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Revised

Statement Before The
Committee on Ways and Means
United States House of Representatives

Hearing
On
The Bush Administration's Proposal to End Double Taxation of Dividends: Impact on Retirement Accounts

Testimony of
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Introduction

- Thank you, Mr. Chairman, for allowing me this opportunity to share observations on how the president's plan to end double taxation of many dividend payments would impact America's pension system.
- A brief comment on terminology: I am including the proposed dividend exclusion, deemed dividend treatment and the recent expansion to include annuities in my comments. I will refer to it generically as the "dividend exclusion proposal" below.

Analysis

- I believe the major impact of the dividend exclusion proposal on qualified defined contribution plans will focus on the following three areas:
    - Employers that may terminate existing arrangements
    - Employers that may have started a new plan had the proposal not been adopted
    - Employees that would be offered qualified plan coverage but choose to forgo it for non-plan investments
- There will obviously be some plan sponsors (particularly among small businesses) that are so close to the margin as to whether they should offer a qualified plan that when the after-tax financial outcome of the next best alternative (i.e., have the owner forgo any contributions and declare a bonus for himself of an equivalent amount) improves via dividend exclusion it would be sufficient to tip the scales towards termination of the plan. I do not mean to imply that personal enrichment is the only reason that qualified retirement plans are offered by small employers. However, the mathematics of the cost/benefit tradeoff for a large number of small plans may be sufficiently modified to result in a significant number of terminations. Of course the real concern is exactly how many of these plans are there and is the loss of benefits for their employees significant? There is no database that I am aware of that can provide this estimate but this is one of the questions that needs to be answered before final analysis of this proposal can be provided.
- It is unlikely that the vast majority of plan participants will see their plans terminated as a result of this proposal. However, one should not minimize the potential problems that may be faced by plan sponsor since non-highly compensated employees may choose (logically or otherwise) to opt out of a 401(k) plan in favor of non-qualified investments which may make ADP testing more difficult. Although it is also possible that the dividend proposal will make ADP testing easier as the highly compensated employees are more likely to contribute to the match level and then invest outside than the average employee stop investing and invest on the outside.
- Congress should not limit its concern merely to existing plans however as it is quite likely that there may be employers that would have started a new plan had the proposal not been adopted. However, I believe this would have a relatively short window as a result of the EGTRRA 2001 provisions that provided for 401(k) plans to allow participants to choose to allocate all or a portion of their contributions to after-tax "Roth contributions" beginning in 2006 and escape taxation on either principal or investment income when benefits are received. It would appear that many plan sponsors may find the Roth 401(k) to be a better option than forgoing a qualified plan and taking advantage of the dividend exclusion. I believe many potential sponsors would not choose to make contributions on an after tax basis just to get a dividend exclusion when they can get a full tax exemption under a Roth 401(k) plan.
- While the employer is under no requirement to allow participants to make after tax Roth contributions, it is likely that both Roth and traditional 401(k) provisions would be provided by most sponsors (especially among small employers) in an attempt to optimize benefit delivery for all of the employees. This results from the fact that some employees anticipate their marginal tax rate will increase between now and eventual time of payment (in which case a Roth contribution is preferable) while others anticipate it will decrease and therefore prefer a traditional 401(k) contribution.
- In addition to either causing the termination of existing plans or the suppression of new plans, the dividend exclusion proposal could also impact employees that would still be offered qualified plan coverage but choose to forgo it for non-plan investments. The list of decision variables in making this choice is obviously specific to each individual but some of the more important determinants are likely to be:
    1. after tax vs. before tax contributions (both from a financial and psychological perspective)
    2. the individuals expectations for tax rates over time

3. the need to access money for emergencies
4. whether or not the employer offers a match

- Regardless of the impact on total savings, some workers are likely to lose the valuable ancillary benefits they derive from participating in an employer-sponsored retirement plan. Some workers will end up investing in "individual" individual accounts as opposed to group (or employer-sponsored) individual accounts either due to the considerations mentioned above or because the employer has chosen not to sponsor a plan in the new environment. These individuals may lose the benefit of having a fiduciary screen for "appropriate" investments and continually monitor the funds. Moreover, employer-sponsored educational programs would likely not be provided, at least to the same extent, if the employee were to save outside of the qualified market. This could also result in higher investment and service fees, which would serve to lower overall retirement wealth.
- The dividend exclusion proposal is also likely to have an impact on IRAs – both regular and Roth versions. The rationale for the likely decrease in future contributions to these vehicles is that investors in IRAs who won't see the tax benefits for years might shift more money into taxable accounts. The latter would have the benefit both of tax free dividends as well as capital gains taxed at only a 20 percent rate. However, this is unlikely to impact a large percentage of individuals as only 5.3 percent of workers contributed to a deductible IRA in 1998.

Conclusion

- Mr. Chairman, having done our own preliminary analysis and having read those produced by others, we are unable to make an estimate as to the extent to which the dividend exclusion proposals would harm qualified retirement plans as there are too many unknown parameters.
- EBRI's latest Issue Brief notes 18% retirement plan participation among employers with less than 10 employees in 2001. This figure has increased by 50 percent since 1991. There have also been dramatic increases in participation rates for the 10-24 and the 25-99 employee firms and is in contrast with their larger firm counterparts that displayed only minor increases. Are these groups big enough (enough people) to justify not doing something for all taxpayers that would be an automatic benefit for stock investors - not something that requires action?
- However, if one were concerned with the potential termination problem they could mitigate it by accelerating the implementation date of Roth 401(k) plans to 2004 to coincide with the time when plan sponsors would first begin to consider the investment strategies and products likely to be created as a result of the dividend exclusion proposal as a viable alternative to qualified plans. Small employers want sheltered income and increased appreciation and also want total tax exemption. In which case the Roth 401(k) would be a more attractive alternative to the small plan sponsor.