Comments on the Administration's Proposals for Retirement Policy

By Mark J. Warshawsky

Mark J. Warshawsky was formerly Treasury assistant secretary for economic policy and is now a visiting scholar at the Mercatus Center at George Mason University.

The Obama administration has proposed several major tax changes and new programs in the retirement area. In this article, Warshawsky argues that while some of them move in the wrong direction and others are overly complex or incomplete, it is good that the administration is offering ideas to get a constructive, bipartisan dialogue started in the broad retirement field, which should include Social Security.

In early February the Treasury Department released its green book explanation of the Obama administration's fiscal 2016 revenue proposals.[1] Taken as a whole, the proposals would significantly increase taxes ($1.7 trillion over 10 years) and budget outlays ($122 billion over 10 years), move the burden of taxes substantially toward upper-income households, redistribute resources toward lower-income households, and increase the complexity of the tax system. In this article, I offer critical comments on the main revenue proposals for retirement, an area that I have addressed in prior *Tax Notes* articles.

Require Automatic IRAs

Current law has several tax-preferred, employer-sponsored retirement savings programs for various types of employers: large, small, private, nonprofit, and public. Small employers can get a temporary, three-year business tax credit for start-up costs for retirement plans. Individuals who lack access to an employer plan may make tax-deductible contributions to IRAs.

In the belief that retirement preparedness is inadequate, particularly for low-wage workers at small employers, the administration is proposing that all employers that have more than 10 employees and do not sponsor a retirement plan be required to offer workers an automatic IRA option, under which regular contributions would be made to an IRA through payroll deductions. The administration would also increase the small employer tax credit for expenses of new retirement plans and create a modest small employer tax credit for the automatic IRA.

The green book description implies that all employees would be included in the automatic IRA, including those under age 18, nonresident aliens, and new hires. It is unclear whether part-time employees would also be included. The green book says that the employer would be responsible for providing employees a standard notice and election form and that the default employee contribution rate would be 3 percent of compensation, up to current-law IRA dollar limits, paid to a Roth IRA. At the same time, the green book says that employees and not employers would be responsible for determining IRA eligibility. The apparent contradiction between an employer obligation for notice to employees and the employee self-determination for IRA eligibility is not explained.

The employer could choose the IRA trustee, allow for employee designation of the IRA vendor, or forward collected funds to a savings vehicle (''standard, low-cost investment alternatives'') specified by statute or regulation. This last choice for the employer, presumably the default, is left quite vague in the green book, but others have proposed using the federal employee Thrift Savings Plan or creating a new federal program. Indeed, because almost all these IRAs would be very small and difficult to administer, at least initially, it is hard to imagine that employers and employees would find any private-sector IRA vendors interested in this money-losing business. The federal government, needing to make a considerable administrative investment in creating a system of retirement accounts (not unlike what was required for the federal health insurance exchange), would perforce step in. Perhaps the Obama administration has the Social Security Administration or the IRS in mind for this responsibility or has simply not thought the proposal through.

The public policy presumption behind this proposal is that a retirement crisis is brewing and the power of automatic enrollment can solve it. This is a controversial presumption. Some say that Social

[1]Treasury, ''General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals'' (Feb. 2, 2015).

Security, which is mandatory, provides adequate retirement benefits for low-wage workers and that raising retirement contributions from them would do more harm than good. Indeed, some low-wage workers would initially opt out of the automatic IRA, and many more would withdraw funds at the first sign of economic trouble or personal distress, defeating the policy purpose of retirement security. In my opinion, serious discussions of automatic IRAs have to be coupled with discussions of Social Security reform to be coherent policy.

Tighten Contribution and Benefit Limits

At the other end of the income spectrum, the administration is again proposing to limit contributions to retirement savings accounts and accruals to defined benefit plans if the worker has accumulated amounts within the tax-favored retirement account system (including defined benefit plans) that exceed the amount equal in actuarial value to a joint-and-survivor life annuity at age 62 paying an annual benefit of $210,000. The green book says that this amount is currently $3.4 million. For a worker younger than age 62, the accumulated account balance would be converted to an annuity payable at 62, so that litmus-test amount would be less than $3.4 million — at younger ages, considerably less. Also, as interest rates rise, the allowable account balance would also decline across all ages.

Indeed, the volatility of interest rates would make this proposal quite difficult to administer, both for the plan sponsor and the participant, because the allowance of contributions will be constantly shifting on and off with interest rate levels as well as with investment returns in the participants' retirement accounts. The interaction between defined benefit and defined contribution plans would be particularly difficult to manage, and this administrative burden was indeed a factor in the repeal of past legislative attempts to limit combined retirement resources across plan types sponsored by a single employer.

The green book says that the proposal is motivated by a desire to control the tax expenditures arising from multiple sources of employer and employee contributions, both in defined contribution and defined benefit plans. Some, however, explain the proposal as a reaction to the 2012 presidential election campaign when it was disclosed that Mitt Romney had tens of millions of dollars accumulated in retirement accounts. Ironically, the target may largely hit elsewhere. Because of the generosity of public pension plans, which include cost of living adjustments and early retirement ages, I believe that higher-paid state and local government workers, like police and fire chiefs and legislative directors, would be particularly affected by this proposal. Moreover, for many participants, the source of large accumulations in the retirement system is not excessive contributions but rather investment success. It is unclear what policy purpose is served in penalizing good investment returns in retirement accounts.

The consequence would be that plan sponsors would offer low-risk and low-return investments as the primary investment choice to be held in 401(k) plans to avoid the impact of the new rule on older and higher-paid employees. Given the nondiscrimination requirements that all participants be given the same rights and features, the resulting change in the emphasis of the investment menu would ultimately hurt the retirement security of lower-paid and younger employees the most.

The administration is proposing to require employers to report the amounts contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2. The green book justifies this proposal by saying that providing information on employer contributions to defined contribution retirement plans, in addition to the current information on employee contributions, would give workers a better understanding of their overall retirement savings and compensation. It also says that this information would facilitate compliance with the annual limits on additions to defined contribution plans.

The first justification is lame because surely what is relevant to the participant for planning purposes is what she sees in and can reasonably expect to get from her retirement account accumulation and income. Those disclosures are adequately covered by the current and proposed Labor Department requirements. The second stated justification seems plausible but would gain more credence if it were backed by some evidence of significant compliance problems with current contribution limits not otherwise capable of treatment.

Reform Minimum Required Distribution Rules

Minimum required distribution (MRD) rules require participants in tax-favored retirement plans and accounts to begin to get distributions after age 70½ over their life expectancy. Under current law, Roth accounts in plans are subject to the MRD rules during the life of the account holder, but Roth IRAs are not. The administration is proposing to apply the MRD rules to Roth IRAs but to waive the rules for retirees whose aggregate value of plan and IRA accumulations is less than $100,000. The administration justifies the first part of the proposal as equitable treatment of Roth accounts inside and outside retirement plans.[2] It justifies the second half of the proposal as a simplification for lower-paid workers, who are likely to have small retirement accounts.

This latter justification is mistaken, however, because it is plan administrators and IRA vendors who actually administer the MRD rules, not individuals, and they do a good job of it under current law. But these entities can do so for only the amounts that they see and for which they are responsible — they do not know whether an individual has more or less than $100,000 in total retirement assets held in various accounts. So the responsibility for MRD management would ironically be thrown onto the individual by the administration's proposal. In the past I have proposed a better reform of the MRD rules: to increase the starting distribution age by five years, to age 75, in accordance with increases in life expectancy since the MRD rules were first put in place in the early 1960s.

The MRD rules also apply to balances remaining after a plan participant or IRA owner has died. For a non-spouse beneficiary, the distribution period is the beneficiary's life expectancy, calculated in the year after the year of death. According to the green book, this treatment allows the beneficiary of an inherited IRA, who can be much younger than the original plan participant or IRA owner, to stretch the receipt of distributions over many years, permitting tax-favored accumulations of earnings over an extended period. The administration is therefore proposing that non-spouse beneficiaries, with some exceptions, be required to take distributions over no more than five years.

The exceptions include beneficiaries who are disabled or chronically ill, individuals who are not more than 10 years younger than the IRA owner, and children who have not reached the age of majority. Presumably the IRS would be responsible for administering those exceptions. The last exception is ironic given the motivation for the proposal, although the administration does temper it somewhat by requiring distributions within five years after the child achieves the age of majority. I agree with the central proposal, because it would focus the public's attention on retirement accounts for retirement income security and not bequests. But because the proposal includes so many and such complex exceptions, I do not think the administration is really serious about it.

[2]In another proposal designed to combat what it sees as abuses of Roth IRAs, the administration would disallow the conversion of after-tax amounts held in a traditional IRA to Roth amounts.

Expand Distributions From Retirement Plans

Early withdrawals from a tax-qualified retirement plan or IRA are subject to a 10 percent additional tax, unless an exception applies. According to the green book, an individual is now eligible for an exception from the additional tax for a distribution from an IRA after separation from employment if (1) the individual has received unemployment compensation for 12 consecutive weeks, (2) the distribution is made during the tax year in which the unemployment compensation is paid or in the succeeding tax year, and (3) the aggregate of all those distributions does not exceed the premiums paid during the tax year for health insurance. There is no corresponding exception from the additional tax for distributions from a qualified retirement plan by reason of a period of unemployment.

The administration proposes to add another exception to cover more IRA distributions to long-term unemployed individuals (exceeding the premiums paid for health insurance) and to include distributions to long-term unemployed individuals from a tax-qualified defined contribution plan. An individual would be eligible for this new exception if (1) she has been unemployed for more than 26 weeks because of a separation from employment and has received unemployment compensation for that period (or, if less, for the maximum period for which unemployment compensation is available under state law applicable to the individual); (2) the distribution is made during the tax year in which the unemployment compensation is paid or in the succeeding tax year; and (3) the aggregate of all those distributions does not exceed the annual limits described below.

The aggregate of all the distributions received by an eligible individual from IRAs may not exceed half of the aggregate fair market value of the individual's IRAs, and the aggregate of all the distributions received by the eligible individual from tax-qualified defined contributions plans may not exceed half of the aggregate FMV of the individual's non-forfeitable accrued benefits under those plans. However, an individual would in any event be eligible for this exception for the first $10,000 of otherwise eligible distributions. Eligible distributions in the aggregate would be limited to an annual maximum of $50,000 during each of the two years when distributions would be permitted under this exception, for a total of $100,000 for any single period of long-term unemployment. A plan would be allowed to rely on an individual's representation that she is an eligible individual to allow the plan administrator to separately track distributions entitled to the exception from the 10 percent additional tax.

At a time when many analysts across the ideological spectrum are worried about leakage from the retirement system, this proposal is quite breathtaking. Because unemployment is a rather common event, even in good economic times, the proposal would freely allow substantial non-penalized distributions from retirement accounts for workers of all ages at all income levels. The self-certification of eligibility would effectively mean that anyone who was separated from service would be able to get a penalty-free distribution from a retirement account if he wanted it.

How this proposal squares with the administration's stated policy motivation for the creation of automatic IRAs is a mystery to me. In my opinion, we should be moving in the opposite direction — toughening up current-law exceptions to the application of the additional tax. We should move to ages 62 and 60, respectively, the ages of exception to the penalty tax on distributions made on or after the employee has reached age 59½ and those made to an employee after separation from service after attaining age 55.

Extend Participation in Retirement Plans

The administration wants to increase the retirement coverage of part-time workers and "increase overall retirement savings." (The irony of this green book statement in light of the above proposal for a considerable expansion in penalty-free distributions is obvious.) Under current law, a qualified retirement plan sponsor is permitted to delay covering employees until after they work at least 1,000 hours in a year. Also, if a sponsor provides for immediate vesting, it can delay covering employees until they work at least 1,000 hours in each of two years. However, this two-year eligibility rule cannot delay beyond one year an employee's eligibility to make 401(k) elective contributions. Similar to the 1,000-hour threshold for coverage eligibility, employees also are not required to be credited with a year of service for purposes of vesting in employer contributions unless they work at least 1,000 hours in a year.

The proposal would require 401(k) plans to expand eligibility to participate by permitting employees to make salary reduction contributions if the employee has worked at least 500 hours per year with the employer for at least three consecutive years. The green book says that the proposal would not require expanded eligibility to receive employer contributions, including employer matching contributions.

The three-year condition is described as addressing the concern that part-time workers tend to change jobs frequently, after accumulating only small account balances that either are cashed out or, if left behind in the plan, can be costly to administer relative to the size of the balance. At the same time, the green book says that the proposal would also require a plan to credit, for each year in which that employee worked at least 500 hours, a year of service for purposes of vesting in any employer contributions that might be earned in the future if the plan requirements changed or if the employee eventually starting working more than 1,000 hours in a year. The green book states that nondiscrimination requirements would be altered to accommodate these changes so employers are not disadvantaged.

Stated another way, a 401(k) plan could be designed so that long-term, part-time workers would be allowed to make employee contributions but not necessarily receive employer contributions including matches. This proposal would introduce much complexity into plan administration. For many employers, it would be easier, but more expensive, to just change the overall work requirement to 500 hours a year for all purposes and even to include short-term workers. Either way, sponsor costs would increase. Perhaps a better approach would be to include long-term, part-time workers in the automatic IRA proposal instead.

Encourage Plan Sponsors to Offer Annuities

The green book cites as an impediment to offering annuities the concern that employers making an accumulation annuity investment available within a plan do not have good options if the employer wants (or needs) to remove the annuity investment option from the plan (for example, because a new trustee or record keeper will not support the annuity investment or the annuity product is no longer available on favorable terms). In some cases, plans and participants may incur significant surrender charges or other penalties if the annuity investment option is discontinued.

The administration's proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan, regardless of whether another event permitting a distribution (such as a severance from employment) has occurred. The distribution would not be subject to the 10 percent additional tax.

The motivation for this proposal is unclear. Because it applies and indeed favors accumulation annuity investments and a particular commercial product and asset class rather than annuity lifetime distributions, it seems inconsistent with other recent administration regulatory activities intended to encourage lifetime distributions per se. I have written elsewhere that the administration should reform the MRD rules more broadly than it has already done to encourage creative experimentation with different types of life annuity and systematic withdrawal strategies.

Conclusion

The administration has put forward many significant and even groundbreaking tax proposals in the retirement area, a welcome sign of policy interest. Unfortunately, most of them move in the wrong direction, increase administrative complexity, or are only half-formed. We should instead proceed in a bipartisan way, collecting ideas across the spectrum and form them in a comprehensive, thorough, and reasoned manner.