

## THE POLITICS OF RETIREMENT

# Impending Changes to Private Retirement Plans

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### Retirement Crisis

The retirement landscape in America is shifting. An uncertain labor market, stagnant incomes, and unreliable financial markets, along with continuing high debt levels, have put the middle class under siege, and all sides in Washington acknowledge that action must be taken on a number of fronts to support this core group. One of the least understood threats to the middle class is an impending crisis in retirement for which so many are financially unprepared. America's retirement system is said to be a three-legged stool consisting of Social Security, private savings, and employer-sponsored pension plans. But each leg of the stool is wobbly, and the private retirement plan system is particularly shaky.

Half of all workers today have no employer-sponsored plan and, of those who do, only 20 percent have a plan that provides a guaranteed lifetime benefit. 401(k)-style plans have failed to deliver on their potential because many workers lack access to them and because savings rates are too low and costs are too high. Further, volatile financial markets threaten account balances that just recently have regained pre-recession levels. Longer life spans stretch existing savings even thinner. Put simply, the majority of Americans are not retirement-ready. Policymakers in Washington are aware of these problems and can be expected to focus on ways to increase retirement savings, protect investment returns, and assist plan participants in efficiently and prudently drawing down retirement savings.

### Harnessing the Power of Inertia

Many of the proposals affecting private pensions are focusing on programs that take advantage of individuals' propensity for inertia and rely on automatic enrollment in savings plans and automatic increases in the amounts saved. Under these programs, individuals would need to consciously opt out of the plans in order to escape payroll deductions, in contrast to plans that require employees to make an affirmative election to create savings.

**Auto-Enrollment and Auto-Escalation**  
Retirement vehicles that provide for automatic contributions utilize an employer payroll system to require salary reduction contributions to 401(k) plans and depend on employee inertia not to opt out. Auto-enrollment of new employees and auto-escalation of 401(k) contributions to 401(k) accounts have been available as optional plan features since 2006. Despite the free pass from nondiscrimination testing that can be achieved if the auto-contribution level is set at 6 percent and the plan provides a qualifying matching contribution, many employers have not embraced these tools. This is especially unfortunate in light of the studies showing that automatic escalation features are likely to significantly increase 401(k) balances, especially for low-income workers.

### Re-Enrollment and Investment Reallocation

Typically, auto-enrollment or auto-escalation cover only new employees; incumbent employees are not subject to the plan's negative election procedures. To expand the

reach of automatic contribution features, many advisors and plan sponsors are now considering re-enrollment features for their 401(k) plans. Under a typical re-enrollment program, participants with low deferral rates are deemed to make deferral elections of, say, 6 percent of pay, subject to participants opting out. Re-enrollments are a standard practice when changing record-keepers, but a plan sponsor may decide to implement a re-enrollment on a one-time basis or even annually.

Advisors also are talking about using negative elections to re-allocate investments. Under this approach, new money and existing account balances are transferred to the plan's qualified default investment alternative (QDIA) unless the participant opts out. Re-enrollments and re-allocations are emerging features that can substantially increase plan contributions and optimize investment returns. We expect the Internal Revenue Service (IRS) and Department of Labor (DOL) to bless these practices by issuing appropriate guidance. The courts already have done so in the 2012 *Bidwell v. University Medical Center Inc.* decision by the U.S. Court of Appeals for the Sixth Circuit, which upheld reallocation to the plan's QDIA safe-harbor.<sup>1</sup>

### Auto-IRA and myRA

We expect a renewed push for automatic individual retirement accounts (IRAs) from the second Obama administration. Under this administration proposal, auto-IRAs would be mandatory for all employers with more than 10 employees that have been in business for two years and do not maintain

a pension plan. Because employees who are at least 18 years old with three months of service would be eligible, most employers would need to modify their plans or have auto-IRA plans in addition to 401(k) plans.

In its fiscal year 2015 version of the proposal, the administration's auto-IRA proposal includes three key features. First, the bill sets the default contribution at 3 percent of compensation. Second, employees would have the choice of contributing to either a traditional pre-tax IRA or Roth IRA. If no choice is made, the post-tax Roth account would be the default vehicle, so that withdrawals would not be taxable. This default rule addresses the likelihood that lower-income workers would be more likely to withdraw money before age 59½. Finally, the auto-IRA provider (a financial services firm) would be selected by the employer or the employer could allow each participating employee to designate an auto-IRA provider. A handful of default investments would be prescribed by statute or regulation. Despite consensus on the need for greater retirement savings, the auto-IRA has elements that are problematic at either end of the political spectrum. Republicans disagree with the employer mandate and Democrats object to private sector management of IRA assets. This conflict makes the prospects for enactment unclear.

To demonstrate executive action and encourage the savings habit while the auto-IRA legislation is stalled, President Obama has ordered the Treasury to create a new starter retirement savings program called "myRA." This program will make Roth accounts available to people who do not have employer-sponsored plans and will be offered initially through employers that volunteer to participate in the program. Married couples can invest if they make less than \$191,000 annually. Once the balance of a myRA reaches \$15,000 (or after 30 years), however, participants will be required to roll the account over to a traditional private-sector IRA.

All myRA accounts will have a single investment option, specifically a Treasury

bond that offers the same interest rate return as the government securities fund under the federal Thrift Savings Plan. Historically this rate has ranged from 1.5 percent to 3.5 percent annually. An initial investment can be as low as \$25 and subsequent contributions as low as \$5. The overall limits on myRA accounts make this a small step in resolving the coverage issue, but it is hoped that the low investment thresholds will allow low-income workers to access tax-advantaged retirement savings vehicles. On the other hand, the program has been criticized for using worker money to support government bonds when better returns are available from private-sector investments.

Because it is voluntary and involves very small amounts, myRA seems more a symbolic gesture than a significant effort to expand opportunities for retirement savings. Given the need to increase retirement savings, arrangements involving automatic enrollment, automatic escalation of deferrals, and automatic investments are likely to be maintained and expanded. The enactment of auto-IRAs will be difficult in the short term, but this ultimately may be an issue where concerns for the well-being of an aging middle class force lawmakers to approve a measure on which they have reservations. Auto-IRAs do not involve the expenditure of employer funds and, given the maximum annual contribution of \$5,000, will not detract from the desirability of establishing qualified plans (which have far higher contribution limits) by employers that wish to do so. Once funded, an auto-IRA will be owned and controlled by the employee, thereby eliminating the administrative responsibilities of the employer. It's unclear whether auto-IRAs will have the same success as automatic 401(k) deferrals, but it likely would result in an appreciable increase in the number of Americans actively saving for retirement.

### Protecting Returns

Policymakers also are working on ways to ensure that the amounts employees are saving in retirement accounts generate appropriate investment returns. As articulated by the 2010 Annual Report by the White House Task Force on the Middle Class, the

Obama administration wants "to ensure that workers have good options to save for retirement, and to provide workers with all the information they need to make the best choices about their retirement savings." The comments of the task force reflect the administration's engagement in regulatory rulemaking with respect to: (1) improving the transparency of 401(k) fees and investment options; and (2) broadening the scope of the ERISA definition of "fiduciary" to cover more providers. Even though Congress has not passed major retirement legislation, a new regime is already underway as the DOL proceeds with its rulemaking agenda.

### Fee Transparency

The administration has indicated it wants to help plan sponsors and participants get a fair price for the services they purchase. Consistent with this goal, the DOL has issued two sets of disclosure regulations: (1) plan sponsor-level disclosures required in order to avoid prohibited transaction violations and (2) participant-level disclosures required under new standards for meeting fiduciary duties.

The plan sponsor rules became effective July 1, 2012, and mandate delivery by service providers to plan sponsors of comprehensive information concerning the hard-dollars and soft-dollars (such as 12b-1 fees) received as compensation for plan services. These disclosures are designed to support a plan sponsor's fiduciary duty to manage plan fees and ensure that they understand the indirect or hidden compensation of providers as well as direct compensation from the plan or plan sponsor.

The new participant-level disclosures that, for calendar-year plans, went into effect August 30, 2012, were designed to supplement the disclosures to sponsors. These rules require plan sponsors to provide participants with charts and side-by-side comparisons of investment options, as well as quarterly fee disclosures. The rationale for both sets of rules is that, if the 401(k) marketplace is to operate efficiently, both sponsors and participants must understand what they are buying and how much it

costs. The hope is that this will drive down fees, and recent press reports seem to indicate this already may be happening. We expect the DOL to fine-tune these rules in the years ahead.

#### Broader Definition of Fiduciary Advice

As part of its campaign to eliminate conflicts in the 401(k) industry, the DOL has decided to expand its regulatory definition relating to who is an “investment advice fiduciary.” Under ERISA’s functional fiduciary definition, actions control status, and you are treated as a fiduciary if you provide investment advice with respect to plan assets. For this purpose, the current regulation imposes a five-factor test, two prongs of which have particular relevance for advisors. The first factor requires a mutual understanding that advice will serve as “a primary basis” for the plan’s investment decisions. The second factor specifies that the advice be provided on a “regular basis.” Thus, in the 2007 case, *Ellis v. Rycenga Homes*, periodic meetings between a broker and a plan trustee over the course of a 20-year relationship that resulted in the plan’s consistently following the broker’s suggestions, led to the court’s holding that the broker was a fiduciary. Under a now withdrawn DOL proposal, however, an advisor would be deemed a fiduciary if there were any understanding that the advice “may be considered” in connection with the plan’s investment decision, even if it is not provided on a regular basis. If the DOL’s anticipated revision of its proposal is similar to the original in this regard, many non-fiduciary advisors could, for the first time, find themselves subject to ERISA’s fiduciary standards.

#### Emerging Best Practices

ERISA fiduciaries must not receive any variable compensation because it could affect their best judgment, if not their undivided loyalty to their plan client. The DOL’s proposal to broaden its fiduciary definition would create a fundamental problem for many financial advisors because they most likely would be viewed as fiduciaries of their plan clients under the new regime. Plan expense accounts (also called ERISA budget accounts) may provide a solution to this

problem. A plan expense account is a book-keeping account generally maintained by a plan recordkeeper or other service provider that typically is credited with all or a portion of a service provider’s indirect compensation (e.g., revenue sharing). The book-keeping credits are applied subsequently for the benefit of the plan (e.g., to pay plan expenses) or amounts equal to the credits are allocated to participants’ accounts by the service provider. Many recordkeepers now are using ERISA budget accounts for their own fees and as a tool to make the compensation of advisors a level percentage of managed assets. Thus, expense accounts could be used to levelize the varying 12b-1 fees the advisor otherwise would receive from the plan’s funds. Interest in these accounts is likely to grow in the future, particularly since last year’s DOL Advisory Opinion 2013-03A has indicated that nothing in the typical plan expense account would cause it to become a plan asset before actual receipt of funds by the plan, thereby eliminating prohibited transaction issues.

The administration’s push to safeguard plan investment returns by requiring more disclosure and expanding the boundaries of fiduciary status has the potential to disrupt large segments of the financial services industry. Providers will need to respond by offering more cost-efficient products and services and developing techniques that will ensure fiduciary duties are satisfied.

#### Decumulation Planning

A third area where focused attention from policymakers and regulators can be expected is assisting participants with drawing down retirement savings after they retire. In the retirement plan industry, this has been labeled “decumulation planning.”

#### Administration Goals

The Obama administration is particularly concerned with the risk that retirees will outlive their assets. To mitigate this risk, the administration wishes to motivate plan participants to annuitize all or part of their plan accounts. Some in the government have described these types of plan-related annuities as providing a “retirement paycheck for life.” But rather than mandating annuity

payment forms in retirement plans, policy-makers are looking for incentives to encourage plan sponsors to offer lifetime income options voluntarily. Specifically, they wish to promote the use of longevity annuities, give participants the ability to roll over 401(k) balances to a pension plan, and remove regulatory barriers to the use of annuities. They also are looking at disclosure rules to persuade participants to think about retirement accounts as lifetime income streams. And finally, they are examining techniques that enable plan sponsors to use annuities as default investments.

#### Longevity Annuities

The Treasury Department and the IRS have taken the first of what will be a series of actions to allow longevity annuities in tax-qualified retirement plans. In July 2014, final regulations were issued relaxing the required minimum distribution (RMD) rules to accommodate the use of longevity annuities in defined contribution plans. A longevity annuity is an annuity product with an income stream that begins at an age later than normal retirement, such as age 80 or 85. The administration would like to see an expansion of their use because they allow retirees to self-manage a significant portion of retirement assets until a relatively advanced age. However, the deferred annuity would commence regular monthly payments at the elected age (e.g., age 80) and provide protection against outliving one’s retirement assets.

Longevity annuities were a problematic investment option for a tax-qualified plan before the final regulations were issued, because of the RMD rules. These rules provide that the minimum distribution amount is calculated by dividing a participant’s account balance by his or her life expectancy and that distribution of this amount generally must commence no later than April 1 following the year in which the participant attains age 70½. Previously, when a participant’s account included a deferred annuity contract, the RMD rules required that the value of the annuity contract be included in the account balance when determining the amount to be distributed, which meant a larger distribution

than otherwise would have been the case. Moreover, if the entire account were invested in the annuity, nothing would be left for required distributions.

Under the new regulation, a plan or IRA investment in a qualifying longevity annuity on or after July 2, 2014, would be exempted from the RMD rules. To qualify for this exemption, aggregate premiums for such an annuity cannot exceed the lesser of \$125,000 (the “dollar limit”) or 25 percent of the participant’s account balance (the “percentage limit”). In applying the dollar limit, premium payments under all qualified plans, as well as under 403(a) plans, 403(b) plans, governmental 457(b) plans, and IRAs (except Roth IRAs) maintained on behalf of an individual are taken into account. The dollar limit will be adjusted for inflation in \$10,000 increments. A qualified longevity annuity also must provide that annuity payments must begin no later than the participant’s attainment of age 85. Further, the annuity cannot provide a cash surrender right or similar feature, although the annuity can include a return of premium feature in case the participant dies before the premium outlay has been recovered.

#### New Tax Rules Favoring Annuities

The IRS has also released a set of revenue rulings to further facilitate the annuitization of plan benefits. Revenue Ruling 2012-4 encourages employers to use defined benefit plans as a way to offer lifetime income options for employees’ 401(k) account balances. Specifically, if an employer sponsors both a defined benefit plan and a defined contribution plan, participants may be permitted to roll over their 401(k) balances to the defined benefit plans under which these balances can be converted to annuities. The advantage of this arrangement for participants is that they can easily annuitize their 401(k) benefits at favorable rates (rather than the rates otherwise available in the retail marketplace). Revenue Ruling 2012-3 also confirms that offering deferred annuities in a 401(k) plan will not accidentally trigger certain IRS

death benefit rules applicable to defined benefit plans.

#### Default Annuities

The debate triggered by the Obama administration’s lifetime income initiatives extends to the use of annuities as default investments in 401(k) plans. Proponents believe that using the power of inertia to help participants who are afraid to take action will achieve better accumulation and decumulation outcomes. One way to implement this regulatory change would be for the DOL to amend its QDIA regulations, which currently limit the liability of

*“Some experts have been critical of default annuities, noting their inflexible nature and that default annuitization may not be easily reversed by participants (without significant economic cost).”*

401(k) plan sponsors who default participants into a QDIA. The tremendous increase in assets for target date funds illustrates how conferring QDIA status on annuity products could result in a substantial flow of retirement assets to them.

Some observers, however, have reservations about the appropriateness of using annuities as a default investment, given the fact that the needs of individuals tend to vary considerably during the decumulation phase of retirement. Some experts have been critical of default annuities, noting their inflexible nature and that default annuitization may not be easily reversed by participants (without significant economic cost). The Government Accountability Office (GAO), the investigative arm of Congress, also has noted that, for some participants, default annuities may not be appropriate given their health or other conditions. In response, proponents of default annuities have developed a proposal to automatically provide for distribution from such a product over a two-

year trial period during which a retiree would receive monthly income unless the retiree made an affirmative decision by the end of the trial period to receive a lump sum.

#### Education and Disclosures for Participants

The GAO has recommended that the DOL update its guidance on non-fiduciary investment education designed to give employers and investment providers relief from fiduciary liability when providing investment assistance to participants with the decumulation phase of retirement. The DOL is likely to issue related guidance in the near future, but it is also sensitive to the potential conflicts of interest that may result if providers are given the ability to highlight their annuity products in the process of giving advice. Therefore, we expect that any expansion of the current rules will come with restrictions on making sales pitches.

As outlined in an Advance Notice of Proposed Rulemaking issued in May 2013, the DOL will likely propose that plan sponsors periodically furnish lifetime income illustrations to participants. Under this proposal, a participant’s quarterly or annual account statement would need to show two estimated streams of lifetime income, one based on the participant’s current account balance and another based on the projected account balance at normal retirement age. Both lifetime income streams would be presented as estimated monthly payments based on the expected mortality of the participant.

These calculations would require sponsors to make assumptions concerning future contributions as well as future investment earnings. The projected account balance also would have to be expressed in current dollars, so it would be necessary to assume a discount rate. Fortunately, the DOL proposal includes safe-harbor assumptions under which it would be reasonable for a plan sponsor to assume that a participant will continue to make contributions based on current contribution levels increased by 3 percent annually. It also would be reasonable

to assume a 7-percent investment return for purposes of calculating the projected account balance at normal retirement age. To discount inflation and bring the projected account balance back to current dollars, it would be reasonable to apply a 3-percent discount rate. The participant account statement would need to provide an explanation of all the assumptions behind the lifetime income illustration, as well as a disclaimer that the projections are merely estimates and not a guarantee of benefits.

As a formal matter, the DOL has yet to actually issue a proposed regulation encapsulating these details. In addition to regulatory action, we also could see the enactment of legislation that would require 401(k) plan sponsors to inform participants annually of how account balances would translate into guaranteed monthly payments.

With the finalization of rules permitting longevity annuities, policymakers are starting to reach a consensus on how lifetime income options can be used to help participants manage the distributions they take from plan accounts. The IRS is likely to follow up with rules facilitating annuities in 401(k) and other defined contribution plans. It is also probable that the DOL will issue guidance in the near future on providing lifetime income illustrations in plan statements and on how employers and providers can provide investment education with respect to plan distribution options. Finally, serious debate can be anticipated when the DOL finally proposes its standards for how annuities may be used as default investments in 401(k) plans.

### Tax Reform

We expect that tax reform and proposals for systemic transformation will focus on a larger playing field than the matters discussed above. Under these broader initiatives, the goal of enhancing the private pension system must be balanced with the need to limit expenditures.

#### How Plans Affect the Deficit

Legislators and policymakers know that the amount of tax revenue forgone on account of retirement plans is very large and this

makes 401(k) plans and other retirement vehicles an easy target for revenue-raising initiatives. In the 2015 federal budget, the U.S. Office of Management and Budget projected that foregone revenue attributable to defined contribution plans (a category that includes 401(k), 403(b), and similar plans) will be \$61 billion and increase annually thereafter, so that for the period 2015–2019, the aggregate expenditure will be \$414 billion. Defined benefit plans are expected to add \$42 billion and \$235 billion, respectively, to these amounts. IRAs are expected to increase the overall retirement savings tax expenditure by an additional \$17.5 billion and \$98 billion, respectively.

Retirement savings through 401(k) plans are tax-advantaged because the government generally taxes neither the original plan contributions nor the investment returns on those contributions until they are paid as benefits. Because the budget process looks at revenues and expenditures within a 10-year window, and the payment of most retirement benefits occurs outside that window, the amount of taxes foregone because of 401(k) contributions tends to be viewed as a permanent expenditure. As pressure builds to control the federal deficit, legislative proposals will be considered to reduce the tax cost of the retirement plan expenditure.

#### Tax Code Contribution Limits

The tax code already contains various limitations on plan contributions that could be adjusted from their 2014 levels for the purpose of reducing tax expenditures and raising revenue. For example, in the case of 401(k) plans, the maximum amount of annual contributions from all sources for any employee is \$52,000, and the limit increases to \$57,500 if the employee is at least 50 years old. The limit on annual contributions includes elective deferrals by participants that themselves are capped at \$17,500. Another limitation subject to being reduced by legislation is the cap on the plan sponsor's deduction for contributions to a 401(k) plan equal to 25 percent of the compensation otherwise paid during the taxable year to the plan's participants. Further, compensation in excess of \$260,000 cannot be

considered in calculating contributions to a participant's plan account.

Over the years, Congress has raised or lowered these amounts depending on the needs of the time. For example, the last major tax reform effort in 1986 reduced elective deferrals from \$30,000 to \$7,000. The Tax Reform Act of 2014 proposed by Rep. Dave Camp (R-MI), retiring chairman of the House Ways and Means Committee, is less drastic and merely freezes the various limits that apply to defined contribution plans until 2024 at which time they would be allowed to rise in accordance with cost of living increases. It is estimated that this restriction would raise \$63.4 billion in revenue over 10 years. Under the Camp proposal, there would be a further change to the annual \$17,500 ceiling on elective deferrals under which only half of the contribution (\$8,750) could be made on a pre-tax basis, with the remainder being deferred as after-tax Roth contributions. This would raise an additional \$144 billion in revenue over 10 years by forcing some plan participants to pay higher taxes up-front.

#### Administration Proposals to Limit Tax Deductions

The Obama administration's FY 2015 revenue proposals put a different spin on the age-old technique of reducing limits by seeking to cap the aggregate accumulation in tax-favored retirement plans benefitting an individual at approximately \$3.2 million. The limit is designed to provide a maximum annual annuity payment of \$210,000 for a 62-year-old plan participant. Thus, the limit on annual contributions would vary with age and have to be calculated annually. Plan sponsors and IRA trustees would be expected to report account balances and contributions to keep tabs on those making excess contributions. Taxpayers would be forced to withdraw any excess contributions or pay income tax on the excess amount both in the year contributed and when later distributed.

The administration's FY 2015 budget also takes aim at the 401(k) tax expenditure in another way, although it is cloaked in a

more general tax increase. The administration proposes to limit the tax value of specified tax deductions and exclusions to 28 percent of the item's amount that would otherwise reduce taxable income subject to the highest tax bracket of 39.6 percent. This is not a new concept. What is new is the inclusion of 401(k) contributions (as well as health care contributions), regardless of who makes them, in the list of affected tax exclusions. Thus, a taxpayer subject to the top statutory rate of 39.6 percent would pay an 11.6-percent tax (39.6 percent minus 28 percent) on the value of any 401(k) contributions. Under this regime, those receiving the highest contributions to 401(k) accounts could be subject to an additional \$6,554 in tax liability. When originally proposed in the 2013 budget, critics pointed out that this restriction results in double taxation, because the same plan contributions would be taxed again when withdrawn from the plan. The FY 2015 version of the proposal addresses this by adjusting a taxpayer's basis in the retirement plan to reflect the additional tax imposed.

#### 20/20 Proposal

Reform proposals driven by purely fiscal concerns are illustrated by the December 2010 report of the National Commission on Fiscal Responsibility and Reform that recommended limiting the maximum excludable contribution to a defined contribution plan to the lesser of \$20,000 or 20 percent of income. This proposal, which covers the exclusion from taxable income of employee elective deferrals, as well as nontaxable employer contributions, is sometimes referred to as the "20/20 cap." Under this formula, if you earn \$100,000 per year, the most that can be put into your 401(k) account is \$20,000. The 20/20 cap is hard on high earners.

#### Brookings Proposal

Other proposals are motivated as much by policy concerns as by deficit reduction. The Brookings Institution has designed a much-discussed mechanism to shift the demographics of those receiving the benefits of the retirement plan tax expenditure from a perceived slant favoring highly compensated employees. Under this approach,

all employer and employee contributions would be included in gross income. Existing deductions and exclusions would be replaced with a flat-rate refundable tax credit to be deposited directly into a participant's plan account. In contrast to other proposals, contribution limits would not change. However, the refundable tax credit would benefit low earners at the expense of the more highly compensated, and critics have noted that this would seriously diminish the incentive many employers have to maintain tax-qualified plans.

#### Reaction to Reduced Incentives

Organizations such as the Employee Benefit Research Institute, which have attempted to analyze the decision-making process of employers in reaction to limitations on the current retirement plan incentive structure, have concluded that the result will be either a reduction in the level of employer contributions or outright termination of plans. Plan termination is particularly likely in the case of small plan sponsors that utilize cross-tested plans because a lower level of employer contributions will not generate enough tax savings to justify continuance of the plan. Even proponents of change admit that the result will be a negative effect on employers' willingness to offer 401(k) plans.

High-income employees will be the group most affected by scaling back 401(k) contribution or deduction limits, although some argue that this group would have saved for retirement anyway and does not require an incentive to contribute to a plan. As Sen. Orrin Hatch (R-UT) has said, however, "Trying to help lower wage workers save for retirement by reducing 401(k) and IRA contribution limits [and thereby penalizing higher-wage workers] is like trying to cure a headache with a guillotine." Still, if 401(k) plans are made less attractive for higher-income households, this group can be expected to seek out Roth options as well as tax-exempt bonds and insurance products that forgo an immediate deduction but can temporarily shelter investment earnings from income tax.

The proposals to reduce 401(k) incentives likely would affect lower-income workers by

causing them to reduce contributions. Surveys indicate that low-income households have a propensity to act in ways that are not necessarily consistent with optimizing financial outcomes. Thus, members of such households have a tendency to view the tax deductions generated by contributions to a plan as very important and will reduce or eliminate retirement contributions to the extent that the ability to deduct them is restricted.

The result of these reactions is likely to be a smaller universe of 401(k) and other retirement plans, thereby jeopardizing retirement security.

#### Systemic Reform

##### USA Retirement Funds Act

We turn now from tax reform initiatives to efforts aimed at changing the current private retirement plan system to achieve broader coverage and other goals. To help prepare workers for retirement, Sen. Tom Harkin (D-IA) has proposed the USA Retirement Funds Act establishing a new universal retirement system built around the following principles: (1) automatic enrollment, (2) a regular stream of income starting at retirement age, (3) financing through an employer's payroll system consisting of employee deferrals and voluntary employer contributions, and (4) management by privately run, licensed, and regulated entities established pursuant to the legislation.

The lifetime annuities to be paid under the new system would be based on the total contributions to a participant's account supplemented by investment performance and government credits for low-wage earners. Up to \$10,000 per year of participant contributions would be automatically made at the rate of 3 percent of compensation in 2015 escalating to 6 percent by 2017. Participants would be allowed, at any time, to decrease contributions or to opt out of the system entirely, but such an election would be effective for no more than two years, so that unless an employee opts out again, employers would need to resume the maximum level of employee deferrals at the end of such period. It is not clear whether the expiration date for an opt-out would necessarily be different for each employee.

Like the automatic IRA initiative, the Harkin proposal is intended to appeal to employers by relieving them of fiduciary responsibility, although it does entail administrative burdens such as annual notification of employees and deadlines for depositing contributions. Moreover, employer participation would be mandatory if the employer has 10 or more employees and does not already offer a plan with a 6-percent level of employee contributions and a lifetime income option. Very few employer-sponsored plans offer both these features, which means that many of these plans would need to be amended if an employer wished to avoid the mandate of the USA Retirement Funds system.

The Harkin initiative is similar to current proposals being considered by state legislatures under which state governments would sponsor hybrid defined benefit-type plans covering private-sector workers, except that the new managing entities, dubbed “USA Retirement Funds,” take on the role of the state government in managing investments.

#### NCPERS Proposal

The National Conference on Public Employee Retirement Systems (NCPERS), a trade organization for public-sector pension funds, has proposed amending ERISA and state laws to allow the establishment of state-administered multiple-employer cash balance plans covering private-sector workers. The NCPERS proposal, or variations of it, is being considered by several state legislatures. The target group that this proposal seeks to benefit consists of employees of small employers that do not have access to a pension plan through their employers. The assumption is that they would benefit from a state’s bargaining power, experience, and expertise. Notwithstanding the substantial role of government in such a plan’s operation, however, it would be structured as a multiple-employer plan with voluntary employer participation and employer contributions. This means that the plan would be subject to ERISA, including the fiduciary duties, minimum funding requirements, and reporting obligations it imposes on sponsoring employers.

The NCPERS Secure Choice Pension (SCP) initiative is a bolder variation of prior proposals for state-run plans (involving voluntary contributions to defined contribution plans) in that it entails a defined benefit plan design under which a periodic fixed benefit would be paid for life. This benefit would be determined by applying actuarial conversion factors to the value, as of retirement, of a hypothetical account maintained for each participant. This account would consist of annual employer and/or employee contributions equal to 6 percent of compensation plus minimum interest credits of 3 percent per year, regardless of actual investment earnings. Interest credits equal to a rate determined by the yield on 10-year Treasury bills plus 2 percent would be made if this rate exceeded 3 percent.

How SCP plans would operate where assets are insufficient to fund the promised lifetime benefit is uncertain. One possibility is cutting back benefits, but this may not be realistic if employees have been promised state-backed benefits. Extending amortization periods for funding purposes is another possible technique. Ultimately, however, the states will be subject to the unfunded liabilities of SCP plans. The possibility that responsibility for private-sector pensions would be shifted to taxpayers at a time when states are struggling to meet the demands of public employee systems is a major political weakness of the SCP proposal.

#### California Secure Choice

In September 2012, the California legislature took the first steps to authorize California Secure Choice, a state-administered automatic IRA program with certain similarities to the NCPERS proposal. Under the California version, employers with five or more employees and no other retirement plans will be required to participate, and the employees will be enrolled automatically and contribute 3 percent of pay through the employer’s payroll system unless they opt out. However, no employer contributions will be permitted, primarily because of the fear that this would create an ERISA plan and subject contributing employers to ERISA responsibilities.

Like the NCPERS proposal, California Secure Choice will provide a guaranteed investment return, but this must be achieved by restricting equity investments, investing in U.S. Treasury securities and purchasing private insurance. Contributions will be pooled and invested by state-selected managers. Implementation of the program is conditioned on receiving an IRS ruling that contributions will be pre-tax and DOL approval that the program is not an ERISA plan.

#### Other States

In Massachusetts, 2012 legislation authorized the state treasurer to create a multiple-employer defined contribution plan that will receive contributions from non-profit employers that employ fewer than 20 people and from the employees themselves. The plan will be managed by the state treasurer separately from the state’s public-employee pension fund and will allow employees to direct the investment of their accounts from an investment menu selected by the treasurer. The Massachusetts legislation requires IRS approval of the plan to ensure that it complies with ERISA.

According to the National Conference of State Legislatures, Connecticut, Illinois, Maryland, Michigan, New York, Pennsylvania, Rhode Island, Washington, Vermont, Virginia, and West Virginia also have considered pension legislation for private-sector employees, although in some cases such proposals only authorize study of the matter and in others the proposals were defeated or tabled.

#### Conclusion

The private pension system is under pressure and may be significantly transformed through tax reform seeking to reduce retirement savings incentives or more direct efforts to transform the character of the system to a more centralized model.

Advocates of centralization who distrust financial markets recognize the deficit reduction debate as a rare opportunity to

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enlarge the role of government in the retirement benefits arena with the ultimate goal of eliminating the role of employers except as a funding source. The issue is often framed as one of providing access to retirement savings vehicles for low-paid workers or employees of small employers, which is a laudable goal, although it should be noted that these employees have always had the ability to establish IRAs on their own.

Generally speaking, the various state and federal proposals provide for auto-enrollment, mandate employer contributions, and either create government responsibility

for funding shortfalls or establish a guaranteed minimum return. Creating such entitlements will result in the formation of interest groups that will lobby for benefit enhancements and extending the scope of these programs. In addition, supplementing the private retirement plan system with an expansion of Social Security or various government-controlled retirement programs is likely to diminish support for employer-provided plans and could eventually crowd them out.

Another harmful effect of authorizing these parallel retirement programs, particularly those backed by the states, would be that each of them would need special rules if they are to insulate employers and states from fiduciary responsibility. This has the

potential to fragment the nationwide uniformity in pension laws achieved by the 1974 enactment of ERISA. The resulting complexity would add to the expense of compliance and create uncertainty. ●

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**Endnote**

1. 685F.3d 613 (6th Cir. 2012).