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New Research from EBRI:

Tax Reform Proposals Likely to Reduce 401(k) Account Balances

WASHINGTON—Two recent proposals to change the existing tax treatment of 401(k) retirement plans, if enacted, are likely to result in lower account balances for many 401(k) participants, according to a new analysis by the nonpartisan Employee Benefit Research Institute (EBRI).

Currently, the combination of worker and employer contributions to a 401(k) plan is capped by the federal tax code at the lesser of $49,000 per year or 100 percent of a worker's compensation (participants over age 50 can make additional "catch-up" contributions). As part of the effort to lower the federal deficit and reduce federal "tax expenditures," two major reform proposals have surfaced that would change current tax policy toward retirement savings:

- A plan recently presented at a Senate Finance Committee hearing that would end the existing tax deductions for 401(k) contributions and replace them with a flat-rate refundable credit that serves as a matching contribution into a retirement savings account.
- The so-called "20/20 cap," included by the National Commission on Fiscal Responsibility and Reform in their December 2010 report, "The Moment of Truth," which would limit individual annual contributions to either $20,000 or 20 percent of income, the so-called "20/20 cap."

"Defined contribution plans, such as 401(k)s, and the IRA rollovers they produce, are the component of retirement security that seems to be generating the most non-Social Security retirement wealth for Baby Boomers and Gen Xers," said Jack VanDerhei, EBRI Research Director and author of the report. "The potential increase of at-risk percentages resulting from (1) employer modifications to existing plans, and (2) a substantial portion of low-income households decreasing or eliminating future contributions to savings plans as a reaction to the exclusion of employee contributions for retirement savings plans from taxable income, needs to be analyzed carefully when considering the overall impact of such proposals."

The analysis is based on EBRI's proprietary Retirement Security Projection Model,™ and is published in the November 2011 *EBRI Issue Brief,* "Tax Reform Options: Promoting Retirement Security," online at www.ebri.org

Among the key findings of the EBRI analysis:

Impact of Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans from Taxable Income: If the current exclusion of worker contributions to retirement savings plans were ended in 2012 and the total match remains constant, the average reductions in 401(k) accounts at Social Security normal retirement age would range from a low of 11.2 percent for workers currently ages 26–35 in the highest-income groups to a high of 24.2 percent for workers in that age range in the lowest-income group.

Impact of "20/20 Cap": Earlier EBRI analysis of enacting the 20/20 cap starting in 2012 showed it would, as expected, most affect those with high income. However, EBRI also found the lowest-income group has the second-highest average percentage reductions in retirement contributions, and that younger cohorts would experience larger reductions given their increased exposure to the proposal. For each of the age groups analyzed, the highest-income group shows the largest average percentage reduction in account balance, ranging from 15.1 percent for the highest-income group for those currently ages 36–45 and falling to 8.6 percent for the highest-income group for those currently ages 56–65. However, other than for those with the highest income, those in the *lowest-income* group showed the second-highest average percentage reductions

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