AMERICAN ACADEMY *of* ACTUARIES

Administration's Retirement Savings Proposals

An Updated Analysis by the Pension Committee of the American Academy of Actuaries

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ADMINISTRATION'S RETIREMENT SAVINGS PROPOSALS

Background

In 2003, the Bush administration proposed a major policy initiative as part of their fiscal budget that was intended to promote retirement savings through the establishment of three new types of savings accounts. These accounts would be funded with after-tax contributions, and earnings would accumulate on a tax-free basis. In addition, withdrawals could be made from one type of account (Lifetime Savings Accounts) without penalty at any time for any purpose, but withdrawals from the other two types of accounts (Retirement Savings Accounts and Employer Retirement Savings Accounts) could only be made without penalty under certain circumstances. The proposal also included other provisions affecting defined contribution plans.

In 2004, the administration issued a revised proposal, which with minor modifications was reintroduced in 2005. This revised proposal included the three types of savings accounts that were introduced in the 2003 proposal (Lifetime Savings Accounts, Retirement Savings Accounts, and Employer Retirement Savings Accounts). They also include an expansion of an existing retirement savings vehicle (Individual Development Accounts). The original proposal was also modified in a number of ways to address concerns raised by the Academy and other parties.

This paper is an update to the American Academy of Actuaries' Pension Committee's original analysis issued on Aug. 13, 2003.

Summary of the Revised Proposals

Lifetime Savings Accounts (LSAs) would be structured like Roth IRAs in that contributions are non-deductible, earnings would be tax-exempt, and distributions generally would be tax-exempt. Unlike Roth IRAs, there would not be any income limits on eligibility to contribute. The annual contribution limit would be $5,000 per person (indexed, and reduced from $7,500 in the 2003 proposal) and contributions could be made by anyone, even individuals who did not have earned income. In addition, a taxpayer could make a contribution on behalf of another individual. Tax-free distributions could be made at any time and there would be no required minimum distributions while the account holder was living. At death, the Roth IRA minimum distribution rules would apply to the beneficiary.

The rules on conversions from Archer Medical Savings Accounts (MSAs), Coverdell Education Savings Accounts (ESAs) and Section 529 qualified tuition program accounts have been modified from the original proposal. Under the new proposal, MSAs cannot be converted and conversions from ESAs and 529 plans would be limited.

Retirement Savings Accounts (RSAs) would be structured like LSAs. Similar to LSAs, the annual contribution limit would be $5,000 (indexed and reduced from $7,500) but the contribution could not exceed 100 percent of earned income and an individual could not make a contribution for someone else. Contribution limits would not be reduced by contributions to LSAs. Distributions would only be tax-exempt if made after attainment of age 58, or on account of death or disability.

Existing Roth IRAs would automatically become RSAs. Traditional IRAs could be converted into RSAs by paying tax on the converted amount (in excess of any accumulated non-deductible contributions). However, unlike current conversion rules, there would be no income limits on eligibility to convert. For conversions during the first year following enactment, tax on the converted amount would be spread over four years.

Existing traditional IRAs could continue under current IRA rules. However, no new contributions could be made to existing or new traditional IRAs except to accommodate rollovers from qualified plans.

Employer Retirement Savings Accounts (ERSAs) would replace Section 401(k), Section 401(b) and Section 457(b) plans. The average deferral percentage and average contribution percentage tests for 401(k) plans and the average contribution percentage test for 403(b) plans would be replaced by a single simplified nondiscrimination average deferral test. Under the administration's proposal, if the average deferral percentage for the non highly-compensated employees was 6 percent or less, then the average deferral percentage for the highly-compensated employees could not be more than two times the average deferral percentage for the non highly-compensated employees. If the average deferral percentage for the non highly-compensated employees was more than 6 percent, then there would be no restriction on the amounts that could be contributed by highly-compensated employees other than the 402(g) limits, which would be the same as under current law (for 2005 — $14,000 plus a catch up contribution of $4,000; for 2006 — $15,000 plus a catch up contribution of $5,000). The test could be satisfied using one of two design-based safe harbors. The employer could make a 3 percent contribution for all eligible participants, or a matching contribution of 50 percent of the amounts deferred up to 6 percent of compensation. The maximum safe harbor match would therefore be 3 percent of compensation instead of the 4 percent of compensation under current law.

Companies with 10 or fewer employees would be able to establish plans with custodial accounts through a financial institution. These plans would not be subject to the ERISA annual reporting requirements.

Many of the other provisions in the 2003 proposal that affected defined contribution plans are not in the 2004 proposal. These include changes to the coverage rules, top-heavy rules, permitted disparity, cross-testing, the definition of compensation, and the definition of a highly-compensated employee.

Individual Development Accounts (IDAs) could be established by low-income individuals (single filers with income below $20,000 and joint filers with income below $40,000) between the ages of 18 and 60. Qualified financial institutions and certain other institutions would sponsor the accounts. The contributions would be made with after-tax dollars. The sponsoring institution would provide a 100 percent matching contribution on the first $500 contributed. This would be reimbursed through a tax credit. The government would also provide a $50 per account per year tax credit to offset certain expenses incurred by the sponsoring institution. Earnings on contributions would be taxed when withdrawn. Matching contributions and earnings would not be taxed if withdrawn for a qualified purpose. Qualified purposes would be higher education expenses, a first time home purchase, and small business startup before age 61, or for any reason after age 60. Nonqualified withdrawals would result in forfeiture of some of the matching contributions.

Analysis of the Proposals

The Academy believes that the law should encourage individuals to save for retirement and agrees that appropriate simplification of the rules for making contributions to savings and retirement accounts would encourage savings contributions. The administration's proposals have merit, including, for example, simplification of the nondiscrimination tests and a change in the rate of matching contribution that will satisfy the safe harbor. However, we have outlined below several aspects of the proposal that concern us.

Reduction in Future Government Revenue

The proposal would make important changes in the federal tax system, and these changes are likely to have significant revenue and equity effects. In particular, the savings proposal would increase current tax revenues in the conversion process of traditional IRAs to RSAs at the expense of future revenues. This could have a profoundly harmful effect, particularly in view of the anticipated financial effect of the retirement of the baby boomers and later longer-living generations on Social Security, Medicare, Medicaid, and Supplemental Security Income. The micro and macroeconomic effects must be carefully analyzed and studied before changes are implemented. In particular, Congress should balance future expenditures with future revenues before proceeding with the types of changes that would reduce future revenues.

Decrease in Personal Savings

The LSA and RSA proposals are unlikely to increase personal savings by low- and moderate-income individuals. In fact, retirement savings by these groups could decrease, as discussed in this and following sections.

Few of these individuals now contribute the maximum amount permitted for IRAs. Therefore, increasing the maximum will have little effect. Furthermore, our experience with employer-sponsored plans strongly suggests that it takes immediate tax deductions and matching contributions to encourage low- and moderate-income workers to save for retirement. Because there will be no restrictions on withdrawals from LSAs, many individuals will only fund these plans (in lieu of RSAs) and may be tempted to withdraw funds for immediate personal consumption instead of holding them for retirement.

An important way that these proposals could benefit low-income individuals is that they might reduce the amount of tax paid on Social Security benefits by shifting to after-tax contributions and tax-free retirement income. However, as stated above, individuals tend to be more motivated by immediate tax benefits. This can be analyzed by reviewing the contribution history of those who are eligible for both traditional and Roth IRAs.

The matching contributions provided to individuals establishing IDAs might encourage participation. However, the maximum income level to qualify for a match may be too low and the amount of the matching contribution may be too small. Increasing these amounts would encourage more low-income individuals to utilize these accounts.

Dramatic Reduction in the Number of Retirement Plans

The proposals could severely undercut the incentive for employers to sponsor retirement plans because owners and other decision-makers could save for their own retirement without establishing and maintaining a retirement plan for other employees. This would be especially true in the case of small businesses. The owner would be able to contribute $10,000 between an LSA and a RSA. If the owner's spouse is included, the contribution could rise to either $15,000 or $20,000. The combination of the low income tax rate paid on dividends and the long-term capital gains for personal investments, along with the level of savings and the estate planning opportunities available to LSA and RSA accounts, could cause some employers to rethink the need for a company-sponsored retirement plan for employees. The cost of contributing for employees and the accompanying administrative burden may outweigh any benefits for the owner in sponsoring an employee plan.

Decrease in Defined Benefit Plans

We are concerned that the proposals do not address retirement savings through defined benefit plans. Over the past two decades, coverage under traditional defined benefit plans has declined from 40 percent to 20 percent of the private workforce, while defined contribution plans, including 401(k) plans, have increased from 17 percent to 43 percent. Today, many employers provide ongoing retirement benefits for their employees exclusively through defined contribution plans. A viable two-pronged retirement strategy is the best way to achieve retirement security with a defined benefit plan providing minimum income security and a defined contribution plan providing retirement asset buildup. Currently, the regulatory playing field favors defined contribution plans. These proposals, by increasing the amounts that can be saved for retirement through tax-favored individual savings accounts and defined contribution plans, will continue the trend that has disadvantaged defined benefit plans to the point where many employers have eliminated them. We believe that any comprehensive retirement reform must focus on both defined contribution and defined benefit plans and not continue the pattern of legislative and regulatory discrimination against defined benefit plans.

Treatment of Tax-Exempt Entities

The administration's proposals would result in more equitable treatment of taxable and tax-exempt entities. However, the current rules that apply to 403(b) and 457(b) plans reflect the special needs of tax-exempt employers. Eliminating these plans may be inappropriate if nothing is done to address these needs. For example, many entities that currently do not need to complete annual discrimination testing would be required to perform these tests, resulting in increased administrative cost. In addition, the consolidation of the different plan types into ERSAs would reduce the amount of income that employees of these entities could defer in employer-sponsored plans.

Simplification of Rules

As stated above, the ERSA proposal would simplify the tax qualification rules for defined contribution plans, which may encourage some employers to these plans for their employees. Simplifying the rules, however, does not necessarily result in a substantial increase in the number of employees covered by retirement plans. If it did, SEP and SIMPLE plans, which are available under current law, would be more popular.

In our analysis of the 2003 proposals, we described some disadvantages to simplifying certain rules. While the 2004 and 2005 proposals addressed these concerns, we recognize that overly cumbersome rules are not appropriate and suggest that Congress consider other ways to simplify the rules. For more information, see the Academy's paper, *Pension Funding Reform for Single Employer Plans* (available at www.actuary.org/pdf/pension/funding_single.pdf).

Simplification of the Internal Revenue Code

Every change to Internal Revenue Code provisions affecting retirement plans imposes certain fixed costs on plan sponsors and administrators in the form of amendments to plan documents, changes in plan procedures, and changes in plan descriptions. For this reason, we believe there should not be frequent changes to the provisions. Employers who have already set up modest plans that meet their employees' needs should not have to go back to the drawing board. Changes should be made only when there is a significant improvement over existing law, and we do not believe this is necessarily the case with these proposals.

Summary

The administration's proposal for two new savings vehicles (LSAs and RSAs), as well as a consolidation of 401(k), 403(b), and 457 plans into ERSAs and new incentives for low-income individuals (IDAs), has been received with a mix of criticism and praise. The fact that LSAs, RSAs, and ERSAs would be funded with after-tax contributions and would accumulate tax-free could provide an incentive for some individuals to save. Nevertheless, with respect to the LSA and RSA plans, it is not clear that low- to moderate-income workers will increase personal savings. We believe these individuals are better motivated by the tax savings in the year in which contributions are made. The IDA proposal may be too modest to have a meaningful effect. In addition, while the proposal modifies existing rules for defined contribution plans, rules encouraging retirement savings through defined benefit plans are not addressed. Enacting changes for defined contribution plans without similar consideration for defined benefit plans only increases the disparity between the two.

The Academy encourages the promotion of options for increasing retirement savings and we believe that the benefits of the proposed savings accounts should be more closely evaluated before any congressional action is taken.