COVER STORY

Beneath the Surface - Could Tax Reform Sink Retirement?

Is tax reform the enemy of retirement security?

BY NEVIN E. ADAMS, JD

Controversy of one sort or another has swirled around many of President Trump's cabinet picks. But there is one common theme in several key nominations that has drawn relatively little attention: tax reform.

"Our No. 1 priority is tax reform. This will be the largest tax change since Reagan," Steven Mnuchin, President Trump's pick for Treasury Secretary, said in an interview on CNBC last December. The former banker served as Trump's campaign finance chairman.

He was referring, of course, to the Tax Reform Act of 1986 (TRA '86), which significantly simplified and streamlined income tax rates. Of course, it also tightened the nondiscrimination rules, reduced the maximum annual 401(k) before-tax salary deferrals by employees by 70% (by imposing the 402(g) limit), and required all after-tax contributions to DC plans to be counted as annual additions under the Code Section 415 limits. And what did all that do for — or rather, *to* — retirement savings?

A "Better" Way

Nor is that support limited to the White House. The day after the 2016 election, Rep. Kevin Brady (R-Texas), Chairman of the Ways & Means tax-law writing committee, noted that Trump's tax proposal in many ways mirrors the "Better Way" tax reform blueprint released in 2016 by House Republicans. Brady said that House Republicans were "ready with the agenda we've laid out, especially fixing this broken tax code, replacing Obamacare with real patient health care, and lifting taxes off businesses so they can grow again."

While the "Better Way" blueprint pledges to "continue the current tax incentives for savings," it directs the House Ways & Means Committee to "consolidate and reform the multiple different retirement savings provisions in the current tax code to provide effective and efficient incentives for savings and investment." So while the current retirement savings vehicles, like 401(k) plans, ostensibly would not be removed from the tax code under the House Republican plan, those vehicles could be combined into one "cookie cutter" approach.

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That might, or might not, mean significant changes for the 401(k), but 403(b)s and potentially even 457(b) programs could be subjected to changes that would render them more like their 401(k) brethren. And of course, it's not beyond the realm of possibility to imagine that a new discrimination testing regime might emerge, as it did with TRA '86.

Additionally, the blueprint directs the Ways & Means Committee to "explore the creation of more general savings vehicles" like so-called Universal Savings Accounts (USAs). These accounts would be individual accounts outside of the employer-based savings system in which account holders make after-tax contributions, much like a Roth IRA works today. But unlike Roth accounts, USA account holders could withdraw both contributions and earnings at any time, and for any reason, without tax penalties.

Indeed, legislation has already been introduced in Congress that would create this new savings vehicle. The question is how these new accounts, combined with other potential changes in the tax code, will affect the relevance of IRAs and possibly even workplace-based savings arrangements.

Nor is the enthusiasm for tax reform limited to the House. Just last month, Senate Finance Committee Chairman Orrin Hatch (R-Utah) told the U.S. Chamber of Commerce that he hopes there will be a tax reform proposal "in the near future" and that "Republicans are united in their commitment to reform our nation's broken tax system." Among the goals is to work toward, he said, a tax system that "picks fewer winners and losers." And he expressed confidence that "because we agree on these principles, there is every reason to believe we can work through the details."

That said, Hatch acknowledged the political realities surrounding tax reform, noting that the Republicans have 52 votes in the Senate, so "the margin for error is only two votes." He said there probably will be a Senate tax bill separate from what the House considers, and that "the Senate will have to work through its own tax reform process if it has any chance of succeeding."

Once in a Generation?

It's been said that tax reform is a rarity — that it only comes once in a generation. True enough, it's been 30 years since TRA '86, which was itself the first wholesale revision of the tax code since 1954. Indeed, the Code is now named the "Internal Revenue Code of 1986." TRA '86 was the last of four significant tax bills signed into law by President Reagan. (The others were the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA) and the Retirement Equity Act of 1984 (REA).)

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While each of these legislative initiatives had unique motivations and characteristics, they worked to reign in the tax advantages of private retirement plans by significantly reducing the contributions and benefit limits alongside new testing requirements — due to both a pervasive skepticism as to the broad-based apportionment of those benefits to lower income workers, and a desire to use the higher tax revenues derived restricting tax deferrals to pay for the revenue reductions resulting from lowering tax rates.

Still, even in hindsight, it is difficult to

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fully appreciate the sweeping impact that TRA '86 had on America's retirement. Consider that it effectively froze the $30,000 maximum annual amount of total contributions (employee and employer) made to any type of DC plan — a freeze that would stand for nearly a decade and a half. TRA '86 also brought us the so-called 402(g) limit that capped the amount of pre-tax deferrals at $7,000 and tightened further the nondiscrimination rules that applied specifically to 401(k) plans. This, mind you, from the hands of a Democratic majority in Congress.

Therein lies what has been the inherent tension between the articulated goals of tax reform in terms of fostering economic growth and spending, and the need to pay for those goals by closing off or accelerating the deferral of taxes via retirement savings.

'Camp' Counseling

And while it may have been a generation since tax reform made it into law, we don't have to look very far back to see a potential roadmap. Just three years ago, Rep. Dave Camp (R-Mich.), then Chairman of the House Ways and Means Committee, released a comprehensive tax reform proposal. Sure enough, when it came to the "pay fors" — revenue-raising provisions needed to offset other provisions that would either cost money or result in lower tax revenues — retirement savings was squarely in the crosshairs.

Camp's proposal would have placed a 25% cap on the rate at which deductions and exclusions (including those relating to retirement savings) reduce a taxpayer's income tax liability. That would have subjected individuals (albeit those in a new, and for them lower 35% tax bracket) to a 10% surtax on all

'MAY YOU LIVE IN INTERESTING TIMES'

The only thing worse than writing about tax reform after it happens is writing about it while those negotiations are in process. As we head to press, tax reform remains very much in the headlines, though other initiatives — the repeal and/or replacement of the Affordable Care Act, cabinet nominee hearings, Supreme Court nominees and various executive orders — could have an impact.

Regardless, the likelihood that there will be tax reform without some impact on retirement plans seems to fall somewhere between slim and none. Stay tuned to www.napa-net.org for the latest insights on this and other legislative initiatives.

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contributions made to a qualified retirement plan — that is, both employer and employee contributions.

In effect, Camp's proposal would have taxed contributions to qualified retirement plans twice: the 10% surtax when contributions were made to the plan, and then again at the full ordinary income tax rate when the money is distributed from the plan during retirement. In all likelihood, this double penalty would have discouraged many small business owners from establishing — or continuing to maintain — a workplace retirement plan.

Moreover, in a throwback to TRA '86, the Camp proposal would have frozen the limits on contributions to qualified retirement plans for a decade — a change that was projected to raise more than $63 billion over the next 10 years to pay for tax reform.

The Camp proposal would also have subjected all elective deferrals to qualified retirement plans above one-half of the pre-tax deferral limit (then $17,500) to Roth tax treatment. In other words, the pre-tax contribution limit would have been cut in half, with the remainder made on an after-tax basis. This change, along with a requirement that all employers with more than 100 employees amend their plan documents to allow employees to make Roth contributions (if not already permitted), was projected to raise $143.7 billion over the next 10 years — again, not to facilitate or encourage retirement savings, but to pay for tax reform.

'Through' Putt?

But that was then, and this is now, right? Not so.

As advisors well know, a not-so-complex financial calculus underpins a delicate balance for small business owners considering offering a retirement plan. As it turns out, the current House Blueprint for tax reform provides a 25% maximum tax rate on income from pass-through entities (partnerships, S corps and small business limited liability corporations). In addition, pass-through income that is reinvested in capital assets will generate earnings that should qualify for a maximum tax rate of 16.5% because of the 50% exclusion under the Blueprint for capital gains income. (You'll find Brian Graff's commentary on this provision on page 8.)

In contrast, retirement contributions (and the accrued earnings on those contributions) will ultimately be taxed at ordinary income tax rates when distributed from the plan. Under the Blueprint, ordinary income tax rates are slated to max out at 33%. As a result, owners of pass-through entities, which are mostly small businesses, will have no incentive to contribute amounts that would otherwise qualify for the 25% pass-through rate and a 16.5% rate on reinvestments. In fact, if the Blueprint is enacted in its current form, these small business owners will take a big financial hit if they defer pass through income

into a retirement plan.

What would small business owners do if presented with this choice? Well, it stands to reason that without some kind of parity between the taxation of retirement plan distributions and non-retirement investments, small business owners who might have considered adopting a new plan will rethink that approach. Moreover, millions of small business owners who do offer a workplace plan will find themselves incentivized to terminate their retirement plan. That would, of course, have a severely negative impact on the availability of these plans to the millions of Americans who work for these small businesses.

And we all know that without access to a workplace retirement plan, millions of middle-income small business employees won't save.

Yes, for all the concerns expressed by those in our nation's capital about retirement security, tax reform is ultimately all about reducing the amount of revenue that the federal government takes in. But with a $20 trillion debt, Uncle Sam will need to find some way to offset the projected loss in revenue — and that's where the tax incentives to establish, fund and contribute to a workplace retirement plan inevitably find themselves in the budgetary crosshairs.

The threats to the retirement system through the tax reform back door are not limited to Republicans. In 2014, Sen. Ron Wyden (D-Ore.), then Chairman of the powerful Senate Finance Committee, claimed that "incentives for savings in the tax code are not getting to the people who need them," and that it was "clear that something is out of whack" with a system that he said taxpayers are "subsidizing" to the tune of $140 billion a year. Yet, Wyden said, "millions" are nearing retirement with little or nothing saved. At the time, Wyden noted that, retirement savings "are going to be a focus in bipartisan tax reform."

While those paying attention to such things realize that most of those tax preferences are temporary — that is, taxes will be paid on those employer pre-tax contributions and the earnings on them when they are withdrawn, the government bean counters look at revenues and expenditures within a 10-year window, and since the payment of most retirement benefits occurs outside that window, the amount of taxes postponed looks, from a budgetary standpoint, to be taxes permanently foregone. And, on that basis, even though the retirement preferences are completely different from other tax deductions, from a budgetary scoring standpoint, it's a big, juicy target.

The bottom line: There remains bipartisan enthusiasm for tax reform, though that interest is generally focused on reducing rates — and those efforts often "pay" tax reform's tab by undermining the incentives that promote, encourage and support the maintenance and creation of workplace retirement plans, specifically among smaller employers.

However one feels about the stated goals of tax reform, to date retirement savings — and retirement security — has largely been viewed as an enabler. Here's hoping it's different this time.