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Say "Goodbye" to Your 401(K) Plan as You Know It?

April 24, 2013

From time to time, we hear about threats to the Social Security System – even talk about eliminating it for younger workers. Some reports indicate that about half of Americans have less than $10,000 in savings, while other reports indicate the "average" savings by Americans to be about $50,000. In either case, these figures simply represent inadequate amounts for retirement. Even statutory changes in federal retirement plan laws in recent years have encouraged more personal savings for retirement. So, if Social Security is uncertain and savings are inadequate for retirement, why would Congress now propose to place more limits on retirement benefits?

The simple answer is that money in, or going into, retirement plans is an attractive target for additional current tax revenue. To freeze or reduce the growth of federal debt, the government needs to spend less or tax more, or both. The debate on how this will play out is raging in Washington. Until now, certain tax breaks have been viewed as essentially untouchable, like the tax deduction for home mortgage interest and charitable deductions. Others, like retirement plan benefits, have been viewed as important to encourage and protect our aging population. Although the home mortgage interest deduction and charitable deductions are still available, we have seen limits added in both situations on how much can be used for the deduction. Despite the tax rate hikes earlier this year, talk continues about raising tax rates on current income and reducing or eliminating deductions from taxable income. Where else can Congress look? Where is the money? Aside from raising tax rates further, what can be done to increase current tax revenue? One answer is to make more income currently taxable at some rate. If less money goes into retirement plans, more pay will be taxed currently and current tax revenues will rise.

What has been, or is being, considered? One proposal made in late 2010 would reduce the limit on contributions into each person's retirement plan account in any year. Under current law, an individual can contribute up to 100 percent of pay, with a dollar cap on individual contributions of $17,500, plus an additional $5,500 if the person is at least age 50. On top of that, the employer can make matching and profit sharing or other employer contributions. Altogether, under current law the combined employee and employer contributions to a person's account in any year can't exceed the lesser of $51,000 or 100 percent of the person's pay for the year. Under a "20/20" proposal, the $51,000 limit on total contributions from all sources would drop to the lesser of $20,000 or 20 percent of pay. For example, under the current law, a person earning $50,000 a year could contribute up to $17,500 (plus $5,500 if they are age 50), and the employer could contribute matching, profit sharing and other contributions equal to the difference between the employee's own contributions and $51,000. Under the 20/20 proposal, the total employee and employer contributions in a year would be limited to $10,000 (20 percent of $50,000). In this example, if the employer matched the employee contributions at a rate of 25 percent, the employee could only contribute $8,000, because the $2,000 in matching contributions would reach the $10,000 (20 percent of pay) limit.

Years ago, there was also a limit on combined benefits where an employer offered both a defined contribution plan, such as a 401(k) plan, and a defined benefit pension plan. Although that combined plan benefit limit was eliminated, a different limit is now being considered. Basically, if an employee's total benefit under a defined contribution plan were actuarially converted to an equivalent assumed annuity benefit at 62, and the combined plans would then provide a benefit in excess of the maximum benefit allowed under a defined benefit plan standing alone, then the employee could not have any additional contributions from any source to the 401(k) or similar plan, or earn any additional benefit under the defined benefit pension plan, until the combined benefits again dropped below the defined benefit limit. This proposal would affect far fewer employees than the 20/20 proposal, as it would apply to persons with benefits the total present value of which is about $3.4 million.

Under another proposal, with certain limited exceptions, the ability of non-spouse beneficiaries to roll inherited accounts to an IRA and receive the balance over their lifetime would effectively be eliminated. In many or most cases, those inherited retirement plan benefits would have to be paid as taxable income over a five-year period, as was the rule until a few years ago. Obviously, allowing payment over a child beneficiary's lifetime rather than over five years would slow down the taxation of the account, and in some cases may reduce the tax rate on the amounts distributed. Possible exceptions to the requirement for a five-year payout would allow longer payouts to disabled individuals and to persons who are within ten years of the age of the deceased employee and may allow payouts to a child of the decedent until age 21 if that is longer than the usual five-year limit.

As the actual and perceived benefits and attraction of retirement plans decrease, and if the contribution limits under employer-sponsored plans get closer to the limits on IRA contributions, more employers may simply choose to terminate existing plans. If so, a legitimate argument can be made that the need for greater savings for retirement will be further impaired.

At this point, these are just some of the proposals for consideration in Congress. It is possible none of these changes will be enacted, or they may be enacted in a different form, or other revenue-raising changes may be considered. The point is that, with a spiraling need for federal revenue, and with well over ten trillion dollars reportedly held in retirement plans, and accounts increasing by about 8 percent per year (close to another trillion dollars), as John Dillinger replied when asked why he robbed banks, "That is where the money is." With that bit of Dillinger frankness, concerned employers and employees should be aware that there may be dramatic changes in the future of 401(k) and other retirement plans.

Should you wish to discuss any employee benefit issues, please contact any one of the attorneys in the Firm's Tax Department.

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