preexisting relationship with other participating employers or the plan sponsor—will reduce administrative and compliance costs and burdens, and ultimately improve the availability of retirement plans to employees of small employers.

Studies have found that concern about administrative costs and burdens are a significant reason that more small businesses do not offer retirement plans. Small employers maintaining their own plan are required to prepare their own plan documents, summary plan descriptions and other participant disclosures, file individual Form 5500s, obtain a separate financial audit, and establish a single trust. Because of the fixed administrative costs of sponsoring a plan, small plans may not qualify for lower cost investment options or lower recordkeeping fees. Allowing multiple, unrelated small employers to participate in a single plan with reduced compliance and administrative burdens and centralized administration will reduce plan costs and help them obtain pricing similar to larger plans.

In addition to administrative and compliance burden, smaller employers may be challenged by the fiduciary responsibility and liability of selecting and monitoring service providers and plan

[2] *See* DOL Advisory Opinions 2012-03A and 2012-04A.

investment options. By providing a level of liability relief for investment options offered under the plan, small employers would be encouraged to participate in a multiple employer plan, while at the same time ensuring that plan participants are protected.

Proposal

The proposal would amend the definition of "employee pension benefit plan" in ERISA to provide that a qualified multiple small employer plan ("QMSEP") will not fail to be treated as a single, ERISA-covered pension plan solely because contributing employers (meeting the definition of a "small employer") to the plan do not share a common economic relationship unrelated to the provision of benefits.

The QMSEP would be a multiple employer plan as described in the Code and Treasury regulations thereunder that is an individual account plan. The QMSEP would only be available to small employers. The term small employer would be defined as meaning any employer with no more than 100 employees who received $5,000 or more of compensation from the employer for the preceding year. If a participating employer fails to be an eligible employer for a subsequent year after participating in the plan for one or more years (including as a result of any acquisition, disposition or similar transaction), it would continue to be treated as an eligible employer for the five years following the last year the employer was an eligible employer.

Key legal protections for plan participants would be as follows –

- Employers would transfer fiduciary responsibility for selecting and monitoring plan investment options to the sponsor of the QMSEP, who would be the "named fiduciary."

- Participating employers in the QMSEP would retain fiduciary responsibility for the selection and monitoring of the QMSEP "named fiduciary." The named fiduciary would be permitted to delegate investment responsibility only to investment managers (who are by definition well-regulated professionals) as already permitted under ERISA. If the named fiduciary delegates its investment authority to an investment manager, the named fiduciary would remain liable for the prudent selection and monitoring of the investment manager. Importantly, as noted above, participating employers would be relieved of the liability of selecting and monitoring the particular investment options – an important incentive to join a QMSEP and offer a retirement plan to employees.

- The named fiduciary would be required to acknowledge in writing that he is a fiduciary to the QMSEP that is subject to all the requirements of ERISA. The named fiduciary, or its designee, would also be required fulfill the role of the QMSEP's "administrator," which means he ultimately would be responsible for all ERISA statutory disclosure responsibilities. The named fiduciary could delegate recordkeeping and other administrative functions to another entity.

- The named fiduciary would be required to register with the DOL and demonstrate to the DOL that it meets requirements related to fiduciary ability, capacity to account for the interests of a large number of individuals, fitness to handle funds, and rules of fiduciary

conduct. These requirements would be similar to those that apply to non-bank trustees of individual retirement accounts.

- The DOL would have authority to conduct audits of the QMSEP's named fiduciary to ensure that he is meeting its legal requirements. The named fiduciary would also be required to disclose to participating employers any pending or past (within the 24-month period preceding the named fiduciary's appointment) investigation or enforcement action by the DOL, Internal Revenue Service, or Securities and Exchange Commission concerning his conduct as a fiduciary or party in interest with respect to any plan, or any pending claims or final judicial adjudication or settlement with third parties for any violation of ERISA.

- All QMSEP assets would be required to be held in trust by a bank or trust company supervised by a State or Federal agency.

- The QMSEP would be prohibited from subjecting participating employers to unreasonable restrictions or fees, or any penalties, that restrict participating employers' ability to cease participation in, or transfer assets from, the plan. This requirement would not prohibit an investment fund from imposing fees or charges normally assessed to any shareholder or investor in the normal course of business, such as redemption fees.

- The QMSEP would include in its Form 5500 the name and identifying information of each participating employer. The DOL would be directed to provide regulatory guidance on how the SPD, Form 5500 and pension benefit statement requirements would apply in the case of a QMSEP.

In addition, the Treasury Department would be directed to prescribe final regulations under which a QMSEP may be treated as satisfying the tax Code qualification requirements despite the violation of those requirements with respect to one or more participating employers. The regulations could require that the portion of the plan attributable to the participating employers violating the qualification requirements be spun off into separate plans maintained by those employers.

Different variations of this proposal appear in the Retirement Security Act of 2014 (S. 1970 Collins, R-ME, and Nelson, D-FL), the Universal Secure and Adaptable (USA) Retirement Funds Act of 2014 (S. 1979, Harkin, D-IA, and Brown, D-OH), the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT), and the Small Business Add Value for Employees Act of 2011 (H.R. 1534, Kind, R-WI).

INCREASE PARTICIPATION AND SAVINGS RATES: MODIFY EXISTING AUTOMATIC ENROLLMENT SAFE HARBOR AND OFFER ADDITIONAL AUTOMATIC ENROLLMENT SAFE HARBOR

Current Law

To encourage use of automatic enrollment, the Code includes a safe harbor that eliminates the need for a 401(k) plan to run complicated non-discrimination tests. The Pension Protection Act of 2006 created a new nondiscrimination safe harbor, known as a qualified automatic contribution arrangement (or QACA). A plan that adopts a QACA is deemed to have satisfied top-heavy requirements and the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) nondiscrimination tests. The Code provides that to qualify as a QACA, employees must automatically be enrolled at an elective contribution equal to a "qualified percentage," defined to be met if the percentage is applied uniformly and is at least 3% for the first plan year beginning when the automatic contribution arrangement is established; at least 4% the subsequent year; at least 5% the year after that; and at least 6% for any subsequent year. While these percentages are minimums, the Code provides that a percentage exceeding 10% will not qualify as a QACA. The plan also must make a matching contribution to all non-highly compensated employees equal to 100% of elective contributions up to 1% of compensation, plus 50% of elective contributions between 1% and 6% of compensation. Alternatively, the plan can make a nonelective contribution equal to 3% of compensation. The matching contribution may be applied to both elective deferrals and employee contributions.

Need for Improvement

For plan sponsors that rely on the QACA safe harbor, the 10% ceiling is a barrier to escalating automatic contributions to levels that in some cases may be more appropriate for ensuring retirement adequacy. (In fact, even plan sponsors that do not rely on the QACA safe harbor often perceive the rule's 10% as a ceiling.) Accordingly, there is broad agreement across the retirement plan community for removing the 10% cap on automatic escalation deferral rates for plan participants.

In addition, while the QACA safe harbor has been applauded for encouraging the use of automatic enrollment, many plan sponsors believe that the default contribution levels are too low and that higher contribution levels are necessary to ensure a secure retirement for plan participants.

Proposal

Amend the safe harbor provisions in Code section 401(k)(13)(C)(iii) to remove the phrase "does not exceed 10 percent" and clarify that the qualified percentages are not maximums. As under current law, a participant would always be able to stop the escalation of his or her contribution

rate at any time, select another percentage, or opt out of the plan. A plan sponsor could also set a maximum (but no lower than 6 percent).

Create a new automatic enrollment safe harbor—which would give employers another option alongside the QACA safe harbor—under which the default contribution would be would be at least 6% in the first year, at least 8% in the second year, and at least 10% in all subsequent years. There would be a 10% cap on the default level of contributions in the first year but no cap would apply thereafter. The employer would be required to make matching contributions equal to 50% of participant's contribution up to 2% of compensation and 30% percent of elective contributions exceeding 2% of compensation, up to a total of 10% of compensation. This arrangement "stretches" the current matching contribution to encourage participants to contribute at least 10% of pay. Like the QACA safe harbor, matching contributions could be applied to both elective deferrals and employee contributions. Nonelective contributions would not be allowed in this safe harbor. A tax credit also might be included to encourage small employers to adopt the new automatic enrollment safe harbor. Another incentive to adopt the new safe harbor could be the option to apply a three-year cliff vesting period to employer matching contributions. The current QACA safe harbor would not be affected.

This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA), and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). A slightly modified version of the second proposal appears in the Retirement Security Act of 2014 (S. 1970 Collins, R-ME, and Nelson, D-FL).

INCREASE PARTICIPATION AND SAVINGS RATES: INDEX IRA CATCH-UP LIMITS

Current Law

Tax law imposes contribution limits on all tax-advantaged retirement savings vehicles. In almost all cases, to ensure workers' ability to save for their future is not eroded by increases in the cost of living, contribution limits are automatically increased periodically to reflect inflation. Because many workers tend to enter and leave the workforce to raise children and because workers tend to have more income available to save for retirement later in their career, Congress in 2001 created "catch up" contributions for all of the important retirement savings vehicles. The catch-up contribution limit for 401(k), 403(b) and 457(b) plans are all inflation indexed. But the catch-up contribution limit for individual retirement accounts—which was last adjusted to $1,000 per year in 2006—is not.

Need for Improvement

Since their creation in 1974, IRAs have played a vital role in building retirement security for workers without access to a retirement plan at work, for small business owners, and for non-working spouses. The general contribution limit for IRAs is indexed so that its value is not

eroded over time. The catch-up contribution limit for IRAs should also be indexed for inflation for the same reason, which simply brings it in line with catch-up contribution limits for those who save at work.

Proposal

Amend Code section 219(b)(5)(B) to provide that, in the case of any taxable year beginning after enactment, the $1,000 catch-up contribution amount will be adjusted for inflation from the year of enactment in the same manner as adjustments under IRC § 415(d). Although cost-of-living adjustments relating to retirement savings contributions typically are adjusted by multiples of $500, because of the small amount involved in this case, smaller increments could be used (such as $200). For example, any increase that is not a multiple of $200 will be rounded down to the next lower multiple of $200.

HELP PARTICIPANTS MAKE INFORMED DECISIONS: MODERNIZE E-DELIVERY DISCLOSURE RULES

Current Law

The IRS and the Department of Labor have no less than four separate regulatory standards that govern the circumstances under which an employee can be given a plan-related document electronically, and the four are not consistent with each other:[3]

- Treasury Regulations permit electronic delivery of notices and disclosures if a participant has the "effective ability to access" electronic media.
- Any disclosures required under ERISA can be made electronically (a) to a participant who has effective access to the document electronically at work and use of electronic information systems is an integral part of the participant's duties or (b) to a participant or beneficiary who offers affirmative consent.
- For pension benefit statements, a DOL Field Assistance Bulletin (FAB) allows the "post and push" method, whereby plan sponsors can use a continuous access secure website for the posting of benefit statements, provided that individuals are notified how to access the website and that they can opt out and receive free paper disclosures instead.
- Participant fee disclosures can be made electronically if the participant voluntarily provides an email address, but the fact that the employer assigns the employee an email address is not sufficient.

[3] Treas. Reg. § 1.401(a)-21; DOL Reg. § 2510.104b-1; DOL Field Assistance Bulletin 2006-03; DOL Technical Release 2011-03R.

Need for Improvement

Allowing plans to make e-delivery the default method for communicating with participants (but allowing participants to opt for paper) will enhance the effectiveness of ERISA communications, maintain security of information, and produce cost savings for the economy and plans that decide to opt for e-delivery. Notably, the President has recognized this; the new *my*RA program promises: "Enrollment and participation in the program will be primarily electronic and individuals will be encouraged to receive program-related payments electronically."

Proposal

Under the proposal, any document that is required by ERISA or the Code to be furnished to a participant, beneficiary or other individual (a "recipient") may be furnished electronically under a number of alternative methods:

- By direct delivery of the document to the recipient's email address.
- By posting on a continuously available website, if the recipient is notified that the document is available.
- Any other electronic means reasonably calculated to ensure actual receipt.

The proposal includes robust safeguards for participants who prefer to receive documents in paper form. Recipients must be informed of the right to request delivery of paper format, and a recipient who requests delivery of a paper document would be entitled to receive it. Any electronically furnished document must be presented in a manner that is consistent with the style, format, and content requirements applicable to the particular document taking into account the electronic form of the document, and the system must incorporate measures reasonably designed to protect personal information.

This proposal is a modified version of a provision in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). A similar proposal for modernizing the rules for electronic disclosure appeared in an earlier version of the Retirement Plan Simplification and Enhancement Act (H.R. 4050, 112th Cong., Neal, D-MA).

HELP PARTICIPANTS MAKE INFORMED DECISIONS: CONSOLIDATE NOTICES

Current Law

Over the years, the number of notices that must be provided to participants and beneficiaries has exploded. When ERISA was enacted in 1974, Congress intended that one document—the summary plan description—would be the notice that informed participants of their rights and obligations. Since then, a large number of additional notices have been imposed on retirement plans under ERISA and the Code—now numbering more than 30 that apply just to retirement

plans. Many of these notices must be provided upon enrollment and annually thereafter, although the specific timing requirements vary according to applicable regulations. The additional notices include:

- *Qualified default investment alternative notice*. *(ERISA §§ 404(c)(5)(B), 514(e)(3))*: Explains how a participant's account will be invested in the absence of an investment election by the participant.
- *Participant fee and investment disclosure*. *(DOL Reg. § 2550.404a-5)*: Provides participants in participant-directed individual account plans with key information about their plan and the investments available under the plan.
- *Safe harbor notice*. *(Code § 401(k)(12)(D))*: Informs participants that the employer will satisfy the Code's nondiscrimination requirements by making matching or nonelective contributions to the plan and explains participants' rights and obligations under the arrangement.
- *Autoenrollment safe harbor notice*. *(Code § 401(k)(13)(E))*: Informs participants in plans using the qualified automatic contribution arrangement safe harbor to satisfy nondiscrimination rules about their rights and obligations under the arrangement, including the default investment.
- *Permissive withdrawal notice*. *(Code § 414(w)(4))*: Informs participants in automatic enrollment plans that allow permissible withdrawals about their rights and obligations under the arrangement, including the right to stop automatic contributions and withdraw them within 90 days.

These notices, taken together, form a second "mini summary plan description" that explains key plan features that a participant might want to know to make the initial decision to enroll, including what happens if the participant takes no action. In practice, these notices may be provided as separate notices in the enrollment packet that employees receive on their first day of work.

Need for Improvement

In implementing these rules, the Departments of Labor and the Treasury have explicitly or implicitly discouraged combining these notices, even though together the notices provide interrelated information about a 401(k) plan's features. This discourages an integrated communication approach, complicates plan administration, and inundates participants with notices. Particularly with technical materials, more is often less, and the proliferation of notices, sent at different times, may serve to confuse many participants and cause many notices to be overlooked. In addition, the annual notice is in some cases unnecessarily tied to the plan year.

Proposal

A single notice (which could be referred to as the "Quick Start" notice) could combine the information currently in the following 11 notices:

1. Qualified default investment alternative notice (*ERISA § 404(c)(5)(B) and DOL Reg. § 2550.404c-5(d)*)

2. Notice of availability of cash or deferred election (*Treas. Reg. § 1.401(k)-1(e)(2)*)
3. Participant fee and investment disclosure (*DOL Reg. § 2550.404a-5*)
4. Safe harbor notice (*Code § 401(k)(12)(D) and Treas. Reg. § 1.401(k)-3(d)*)
5. ERISA automatic contribution arrangement notice (*ERISA § 512(d)(3)*)
6. Eligible automatic contribution arrangement notice (*Code § 414(w)(4) and Treas. Reg. § 1.414(w)-1(b)(3)*)
7. Qualified automatic contribution arrangement notice (*Code § 401(k)(13)(E) and Treas. Reg. § 1.401(k)-3(k)(4)*)
8. Automatic enrollment under eligible combined defined benefit and defined contribution notice (*Code § 414(x)(5)(B)*)
9. ERISA notice regarding availability of investment advice (*ERISA § 408(g)(6) and DOL Reg. § 2550.408g-1(b)(7)*)
10. Code notice regarding availability of investment advice (*Code § 4975(f)(8)(F)*)[4]
11. Proposed regulations regarding target date funds (*75 Fed. Reg. 73987 (Nov. 30, 2010)*)

Plans could decide which of the aforementioned notice requirements to satisfy through the combined Quick Start notice. In addition, a number of notices have become redundant or irrelevant. The following notices would be eliminated:

- *Summary annual report* (*ERISA § 104(b)(3)*). This notice summarizes the annual report (Form 5500) filed by the plan with the Department of Labor, Internal Revenue Service, and Pension Benefit Guaranty Corporation. For example, it reports total assets, expenses, and income of the plan, and information on how to obtain the full annual report. The summary annual report is much less useful than the pension benefit statement provided to participants, which has specific information on the participant's account or benefits. In addition, the "Quick Start" will alert participants that they can request a copy of the annual report.
- *Deferred vested pension statement* (*Code § 6057(e)*). This section requires plan administrators to provide participants who have separated from service with a statement of deferred vested benefits. In practice, this is now duplicated by the pension benefit statement requirement under ERISA section 105.
- *Pension benefit report* (*ERISA § 209*). This section requires a plan administrator to furnish a report to employees sufficient to determine their benefits. This notice is redundant because of the pension benefit statement requirement under ERISA section 105, which requires benefit statements either on a periodic basis or upon request.

This proposal is a modified version of provisions in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT) and the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA).

[4] The notice would continue to apply in the case of individual retirement plans and similar arrangements.

HELP PARTICIPANTS MAKE INFORMED DECISIONS: MAKE PERFORMANCE DISCLOSURE FOR TARGET DATE FUNDS MORE EFFECTIVE

Current Law

In 2010, the Department of Labor finalized a regulation under ERISA section 404(a) requiring participants in participant-directed individual account plans to receive certain information about their plans and the investment options available under the plans. The rule is intended to ensure that all participants in such plans have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings. The regulation includes a requirement that the historical performance (1-, 5-, and 10-year returns) for each designated investment alternative for which the return is not fixed, be compared to an appropriate broad-based securities market index.[5] For example, for an equity fund, a plan would provide participants the 1-, 5-, and 10-year returns of the equity fund, alongside returns of an appropriate broad-based index (like the S&P 500, which represents the same asset class). This rule does not specifically address investments like target date funds that include a mix of asset classes. In the preamble to the final regulation and subsequent interpretive guidance,[6] DOL indicated that a plan could provide the required benchmark and *additional* benchmarks, so long as the additional benchmarks are not inaccurate or misleading. For example, for an investment option that has a mix of asset classes, an additional benchmark could be created by blending the returns of more than one appropriate broad-based securities market index. (The blended benchmark must proportionally reflect the actual holdings of the investment option.) The DOL benchmarking rule is based on a similar requirement under the securities laws for mutual fund prospectuses,[7] which requires a fund (in its prospectus) to compare its performance to an appropriate broad-based securities market index and allows comparison to another broad-based index, so long as the comparison is not misleading. In order to provide a blended benchmark index for a given investment option, if there is no appropriate broad-based index that reflects a mix of asset classes, the disclosure materials may need to include at least two different benchmarks for the option, which could confuse participants and unnecessarily lengthen the disclosure.

Need for Improvement

In the context of DOL's participant disclosure rule (in which key information, such as performance and fees, about each designated investment option under a plan must be provided in a comparative format so that participants can directly compare the options and allocate their investments among them), providing two different benchmarks for a target date fund, for example—one that tracks the fund's allocation and one that does not—detracts from the usefulness of the comparative chart. For purposes of the comparative chart, plans should have the option to provide a single benchmark that tracks the asset allocation of the particular fund, so

[5] DOL Reg. § 2550.404a-5(d)(1)(iii).
[6] *See* 75 Fed. Reg. at 64916-17; Field Assistance Bulletin 2012-02R, Q&A-16.
[7] *See* Form N-1A, Item 27(b)(7).

that participants can make more focused comparisons of the different investment alternatives available to them.

Proposal

DOL would be directed to modify its participant disclosure regulation so that an investment that uses a mix of asset classes can be benchmarked against a blend of broad-based securities market indices, provided (a) the index blend reasonably matches the fund's asset allocation over time, (b) the index blend is reset at least once a year, and (c) the underlying indices are appropriate for the investment's component asset classes and otherwise meet the rule's conditions for index benchmarks. (These conditions are important to prevent the blended benchmark from being manipulated.)

This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA) and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).

HELP PARTICIPANTS MAKE INFORMED DECISIONS: EXPAND ACCESS TO EDUCATION AND INFORMATION ON INVESTING AND RETIREMENT INCOME PLANNING

Current Law

Under current law, section 3(21)(A)(ii) of ERISA provides that a person is a fiduciary to the extent such person "provides investment advice for a fee." This definition has been interpreted by DOL through regulations to require that a person satisfy a five-part test described in 29 C.F.R. section 2510.3-21(c) in order for the person to be deemed an investment advice fiduciary. The DOL is working to re-propose a regulation that would broaden the reach of the investment advice fiduciary definition and have the effect of causing many service providers that are not fiduciaries under the current definition to become fiduciaries.

Interpretive Bulletin 96-1 ("IB 96-1") currently provides important guidance on the provision of investment-related education and information to participants and beneficiaries in participant-directed individual account plans. Persons who solely provide information covered by IB 96-1 are deemed not to be "fiduciaries" under ERISA and therefore are not exposed to liability for the provision of investment information. IB 96-1 currently applies only to the following types of information provided to participants in participant directed plans –

- Plan information (relating to benefits of participating, plan terms and investment alternatives),
- General financial and investment information,
- Asset allocation models, and

- Interactive investment materials (such as questionnaires, worksheets and software that can assess future retirement needs and the impact of different asset allocations on retirement income).

IB 96-1 has resulted in plan sponsors and service providers providing investment education and information to participants and beneficiaries to assist them in making more informed decisions with respect to their individual accounts.

Need for Improvement

Eighteen years have passed since DOL issued IB 96-1. That guidance should be codified and updated in a tailored way (as described below) to provide greater certainty regarding the types of investment education and information that may be provided to plan sponsors and participants and to expand the types of information (*e.g.*, distribution and retirement income information) that may be provided. For example, it is unclear whether IB 96-1 currently covers certain types of arrangements (such as IRAs) where investment education is important and the IB does not cover education or information provided to plan sponsors and other fiduciaries. In addition, IB 96-1 has been successful in encouraging plans and their service providers to provide investment education during a working career, but it does not clearly address educating workers on how to take their savings and manage it in retirement (often called the "distribution" phase). Expanding IB 96-1 to cover distribution decisions and retirement income approaches would be simple and logical, and would have the same positive impact on the provision of educational materials geared toward the distribution phase as the original IB 96-1 had on provision of investment education materials generally.

These steps are particularly important in light of the uncertainty caused by the DOL's intention to re-propose its regulation changing the definition of a fiduciary. Codifying and expanding upon IB 96-1 will result in more quality investment and distribution-related information being available to plan fiduciaries and plan participants. This would result in better investment and retirement income decision-making, which will increase retirement security.

Proposal

The provision would amend ERISA as follows:

- To clarify that the educational information and materials described in IB 96-1 (as modified by this proposal) may be provided to owners of individual plans described in Code sections 4975(e)(1)(B) through (G) (IRAs, Archer MSAs, HSAs, and Coverdell educational savings accounts).

- To allow service providers to provide investment education and information to plan sponsors and other fiduciaries (*e.g.*, plan committees). Service providers should be permitted to provide investment education and information to plan sponsors and other fiduciaries of qualified defined contribution and defined benefit plans, as well as other funded employee benefit programs such as VEBAs, without such communications being deemed fiduciary investment advice under ERISA.

- To clarify that information, materials, and tools that inform a participant or beneficiary about distribution options and income in retirement shall not be considered investment advice for purposes of section 3(21)(A)(ii) nor a "recommendation" for purposes of 29 C.F.R. § 2510.3-21 (or any successor regulation), including information, materials, and tools that are generally-applicable, plan specific or interactive; and to add illustrative examples covering the provision of information, materials, and tools regarding distribution options and income in retirement. Such information could include information on plan distribution options (*e.g.*, advantages and disadvantages; tax implications), general information about managing assets in retirement (*e.g.*, systematic withdrawals, managed payout products, annuities and other guaranteed products), retirement income models (*e.g.*, sample calculations) on distribution methods or income streams for hypothetical individuals, and interactive tools and services (*e.g.*, questionnaires, worksheets, software or similar materials or services) that allow a participant or beneficiary to estimate retirement income streams. Such information also could include information regarding potential rollovers from plan accounts to IRAs or other plans provided that such information describes: (i) general financial and investment information regarding plan options and IRAs; (ii) differences in investment options available to the participant or beneficiary under their current plan versus those available through an IRA; and (iii) fees attributable to the current plan versus those fees charged in the IRA or other plan.

PERMIT GREATER FLEXIBILITY FOR PARTICIPANTS: UPDATE REQUIRED MINIMUM DISTRIBUTION RULES

Current Law

Workers are required to begin taking distributions from qualified retirement plans and IRAs at age 70½. These "required minimum distributions" were first added to the Code in 1962 to prevent business owners from using retirement vehicles for estate planning. Congress has since applied the RMD rule to virtually all tax-advantaged retirement accounts, but has never reexamined the required beginning age to reflect changing patterns of retirement savings or increases to life expectancy.

Need for Improvement

Research shows that workers tend to roll their retirement savings into IRAs at retirement, where they tend to preserve them until the law *forces* a distribution.[8] According to the Social Security Administration's Period Life Expectancy Table, the life expectancy of a person aged 65 in 2013 is about five years longer for men and four and a half years longer for women than it was in 1962

[8] Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2013," *ICI Research Perspective* 19, no. 11 (November 2013); available at www.ici.org/pdf/per19-11.pdf.

(when the 70½ rule was first added).[9] In fact, with a married couple both aged 65 in 2000, there is a 72% chance that one will live to age 85 and a 45% chance that one will live to age 90.[10]

Proposal

Amend Code section 401(a)(9) to increase the required beginning age from 70½ to at least 75, and permit those receiving RMDs to stop if they have not yet reached the new required beginning age.

PERMIT GREATER FLEXIBILITY FOR PARTICIPANTS: SIMPLIFY HARDSHIP RULES

Current Law

While retirement assets generally should be held for use in retirement, the Code recognizes that allowing distributions for heavy financial need actually encourages savings because workers know that they can access their savings in an emergency. Current IRS regulations impose a number of unnecessary administrative burdens on hardship distributions. First, unlike other distribution events, when a participant receives a hardship distribution from elective deferrals, only the participant's contributions, and not any earnings, may be removed. Second, safe harbor employer contributions, qualified non-elective contributions, and qualified matching contributions – unlike all other employer contributions to a profit-sharing plan – may not be distributed upon hardship. Third, a hardship distribution generally may not be taken until a participant exhausts all loans available under the plan. Finally, a participant is restricted from making elective or employee contributions for six months after the hardship is received.

Need for Improvement

Unnecessary restrictions on hardship distributions complicate plan administration. These restrictions are unnecessary to discourage hardship distributions because the Code already applies a 10% penalty for any hardship distribution before age 59½. In addition, the IRS safe harbor rule restricting the employee from making contributions for six months after a hardship distribution reduces retirement preparedness.

Proposal

The proposal would make the following changes:

[9] *See* 2014 OASDI Trusties Report Table V.A3. Period Life Expectancy, Social Security Administration; available at www.ssa.gov/oact/TR/2014/lr5a3.html#hist.
[10] https://personal.vanguard.com/us/insights/retirement/plan-for-a-long-retirement-tool.

- Hardship withdrawals can be made from all employer contributions to a profit-sharing plan or stock bonus plan, including safe harbor contributions, qualified nonelective contributions (as defined in section 401(m)(4)(C)), and qualified matching contributions (as described in section 401(k)(3)(D)(ii)(I)).
- A hardship withdrawal can include earnings on contributions.
- In determining whether a hardship has occurred, the Secretary of the Treasury cannot take into account whether a participant makes elective or employee contributions for any period after the withdrawal.

This proposal appears in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT). The provision relating to contributions after a hardship withdrawal appears in the Shrinking Emergency Account Losses Act of 2013 (S. 606, Nelson, D-NE, and Enzi, R-WY) and in the discussion draft entitled "Tax Reform Act of 2014"released by Ways and Means Chairman Camp (R-MI).

IMPROVE PLAN ADMINISTRATION: EXPAND EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

Current Law

Under a literal reading of applicable law, certain imperfections in a plan document or any single failure to operate a plan in accordance with the plan's written terms disqualifies the entire plan and trust, resulting in severe income tax consequences to innocent participants. The IRS' Employee Plans Compliance Resolution System (EPCRS) allows qualified plans and 403(b) plans to correct inadvertent errors in a plan document or plan administration without unnecessary tax consequences befalling innocent participants. It is widely recognized as a very successful program.

Under the program, certain errors can be self-corrected by the plan; other errors require a voluntary correction filing (called VCP) which can be expensive to prepare and which can take a long time for the IRS to process.

Need for Improvement

Because the IRS releases updates somewhat infrequently and because of limited IRS resources, EPCRS has not kept up with the ever growing complexity of plan administration.

In particular, a common error that requires a VCP filing is the correction of a single loan error. The cost of correcting a loan error typically would be less than the cost of the VCP filing itself. In addition, with the spread of automatic enrollment, consistent and workable corrections for automatic enrollment are needed.

There currently is no correction program available for errors relating to IRAs.

Proposal

Treasury would be directed to modify EPCRS:

- to allow for self-correction of loan errors (directing the Secretary of Labor to treat any loan self-corrected under EPCRS as also meeting the requirements of Labor's voluntary correction program);
- to allow self-correction, without an excise tax, of a required minimum distribution that is made within 180 days after the distribution was required to be made from the plan;
- to establish specific correction methods for errors implementing automatic enrollment and automatic escalation features;
- to provide the same comprehensive program of correction for governmental 457(b) plans; and
- to expand EPCRS to allow custodians of IRAs to address inadvertent errors for which the individual owner was not at fault (including waiver of the excise tax for failure to make required minimum distributions; waiver of the 60-day deadline for rollovers; and inadvertent rollovers, such as a rollover by a nonspouse beneficiary or a rollover from a 457 plan).

This proposal appears in the Retirement Plan Simplification and Enhancement Act of 2013 (H.R. 2117, Neal, D-MA) and in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).

IMPROVE PLAN ADMINISTRATION: SIMPLIFY 403(b) TERMINATION

Current Law

In 2007, Treasury and IRS completed a comprehensive overhaul of the regulations governing 403(b) plans. For the first time, the regulations provided that a 403(b) plan may be terminated. But the regulations provide only limited guidance regarding the mechanics of plan termination. When a 403(b) plan is invested in annuities, the termination can occur through distribution of a fully paid annuity contract to the participants. When the 403(b) plan is invested in regulated investment companies in a custodial account (as the Code allows), the administrative process is more difficult. When a participant can be located and responds to communication from the plan, the account can be rolled over into an IRA. It is inevitable, however, that there will be participants who are either not located or unwilling to voluntarily liquidate their existing 403(b) accounts, perhaps because they prefer their current investment provider or because of sales charges. The problem of missing participants is particularly problematic in the context of 403(b) plans because these plans are often funded through a number of different vendors. Many participants will hold contracts issued by vendors that do not have a current relationship with the

employers. The IRS issued a ruling in 2011 (Rev. Rul. 2011-7) that appears to require an election by the participant to distribute funds in the custodial account, which is often not possible to obtain.

Need for Improvement

Unlike with 401(k) and other qualified plans, the Code does not provide a process for terminating 403(b) plans, which has left the IRS with little guidance. Providing an orderly process for termination which protects participants and maintains the tax qualified nature of the account is consistent with prior Congressional efforts to harmonize the rules for 403(b) plans with qualified plans. Providing for the "in-kind" distribution of a custodial account to a participant upon plan termination, so that the account retains its 403(b) status outside of the plan, also would provide parity for 403(b) participants who invest in mutual fund custodial accounts and want to remain invested in the same vehicle after plan termination, just like 403(b) annuity contract holders who can maintain their contract after plan termination.

Proposal

The proposal would provide that if an employer terminates a 403(b) plan under which amounts are contributed to a custodial account, an account of a participant or beneficiary shall be considered "distributed" for plan termination purposes if the account is distributed "in-kind" to the participant or beneficiary (in which case amounts actually distributed from the account will be taxed in the year in which so distributed under Code section 72, unless rolled over to another qualified account). A custodial account would not be considered "distributed" to a participant or beneficiary if the employer has any material retained rights under the account, but the employer would not be treated as retaining material rights simply because the custodial account was originally opened under a group contract.

This is a modified version of a proposal that appears in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).

IMPROVE PLAN ADMINISTRATION: REDUCE PLAN AMENDMENT BURDENS

Current Law

Plan documents must be amended for changes in applicable law or regulation. Under the IRS' so-called "interim amendment" rules (Rev. Proc. 2007-44), these amendments must occur nearly every year, even though plans are now submitted to IRS for approval every five years (or six years in the case of pre-approved plans). In addition, any amendment that is discretionary – a change not required by law or regulation – must be adopted by the end of the plan year in which the plan amendment is effective.

Need for Improvement

The almost constant need for plan amendments results in significant administrative complexity and unnecessary foot-faults. The Code's singular provision addressing plan amendments has not been addressed by Congress since 1974 and is need of an update to reflect the proliferation of retirement plans and the near constant changes to the rules that govern them.

Proposal

Amend Code section 401(b) as follows:

- For any "required amendment" – an amendment required by, or integral to, a federal law or Treasury or DOL regulation – the amendment may be adopted by the last day of the "remedial plan review period." This is the period set by Treasury as the regular cycle of review for determining whether a plan meets the requirements of Code section 401(a).
- If a plan amendment is adopted by this deadline, the plan will not be treated as violating the "anti-cutback" rule in Code section 411(d)(6) and ERISA section 204(g).
- Discretionary amendments – *i.e.*, any amendment that is not a required amendment – must be adopted no later than the due date, with extensions, of the employer's tax return for the taxable year in which the plan year in which the amendment will take effect ends. This essentially applies the current rule in Code section 401(b) to discretionary amendments. No "anti-cutback" relief is provided for discretionary amendments.

The proposal would not relieve a plan from operating in compliance with any statutory or regulatory deadlines.

This proposal appears in the Secure Annuities for Employee Retirement Act of 2013 (S. 1270, Hatch, R-UT).

APPENDIX

LIFETIME INCOME DISCLOSURE ACT

Current Law

Section 105 of ERISA requires 401(k) plans to give participants quarterly benefit statements showing the participant's total benefits accrued (current account balance), the value of each investment to which assets are allocated, and certain other enumerated information.

Need for Improvement

Information on how an account balance might translate into a regular stream of income in retirement is useful and helps workers see if their retirement savings is on track. While the information is not currently required, some plan providers successfully include estimates of what monthly income the participant might receive from the account at retirement. Any legislation should allow current best practice to continue.

The Lifetime Income Disclosure Act has been introduced in prior Congresses. The Institute has recommended certain changes to the bill language. Any amendment to ERISA to require plans to give participants lifetime income estimates should:

- Allow plans the option to project future contributions and investment experience of the account to give participants, especially those far from retirement, a more realistic estimate of monthly income.
- Not specify a single method but rather allow plans to express the estimate as an annuity payment, a percentage of the account balance designed to spread payments over the participant's life, a life expectancy calculation based on IRS minimum distribution rules, or other appropriate method. This recognizes, as the Departments of Treasury and Labor have stated, that there is no single way to obtain a lifetime income stream from a retirement account.
- Require certain explanations to help participants understand the information.
- Not freeze innovation and evolution of best practice disclosure. Letting this competitive market evolve will better serve the interests of plan participants – the users of this information – than codifying a single approach at this time.

Comparison of Proposed Alternative Language and Past Bill Language

We compare ICI's proposed Alternative language to that of S. 1145, as introduced in the 113th Congress.

Both the Alternative language and S. 1145 would require plans to give workers annually an estimate of the monthly income the participant might receive from the account at retirement. Annual Social Security statements also illustrate future benefits as monthly income.

S. 1145 requires the income stream to be expressed as an annuity. S. 1145 identifies just one specific method for translating the account balance into a lifetime income stream – the annuity equivalent. Other effective methods in use today or any additional methods that may be developed in the future could not be used to satisfy the proposed disclosure. The Alternative language makes clear plans have the choice to express the estimate as an annuity payment or use existing methods that have been well-received by plans and participants. While an annuity is one way to generate a lifetime income stream, as the Departments of Treasury and Labor have acknowledged, there are also other ways. These include dividing the projected account balance by the life expectancy stated on IRS tables at a certain age, such as age 65, or to start with a percentage (such as 3 or 4 percent) of the projected final account balance at retirement – the approach some financial planners use. The law should not lock in one specific method for calculating the estimated income stream.

S. 1145 uses the current account balance in estimating the future income stream. S. 1145 restricts the disclosure to a snapshot of the participant's current account balance (including future earnings only if permitted by DOL), which would not reflect the impact of future contributions to the participant's account – thus providing only a limited view of the potential income stream. The Alternative language allows plans the option either to use only the current account balance or to include projections of contributions and investment experience. The latter approach follows the lead of Social Security, which calculates estimated benefits based on the assumption that an individual will continue to work and earn the same salary until certain specified retirement ages. Because the accounts of new workers who just began making contributions (even those contributing the maximum) will be small and generate very small annuity equivalents, using only the current account balance to estimate retirement income may provide an incomplete picture and discourage plan participants (or encourage workers changing jobs to cash out their accounts). Plans should be able to satisfy the income stream disclosure requirement by including useful projections of future contributions and investment experience.

S. 1145 would direct the Department of Labor to develop the specific assumptions used in calculating the annuity equivalent and a model disclosure form. Instead of requiring detailed DOL rulemaking to implement the new disclosure requirement, the Alternative language requires plans to explain that the lifetime income stream equivalent is an illustration and an estimate, explain how the amount was calculated, and disclose any applicable assumptions. Section 105 of ERISA already requires benefit statements to be written in a manner calculated to be understood by the average plan participant. Our approach avoids delay in implementing the disclosure requirement by not specifically requiring rulemaking. DOL has broad authority under ERISA section 505 to promulgate interpretive rules, which would allow it to provide guidance or step in if it perceives any problems. By not mandating up front that the DOL create a model form and determine applicable assumptions, the Alternative language allows disclosure best practices to continue to evolve and develop.

LIFETIME PAYMENT ACCOUNTS

Proposed Tax Exclusion for Annuity Payments

Bills have been introduced in past Congresses that would provide an exclusion from gross income for a specified portion lifetime annuity payments received from a qualified retirement plan (and in some bills, from a taxable account), for a specified number of years. The annual exclusion typically is capped at a specified amount and may be phased out at certain income levels.

The insurance products covered by these bills go beyond immediate annuities and would also include variable annuities, including guaranteed minimum benefit products. More specifically, under the bills, "the amount of the periodic payments [covered by the bill] may vary in accordance with investment experience, reallocations among investment options, actuarial gains or losses, . . . or similar fluctuating criteria." Furthermore, "[t]he availability of a commutation benefit or other feature permitting acceleration of annuity payments (or a modification of the period during which such a benefit is available), a minimum period of payments certain, or a minimum amount to be paid in any event shall not affect the treatment of a distribution as a lifetime annuity payment."

Thus, among other things, the bills would cover contracts that go beyond pure annuities, permitting the holder to receive payments that vary based on the performance of underlying investments and allowing the holder to reallocate account balances among those underlying investments. In this respect, the bills would cover products that are similar to the managed withdrawal accounts, or Lifetime Payment Accounts (withdrawals based on remaining life expectancy) described below. It has always been our position that similar products should receive similar tax treatment. We have difficulty understanding why the special tax benefits provided by the bills to insurance company sponsored products should not be extended to managed withdrawal accounts under the circumstances here.

In pursuing the laudable policy goal of making retirement savings last a lifetime, Congress should recognize and include the varied alternatives of financial services and products that fulfill this purpose, including Lifetime Payment Accounts.

Need for Product Neutrality and Preservation of Consumer Choice

Policymakers are concerned both with helping individuals build up retirement savings and encouraging their careful distribution so that savings last throughout the retirement years. For some people entering retirement, insurance products may offer all or part of that distribution help. However, no one financial product is best suited to address all of the risks that individuals can potentially face in retirement, and more than one financial product enables individuals to secure a lifetime stream of payments.

For example, Lifetime Payment Accounts ("LPAs") are systematic withdrawal programs that provide periodic distributions from mutual fund accounts over the investor's life. For many people entering retirement, this will be the simple, flexible and affordable path that is best suited to their needs and their families' needs. Any distribution assistance should recognize and encourage this option, too – otherwise, many of the retirement savers in need of this help may find themselves left out.

Mutual Funds Can Provide a Lifetime of Security

LPA distributions are determined based upon long-established IRS methodology. This methodology requires only two pieces of data, both of which would be known to the mutual fund; these data elements are the investor's age on December 31 of that year and the account's beginning-year balance. From this data, the mutual fund will calculate the calendar-year LPA distribution. The size of the LPA would vary over time, with diversification protecting the downside and continued investment providing the growth needed to address inflation. The LPA will never be fully depleted. Upon the investor's death, the LPA's remaining balance would go to the investor's designated heirs.

Mutual Fund LPAs Provide a Needed Complement to other Lifetime Distributions

Competition – Competition among financial services and products is good for American consumers. Tax incentives for promoting lifetime distributions should be afforded to the range of financial services and products that meet the policy goals of lifetime security and the broad range of retirement savers who need and value those varied options.

Lower Income Households – Many low-income households have limited amounts of assets to annuitize beyond Social Security, and their purchasing an annuity typically produces only a modest annuity payment. The monthly payment provided by additional insurance, while helpful, may not provide the needed or desired level of income replacement and may deprive them of flexibility they need to access resources in case of health care needs or other emergencies. These households may be better served by tax incentives to encourage LPAs so that they are helped to withdraw carefully but without losing the affordable flexibility they need.

Costs – Insurers must impose a risk charge associated with the company's obligation to continue payments if an annuitant lives beyond life expectancy. In addition, there may be other costs associated with an insurance company's distribution system. Consequently, LPAs will generally be subject to lower and simpler costs and provide an alternative means of balancing safety and investment that many retirees will need.

Early Death – While annuities protect retirees who live longer than expected, they also penalize retirees who may die before reaching their projected life expectancy. Upon death, annuity payments cease, and there often is no residual value. LPAs, on the other hand, allow individuals who die to pass the remaining LPA assets on to their heirs.

Inflation Risk – Annuities can be subject to significant inflation risks because the payments tend to be fixed at the time of the annuity's purchase. Some annuities are inflation adjusted and can

increase over time, but their initial payout is reduced relative to a fixed annuity to pay for this "inflation risk" feature. LPA savers in mutual funds are generally protected against inflation risk because market returns will typically adjust when expectations of inflation increase. With the average life expectancy of 65-year-old individuals extending into their 80s, a reasonable amount of market risk – as part of a diversified investment portfolio with the potential for greater returns – is appropriate for most individuals to address inflation risk and the resulting decline in purchasing power.