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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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Washington, DC

March 6, 2003

[1] EBRI is a private, nonprofit, nonpartisan public policy research organization based in Washington, DC. Founded in 1978, its mission is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI does not lobby and does not take positions on legislative proposals.

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  Dallas Salisbury is president and CEO of the Employee Benefit Research Institute (EBRI), Washington, DC. Salisbury has headed the Institute since its founding in 1978.

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The Bush Administration's Proposal to End Double-Taxation of Dividends:

Impact on Retirement Accounts

Statement by Dallas Salisbury, president and CEO
Employee Benefit Research Institute

House Ways and Means Committee
March 6, 2003

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.

It is bold as a move in policy. This is particularly true when it is combined with the savings proposals for LSA, RSA, and the Roth 401(k) acceleration to 2004. These last provisions essentially allow low- and moderate-income individuals to save with a 0% tax rate on interest, dividends, and capital gains. These are the groups most likely to own mutual funds versus individual securities, and the most likely to have money in regular savings accounts versus other vehicles due to their low savings rates. Total exclusion would not likely move them toward the purchase of dividend-paying stocks, but rather would create indifference.

It is likely to have only a limited impact in any direction on most current retirement and savings plan participants. Once the Roth 401(k) is in place in 2006, under current law, this becomes even more the case. A future exclusion from any taxes on any income or capital gains will clearly trump a stand-alone dividend exclusion. Some small employers could decide to not have a plan and simply move their money into a portfolio of high-dividend stocks. However, the Roth 401(k) would provide a better means of exclusion for these individuals, since they could also exclude interest and capital gains income. Since the theory of ending a plan due to this provision means a willingness to save after tax-dollars, the Roth 401(k) can be seen as a reasonable alternative for first dollars. The small employer might then also contribute to an LSA for family members. Roth 401(k) s, LSAs, and RSAs would also be more attractive options to small employers than simply moving their money into high-dividend stock portfolios.

It is unlikely that a dividend tax exclusion would lead to significant asset shifting for most individuals. Most defined contribution plan participants have small account balances, as most Americans have little in savings. The administration's proposal should not have an effect on lower-compensated workers, as these workers are unlikely to have saved enough at any one time to make a stock purchase worthwhile, and the tax deduction is going to far outweigh any savings in dividends over their lifetimes and at withdrawal time.

Even with a dividend tax exclusion, higher-compensated workers would still want an employer-sponsored retirement plan, particularly if there is a match. These workers can always diversify into bonds in the retirement accounts and stocks in nontax-favored settings. Furthermore, if the retirement plan fees are subsidized by the employer, this may mitigate the benefits of not having dividends taxed, since dividends are running around 2 to 3 percent of value.

It is unlikely the administration's proposal will cause a large number of people to change the way they invest. It appears more to be just a tax "break" for stock owners, and for many it will be quite small. At this point it is uncertain whether this would really have an effect on mutual fund providers. If, at some point in the future, corporations decided to significantly increase their dividend payouts, this analysis would change. But that is unlikely (certainly in the current economic environment), and stock appreciation will always be important.

The savings proposals will discourage targeted retirement savings, however. For employees not participating in a 401(k) plan offering an employer match, the LSA would often be the first place to put the first $7,500 per family member due to the lack of restrictions on when a participant can take a distribution as well as the lack of early withdrawal penalties. Since this amount is more than most Americans save in a year in any form,[2] it could absorb all savings for most.

It is a next step in a long-term policy progression toward incentives for savings other than for retirement. Until the mid 1990s the incentives were offered for retirement savings only. These incentives were often reinforced through early withdrawal penalties and, in the case of certain 401(k) monies, in-service withdrawals were permitted in only limited situations. The Taxpayer Relief Act of 1997 created a new tax-favored savings vehicle called a Roth IRA that introduced the concept of "no deduction," "no tax on withdrawal" to retirement planning.[3] Then came 529 plans for college savings, Individual Development Accounts, etc. Now, the proposed Lifetime Savings Account would allow for withdrawal for any purpose without tax or penalty at any time.

It is likely that there will be two groups that would forego the LSA for at least a portion of their annual savings. First, those who have a retirement plan at work with a matching contribution and are willing to have limited access to the money are likely to choose to participate in the 401(k) plan instead. Second, those motivated by the ability to make before-tax contributions to have an immediate tax reduction would likely prefer the 401(k) plan also. This later group is likely to be high-income individuals who believe they will be in a higher tax bracket when they withdraw the money or intend to leave the account to their non-taxable estate.

The savings proposal could cause some small employers to terminate retirement plans and others not to start them. This is especially likely to happen with small plans, since the employer could put away $15,000 for him/herself with similar amounts for a spouse and each child without having to deal with administrative details of qualified plans or the employer contributions necessary to make a safe-harbor 3% contribution, a safe harbor matching contributions, or to induce sufficient contributions from the NHCEs to pass the nondiscrimination tests. Moreover, at least initially, the $15,000 is greater than the $12,000 under Sec. 402(g), which would still apply to ERSAs.

Certain elements of the savings proposal would work toward increasing total savings. First, the LSA and the RSA would apply to all persons with identical provisions so that advertising them would be easy and clear and much confusion would be eliminated. The universal eligibility and relatively simple design of the attendant financial instruments should increase both the supply and demand for these options. Second, the increased flexibility with respect to withdrawal access should also appeal to those with limited resources who prefer to have ready access to liquid assets in the case of financial emergencies.[4] Third, taxpayers who believe their personal long-term tax rates will increase would find

[2] In the calendar year 1999 data from the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, the average before-tax 401(k) participant contribution as a percentage of salary was 6.8 percent. The average total participant contribution as a percentage of salary was 6.9 percent. Based on an average annual participant salary of $44,187, this produces an average annual before-tax contribution of $3,004, or $3,048 if after-tax contributions are included. See Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants." ICI *Perspective*, Vol. 7, no. 4; and *EBRI Issue Brief* no. 238 (Investment Company Institute and Employee Benefit Research Institute, October 2001).

[3] Technically, after-tax contributions and recovery of the cost basis tax-free were quite common before 401(k) plans. However, Roth IRAs also allow for tax-free withdrawal of investment income.

[4] Holden and VanDerhei show that a participant in a plan offering loans was expected to contribute 0.6 percentage point more of his or her salary to the 401(k) plan than a participant with no borrowing privileges. Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants."

the after-tax nature of the LSA and RSA desirable and might choose to increase their annual savings as a result.[5]

However, there are also reasons to hypothesize that the savings proposal may not increase total savings. First, most taxpayers already have both the regular IRA and the Roth IRA available but few have chosen to contribute to either.[6] Given that Roth IRAs need to satisfy a five-year holding requirement that does not apply to LSAs, there may be more of a demand for the latter, but it might simply capture short-term savings. Second, if the proposal were adopted, it would likely lead to termination of existing defined contribution plans, especially among the small employers. Since employee contributions are mostly driven by matching employer contributions,[7] this would not only deprive a significant number of employees from receiving employer contributions, but it would likely cause them to discontinue their own contributions as well.

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.

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[5] There are many reasons why an individual taxpayer may believe their tax bracket would increase later in life even if the tax rates remain static. However, growing budget deficits (and the promises for Medicare and Medicaid already in law for the elderly), which are growing rapidly, may provide additional incentive for individuals to choose the after-tax contributions.

[6] Only 5.3 percent of workers contributed to a deductible IRA in 1998. Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes*, no. 12, (December 2002).

[7] Jack VanDerhei and Craig Copeland. "A behavioral model for predicting employee contributions to 401(k) plans." *North American Actuarial Journal* (First Quarter, 2001).