Recent Developments in Retirement Plan Reform in the U.S.

– *Proposed Alternatives to Succeed the 401(k)* –

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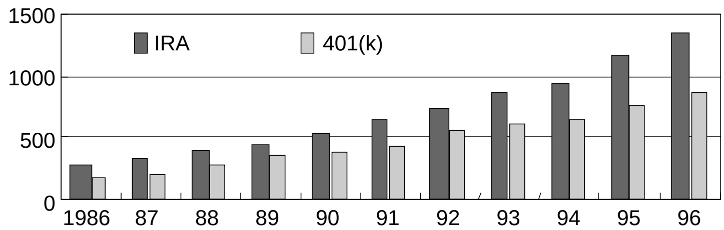
Introduction

While Japan is preparing to introduce a 401(k) type plan modeled on the U.S. version, defined benefit plans in the U.S. are getting a strong boost from the stock market. Still, a large segment of the American society continues to undersave for retirement. Larger companies have been more prone to introduce 401(k) plans but smaller companies are less able to handle the burden. A simplified defined benefit plan called SIMPLE has gained some acceptance among smaller companies. However, because retirement benefits remain low compared to compensation levels of workers with long years of service, the promotion of defined benefit plans has been targeted by the Clinton administration as a major priority.

In addition to company sponsored retirement plans, the U.S. also has a personal retirement plan called IRA (individual retirement account). An IRA has an annual contribution limit of $2,000 depending on factors such as income level and participation in other retirement plans, and offers tax savings. Like the 401(k), owners can choose their investment options, and earn varying returns depending on the performance of investments. When workers change jobs, they usually transfer their 401(k) into an IRA called a rollover IRA. While less well known in Japan than the 401(k), the IRA is an important personal retirement savings plan with aggregate net assets exceeding that of 401(k) plans.

Figure 1 Assets in IRA Accounts and 401(k) Plans ($ billion)



Source: Investment Company Institute

The tax reform of 1997 created the popular Roth IRA, which differs from a regular IRA in that contributions are non-deductible but withdrawals are tax exempt. Following its success, Congress is now deliberating on a Roth 401(k) plan proposal. The proposal would raise the maximum contribution for both the 401(k) plan and IRA, and ease eligibility restrictions. In addition, the Clinton administration has proposed, as part of its Social Security reform, a new personal retirement account called the USA plan that would cover most workers and provide matching contributions by the government. It has also proposed a simplified defined benefit plan for small businesses called the SMART plan. In this paper, we look at recent developments in the U.S. regarding retirement plans following the 401(k) plan.

1. The Popular Roth IRA – After-tax Contributions and Tax-free Withdrawals

Created in the tax reform of 1997, the Roth IRA is named after its sponsor, Senator William Roth of Delaware. Until then, contributions to IRAs and other defined contribution plans were deductible, and the contributions and earnings were tax-deferred until withdrawal, at which time they were taxed as ordinary income tax. In addition, a mandatory withdrawal minimum was stipulated from age 70.5. With the Roth IRA, while contributions are paid from after-tax income, withdrawals are tax-free if certain conditions are met. Compared with the traditional IRA, a major characteristic is that earnings are not taxed. In addition, since withdrawal is not mandatory from age 70.5, the Roth IRA can be inherited by a designated beneficiary.

While the traditional IRA and Roth IRA both have advantages, the Roth IRA has been particularly well received by the following segments: young persons who expect to be in a higher tax bracket when they retire,[1] persons whose contributions are nondeductible due to high incomes, and elderly persons who want to bequeath IRA assets without incurring tax liabilities. The assets of a traditional IRA cannot be inherited and must be withdrawn upon death, which can result in a large tax liability. However, the Roth IRA not only serves as a retirement savings plan but also as a vehicle for inheritance planning.

For a single filer or joint filers with adjusted gross income (AGI) below $100,000, a traditional IRA can be rolled into to a Roth IRA by paying taxes on the contributions and profits. If the transfer was made during 1998, these taxes can be paid over the next four years. If the number of workers who prefer taxable contributions and tax-exempt withdrawals increases, employers will need to make their 401(k) plans more attractive to compete with the Roth IRA.

Table 1 Comparison of Roth IRA and Traditional IRA

	Roth IRA	Traditional IRA
Annual contribution	Lesser of total taxable compensation or $2,000	Lesser of total taxable compensation or $2,000
Eligibility	Single filer with less than $110,000 AGI; married couple with less than $160,000 AGI if filing jointly, $110,000 if filing separately. Spouse cannot be covered by employer's retirement plan. No age limit.	Must be under age 70 1/2 and receive taxable compensation. A joint filer must have less than $160,000 AGI; spouse must not be covered by employer's retirement plan.
Deductibility of contribution	None	Full amount is deductible, if you do not participate in an employer's qualified retirement plan; otherwise deductibility phases out as income increases.
Tax on distribution	Tax exempt if account was opened at least 5 years ago, and after age 59 1/2. Exceptions include withdrawals due to death, disability, to pay costs of first-time home purchase up to $10,000, to pay unreimbursed medical expenses exceeding 7.5% of AGI, and to pay medical insurance premiums after receiving unemployment compensation for more than 12 weeks.	Deductible contributions and profits are taxed as ordinary income when withdrawn. Non-deductible contributions are not taxed when withdrawn.
Early distribution penalty	Excluding special circumstances, if before age 59 1/2 your profits are taxed as ordinary income, and you pay a 10% penalty.	Excluding special circumstances, before age 59 1/2, tax- deductible contributions and profits are taxed as ordinary income, and you pay a 10% penalty. Transferring a traditional IRA to a Roth IRA before a 5-year period is considered an early withdrawal.
Mandatory distribution	None	Mandatory distributions must begin at age 70 1/2; minimum distributions are stipulated.

2. The Retirement Savings Opportunity Act

Following the success of the Roth IRA and strong calls to create a corresponding 401(k) plan, on March 17 Senator William V. Roth Jr. (R-Del.) submitted the Retirement Savings Opportunity Act of 1999 (S. 646), which includes provisions for a Roth 401(k) plan, to the 106th Congress. The Roth 401(k) has non-deductible contributions, but makes withdrawals tax-free. Unlike the Roth IRA, it retains the requirement to begin withdrawals by age 70.5. Despite this inheritance limitation, since the 401(k) allows larger contributions than the IRA, the potentially larger tax-free profits are an attractive feature. In addition to the 401(k), which is available to company workers, S. 646 also offers similar provisions for the 403(b) plan offered by non-profit organizations and public schools.

Table 2 The Retirement Savings Opportunity Act of 1999 (S. 646)

	Present	Proposed
Roth 401(k), Roth 403(b)	None	Introduced
Max. contribution per year to IRA	$2,000	$5,000
Max. contribution per year to 401(k)	$10,000	$15,000
Max. contribution per year to SIMPLE	$6,000	$10,000
Max. income for making unrestricted contribution to Roth IRA (single filer)	$95,000	Repealed
Max. income for making unrestricted contribution to Roth IRA (joint filer)	$150,000	Repealed
Max. income for rolling over into Roth IRA	$100,000	$1 million
Provision to increase contribution limit as retirement age nears	None	Introduced
Employer's max. matching contribution to defined contribution plan as % of compensation	25%	Repealed
Employer's matching contribution to IRA	None	Allowed
Percentage limit of deductible contribution to defined contribution plans	150%	Repealed

In addition to the Roth 401(k), S. 646 also enhances the Roth IRA by expanding the scope of eligibility, increasing maximum contributions, and adding a catch-up provision that increases maximum contribution by 1.5 times after persons reach the age of 50. The catch-up contribution provision addresses the problem of elderly persons who tend to accumulate too little under defined contribution plans, and is meant to add an element from defined benefit plans.

Senator Roth's proposed plans have been well received by the business community and by people who stand to benefit from the changes. On the other hand, there is criticism that the reforms will benefit the wealthy more than low income persons who truly need to save for retirement. The Clinton administration claims that the generous tax rules will cost the government an inordinate amount, and would be detrimental to the paramount goal of reforming the social security system.

3. The President's USA Plan – Federally Matching Contributions

In support of his bill, Senator Roth points out that over half of all Americans, 30% of people nearing retirement aged 51-61, and 40% of baby boomers have savings of less than $10,000. The present rules are too strict, he argues, and must be relaxed to encourage saving. However, the fact is that not all eligible persons pay maximum allowable IRA contributions. The higher maximum contribution and expanded eligibility in the Roth bill are welcomed by persons who can afford to and want to contribute more, but the impact on low income person who cannot even pay the current maximum contribution is questionable. The limited use of the IRA is attributed in part to the lack of matching employer contributions, which reduces its attractiveness.

To establish individual retirement accounts for all employees, the Clinton administration has proposed the USA (Universal Savings Account), a 401(k) type retirement plan in which the federal government pays matching contributions. The USA plan would cover 124 million Americans between the age of 18 and 70, having a household income of at least $5,000, and maximum adjusted gross income of $100,000 for married couples and $50,000 for single persons. Persons exceeding these AGI limits can also be covered if they do not belong to a company sponsored plan.

Lower and moderate-income workers would first automatically receive a $300 tax credit to individual accounts, and also make a 100% matching contribution. The tax credit and matching contribution would respectively slide down to zero and 50% for persons with high incomes. However, the maximum annual contribution is $350.

Table 3 Annual Contribution Under the USA Plan
(personal contribution of $350; $1,000 total)

Tax credit	Personal contribution	Government contribution
$300	$350	$350

Like the 401(k), account owners have a wide range of investment options including stocks and bonds. According to the administration's calculations, if a middle income married couple both contribute the maximum $350 each year for 40 years, they will have accumulated $253,680 in savings. In the USA plan, while the government's contributions are tax deductible, personal contributions are not. In place of deductible contributions, a tax credit is granted. The principal and earnings are tax-deferred until withdrawal, but 15% of the amount is tax-free to reflect the personal contributions. Withdrawal is not allowed until age 65.

If a USA plan owner makes a personal contribution to a 401(k) plan, the government will recognize it as a contribution to the USA plan and pay up to the maximum matching contribution to the USA account. This is intended to prevent people from neglecting their 401(k) contributions, given that the USA plan offers matching government contributions. The estimated $38 billion annual cost of the USA plan will be funded from 12% of the budget surpluses over the next 15 years.

While the USA plan is praised by some as the first step toward building retirement savings for people who otherwise would not have any, insurance companies and related industries oppose the plan on the grounds that it will discourage employers from offering 401(k) and other retirement benefit plans, and that its reliance on budget surpluses for funding could potentially lead to financing problems. Chairman Bill Archer of the House Ways and Means Committee also criticizes the USA plan as being detrimental to the 401(k) plan, and for not providing a solution to the social security system's long-term fiscal problems. The administrative burden of keeping track of millions of individual retirement accounts has also been cited.

In response, the Clinton administration argues that since the USA plan would primarily cover persons who do not have a 401(k) plan or IRA, it will not have detrimental effects. And since the government will also match personal contributions to 401(k) plans with contributions to USA accounts, it would actually encourage 401(k) plans as well.

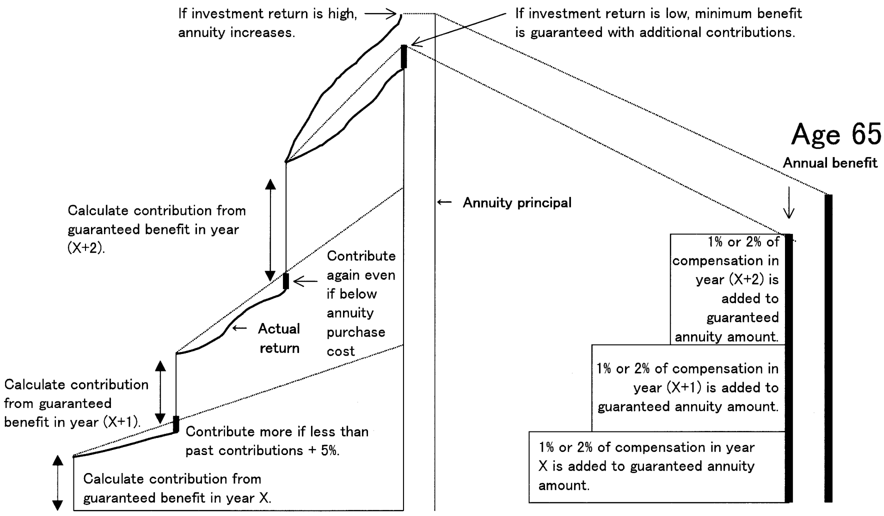
4. The President's SMART Plan

Although a simplified defined contribution plan known as SIMPLE was established for small businesses in 1996 with some success, the Clinton administration has made defined benefit plans a priority. While several tax measures have addressed defined benefit plans, the administration's latest proposal is a simplified defined benefit plan called SMART (Secure Money Annuity or Retirement Trust). SMART is targeted at companies with less than 100 workers, where workers have W2 reported incomes of at least $5,000 but do not have a qualified retirement benefit plan other than a SIMPLE, 401(k) or 403(b) plan. In helping small companies to set up a defined benefit plan, it restricts the options for plan design and funding method, but eases other conditions that apply to conventional defined benefit plans. For example, it omits the burdensome non-discrimination test and top-heavy rules. The simplified arrangements also reduce the burden of actuarial calculations.

While reducing the administrative burden on small businesses, SMART is characterized by its use of defined contribution elements to remedy the disadvantages of defined benefit plans.

As a defined benefit plan, it guarantees a minimum benefit, and is insured by the PBGC. However, the insurance premium is only $5 per person.[2] An individual account is established for each worker, and the employer credits the account each year with 1% to 2% of the worker's annual compensation as a guaranteed annuity amount. For the first five years after the account is set up, workers can choose to contribute 3% of their annual compensation as a guaranteed annuity amount. The maximum annual income is $100,000. Based on actuarial assumptions, the employer is required to contribute enough so that benefits can be paid at age 65. Contributions are paid into individual accounts, and the accounts are credited with investment returns. However, if the actual return falls below 5%, the employer must make up the difference with an additional contribution. Furthermore, whenever the account balance deviates from the annuity purchase price for a guaranteed benefit, the employer is required to make an additional contribution. On the other hand, if the actual investment return exceeds 5%, the benefits will be based on the actual return. Thus the minimum benefit is guaranteed, and benefits can increase if the investment return exceeds the assumed return. An added benefit is that the vesting is immediate and 100%.

Figure 2　The SMART Plan



Unlike the 401(k) and IRA, individual accounts under the SMART plan are administered internally, and individuals cannot make investment decisions. It should be noted that asset management methods are the same as for ordinary defined benefit plans.

The rules for withdrawal in the SMART plan are the same as for ordinary defined benefit plans: excluding death or disability, withdrawals are not allowed until age 65. However, if net assets are less than $5,000, the SMART annuity and individual retirement account called SMART account can be rolled into an IRA without having to pay taxes. In addition, employers can also let workers transfer assets into a SMART annuity or SMART account.

Table 4 Comparison of SMART and Other Retirement Plans

	SMART	SIMPLE	Defined benefit plan	Defined contrib. plan
Non-discrimination test, etc.	X	X	○	○
Design flexibility	△	X	○	X
PBGC insured	○	X	○	X
Individual accounts	○	○	X	○
Portability	△	○	X	○
Guaranteed minimum benefit	○	X	○	X
Potential for higher returns	○	○	X	○

Compared to the ROTH proposal and USA plan, reaction to SMART has been more favorable. Defined benefit plans are seeing a revival in the U.S., and large companies in particular are avidly adopting the cash balance plan, which includes defined contribution features. However, with respect to the increased penetration of defined benefit plans among smaller companies, and the encouragement of adequate retirement savings for more people, expectations appear to be higher for the SMART plan.

Conclusion

Even with the growth of 401(k) plans in the U.S., there remains a large segment of low and middle income person who are not saving adequately for retirement, and this is an important issue. As the social security system reaches its limits, private retirement plans will play the key role in retirement savings. The main point of contention between the USA plan and Senator Roth's proposal is one of priorities: whether to offer a retirement savings plan for middle and low income persons not covered by an employer's retirement benefit plan, or to offer a plan containing obvious tax breaks for the wealthy with the expectation that others will be encouraged to follow.

While the 401(k) plays a supplemental role as a retirement savings plan, there are difficulties with substituting it for defined benefit(pension) plans. The fate of the SMART plan, which tries to lighten burdens and correct problems so that defined benefit plans can become more common at smaller businesses, is being closely watched.

Other retirement plan reforms have been proposed in the U.S. One measure provides tax credits over three years to small businesses for half of the administrative and educational costs associated with setting up a new qualified retirement plan. Another encourages women to save for retirement. With the daunting task of balancing different interests, progress is slow and a conclusion may not be seen this year. But the national debate over retirement plan reform, including the different types of defined contribution plans that call for employer contributions and personal contributions, is highly instructive for Japan's ongoing debate over reform of private retirement savings, as public pension finances may be even more perilous than in the U.S.