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On behalf of the
American Retirement Association

Senate Finance Committee Hearing on
Corporate Integration
May 17, 2016

Thank you Chairman Hatch, Ranking Member Wyden and members of the Committee for the opportunity to talk with you about the impact of corporate integration on qualified retirement plans for small business.

Data clearly shows workplace savings is critical to retirement security. In fact, workers earning from $30,000-$50,000 are *15 times more likely* to participate in a plan at work than to save through an IRA on their own. This means the impact of a corporate integration proposal on the establishment and maintenance of workplace retirement plans must be considered when assessing the proposal's impact on the retirement security of American workers.

Two key features distinguish retirement savings tax incentives from other incentives in the Internal Revenue Code – the deferral nature of the incentive, and the nondiscrimination rules that make employer-sponsored retirement plans very efficient at delivering benefits across the income spectrum.

These tax incentives play an especially critical role in encouraging small business owners to establish and maintain a retirement plan. When that small business owner decides to set up a 401(k) plan, he or she agrees to take on the administrative costs and responsibilities of operating the plan. But that's not all. To comply with the nondiscrimination rules, there typically will also be an obligation to make contributions for the other eligible employees.

A corporate integration proposal that treats retirement plan assets the same as investments made outside of a plan would be a broadside hit on the tax incentives for

establishing, maintaining and participating in a retirement plan. The impact can be illustrated by considering a couple of examples. For illustration purposes, assume the proposal requires mandatory 35% withholding on dividends and interest paid on all domestic stocks and bonds, including those held in a retirement plan, with no ability to recover the withholding. Also assume all investment income is from dividends and interest, funds are initially invested 50% in equities and 50% in bonds, the annual earnings rate is 5%, and the taxpayer's marginal rate is 28%.

First, let's consider an individual with $10,000 to invest in either a 401(k) plan or in a personal account outside of the plan. With corporate integration, both accounts would net the same amount after 20 years. In other words, there would be no *tax* incentive for investing in the 401(k) plan. Since money held in a 401(k) or similar plan is also subject to restrictions on withdrawal before retirement – in some case including a 10% penalty – there would actually be a *dis*incentive to contribute to the 401(k) plan.

Corporate integration would look even worse for a small business owner deciding whether or not to set up a 401(k) plan. The business has been in operation for 5 years and is now turning a profit. There are five non-owner employees with total payroll of $300,000. The owner takes $10,000 per month during the year, then takes a year-end bonus equal to the company's profit, which is $65,000 for the current year. Without a retirement plan, the owner will pay individual income taxes on the bonus at a marginal rate of 28%, leaving $46,800 after taxes are paid.

A retirement plan consultant recommends setting up a safe harbor 401(k) plan with an additional "cross-tested" contribution instead of taking the bonus. With this type of plan the owner could contribute $50,000 of the profits to the plan on her own behalf, but thanks to the nondiscrimination rules, the owner will also have to contribute 5% of pay for the employees, which is $15,000. So, instead of taking home $46,800 and sending IRS a check for $18,200, the owner could contribute $50,000 to the plan on her own behalf and $15,000 for the employees.

With corporate integration, the deduction for the contribution would still largely cover the costs of the contribution, but looking at her investment horizon, setting up a 401(k) plan just would not make sense for the owner. If the owner just paid tax on the $65,000 now and invested the difference, she would end up with significantly more savings 20 years from now than if she put in the 401(k) plan, *even if she drops to a 15% marginal rate in retirement. With a 28% rate, she could increase her savings by 30% by not sponsoring a 401(k) plan.*

Given all of the strings attached to withdrawing money from a 401(k) plan, she also would have more flexibility holding those savings outside of a plan. *In other words, with corporate integration, the owner would not only have less expense, less liability, and more flexibility, she would actually have more long term savings by just saying "no" to setting up a 401(k) plan.*

In summary, corporate integration may be good tax policy in theory, but it would be horrible retirement policy in practice, if there is no incentive for a small business owner to set up and maintain a workplace retirement plan. Without a plan at work, most workers with modest income simply do not save for retirement.

We would be pleased to work with the Committee on how the proposal can be fashioned to preserve the tax incentive for retirement savings. Again, thank you for inviting me, and I would be pleased to discuss this issue further with the Committee or answer any questions you may have.