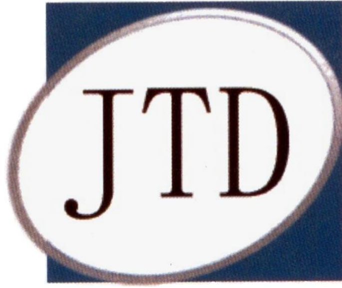

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COULD BIG CHANGES BE COMING TO 401(k)s?

Two federal tax reform proposals could make them less attractive.

Provided by Frank DeMaio*

Our federal government needs to reduce its massive deficit - and among the many revenue-generating ideas being discussed in Congress, two in particular could have disturbing consequences for employees saving for retirement.

There is no need to panic yet – these ideas are a long way from law. Still, a new report from the nonpartisan Employee Benefit Research Institute (EBRI) indicates that the bipartisan "super committee" of 12 legislators assigned to slash the deficit may be giving them at least a casual look.

What if you couldn't deduct 401(k) contributions? In September, representatives from the Brookings Institution proposed a remodel of current 401(k) plan rules at a Senate Finance Committee hearing. The big idea: end tax-deductible contributions to 401(k)s. Both employee salary deferrals and employer matches would be taxed. (Traditional IRA contributions would also be rendered taxable by this proposal.)[1,2,3]

So by this concept, you would be taxed twice: once on your 401(k) contributions and once again on your 401(k) withdrawals.

In apology, the federal government would provide employees (and their employers) with its own version of a match: qualified employer and employee contributions would be eligible for a flat-rate refundable tax credit which would be deposited directly into the 401(k). This credit would either be 18% or 30%.[1,3]

We all know most people don't save enough for retirement. How would being taxed twice encourage them? In January 2011, an EBRI poll found that 25% of employees would cut back on 401(k) contributions if they weren't able to deduct them.[1]

What if 401(k) contributions were capped? Another proposal – courtesy of the National Commission on Fiscal Responsibility and Reform – would put a ceiling on annual contributions to 401(k)s and other defined-contribution retirement plans. The so-called "20/20" modification would limit total annual employer and worker 401(k)

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contributions to either $20,000 or 20% of an employee's income, whichever is lower. So this proposal could hurt low-income and high-income workers.[3]

The "super committee" of 12 is under pressure to come up with a plan to hack $1.2 trillion off the federal deficit this month – and when it comes to preferential tax treatment in America, 401(k)s are a nice example. Would the committee dare get behind either of these proposals? Could any politician get reelected amid cries that (s)he wants to cap or double-tax your retirement savings?

As Congress searches for revenue, the tax treatment of 401(k)s may get a second look – and a third. As EBRI research director Jack VanDerhei told a reporter from the financial services industry website AdvisorOne, "I can virtually guarantee that the whole concept of [401(k)] tax preferences will be reexamined in 2012 and 2013."[1]

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Citations.

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