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M E M O R A N D U M

Re: Obama Administration's Proposed "$3 Million" Limitation on Tax-Advantaged Retirement Savings

In his fiscal year 2014 Budget released on April 10, President Obama calls on Congress to create a new limitation – the "maximum permitted allocation" (MPA) – on aggregate value across tax-advantaged retirement plans and accounts. The media have focused on the Budget's assertion this proposal would newly "limit an individual's total balance across tax-preferred accounts to an amount sufficient to finance an annuity of not more than $205,000 per year in retirement, or about $3 million for someone retiring in 2013." But because it is based on actuarial assumptions tied to defined benefit (DB) plan benefit limits, the MPA will, in reality, likely be *far lower than* $3 million – both if interest rates return to historic averages and (even if interest rates remain at historic lows) for younger workers.

Based on our close read of the Budget and the Treasury Department's explanatory volume (the "Greenbook"), as well as on conversations with actuaries and Hill sources, we have prepared this explanatory Memorandum, in Question and Answer format.

- ***What plans and accounts would be subject to the MPA?***

The MPA measures the aggregate value for all of a taxpayer's[1] tax-advantaged retirement plans and accounts – section 401(a) plans (including money purchase plans, defined benefit retirement plans, and profit sharing [401(k)] plans); section 403(b) plans; and funded section 457(b) arrangements maintained by governmental entities. Although not specifically addressed, it appears that the aggregate value would include savings held in Roth-style accounts, as well as after-tax employee contributions and employer contributions and accruals that have not yet vested. In addition, while it appears that nonqualified annuities are not encompassed, we believe that both annuities distributed from plans and annuities purchased upon plan termination would be included, as those products take their favorable tax treatment from the qualified plan. The proposal does not purport to apply to accumulations in non-qualified deferred compensation plans (other than governmental 457(b) plans), non-qualified annuities, or cash value life insurance

[1] It appears that married taxpayers are not treated as a single unit for purposes of this proposal – that is, each spouse is given his or her own separate MPA.

[2] Of course, outside a DB plan, it is unlikely that an individual could actually purchase an

contracts. (Of course, those arrangements are not subject to contribution limits under current law.)

- ***How is the MPA computed?***

The MPA would be based on the maximum annual benefit permitted for a DB plan. Internal Revenue Code section 415(b) establishes a maximum annual benefit that a DB plan may pay upon retirement; the limit is currently $205,000 per year. (The dollar amount is adjusted each year for increases in cost of living.) The basic idea in applying section 415(b) to the MPA is that an individual's aggregate value would be converted to an annuity payable at age 62 and in the form of a 100% joint and survivor annuity. If the individual's aggregate value, plus any benefit accumulated in any DB plan, exceeded the section 415(b) limit, the individual would exceed the MPA. According to the Greenbook, the MPA for a person age 62 currently is approximately $3.4 million.[2]

- ***Won't interest rates impact the MPA?***

Most certainly. The proposal says that account balances would be converted to an age 62 annuity using "the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans." The Code contains rules that prescribe how to convert between annuities and lump sums; these rules mandate the interest rates that must be used.[3] Because the MPA is tied to these interest rate assumptions, the aggregate value will fluctuate with interest rates. And given that today's interest rates are exceptionally low, it is highly likely that over time, the MPA for a 62-year-old worker would be considerably lower than $3 million – in other words, the fact that the MPA is as high as $3 million in today's interest rate environment is an historical aberration. For instance, based on its analysis of a time series of "annuity purchase prices for males age 65 going back to late 2006," the nonpartisan Employee Benefit Research Institute found that "the actuarial equivalent of the $205,000 threshold could be as low as $2.2 million."[4]

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[2] Of course, outside a DB plan, it is unlikely that an individual could actually purchase an annuity on equivalent terms as those available for purchases within a DB plan. That is because the Code makes assumptions for converting between annuities and lump sums that are based on investment-grade corporate bond interest rates, while interest rates for retail annuity purchases tend to be significantly lower.

[3] The Code contains a few different methods for converting from an annuity to a lump sum, or vice versa. Based on the numbers in the Greenbook, we believe Treasury intends that the factors in Code section 417(e) will be used. Code section 417(e) provides that a lump sum distribution from a DB plan may not be less than a certain amount using mandated interest rate and mortality assumptions. Another possible conversion method is described in Code section 415(b)(2).

[4] *See* Advisory from EBRI, *The Impact of a Retirement Savings Cap*, Apr. 12, 2013, *available online* at www.ebri.org/pdf/PR-1019.Advise2.12Apr13.RetCap-Update1.pdf.

- ***And won't age also bear on an individual's MPA?***

Absolutely. Under the proposal, when making the calculation, individuals age 62 and older are treated as if they are 62, such that the MPA is the amount needed currently to purchase the stated form of annuity. But if an individual is under age 62, her aggregate value for the prior year would be converted to a 100% joint and survivor annuity – purchased today but not payable until she attains age 62. Again, the conversion would be made under actuarial assumptions for converting between annuities and lump sums under DB plans – resulting in a far lower MPA for younger workers.

Take an example. Assume an individual age 40 years old has accumulated $500,000 in her 401(k) plan and a few IRAs. She would take that $500,000 and convert it to a 100% joint and survivor annuity commencing at age 62. (The joint and survivor, rather than a single life, annuity would be used *even if* she were not married.) This is done by projecting the $500,000 forward 22 years using the required interest rate, and taking that amount and creating the equivalent annuity income at age 62 using the required interest rate and mortality assumptions. If the resulting annuity exceeded $205,000 per year, she will have exceeded her MPA.

This process can also be done in reverse. She could take the $205,000 as a 100% joint and survivor annuity commencing at age 62 and calculate, using the same factors, the maximum in account balance for someone age 40. If her accumulated account balances exceeded that number, then she has reached her MPA.

The key point – and one not highlighted in the materials released by the White House in connection with the budget – is that *the lower an individual's age and the higher interest rates at the time of measurement, the lower her MPA expressed as an account balance today***.**

- ***So where might the MPA fall for representative ages and based on current and historic interest rates?***

We have spoken with actuaries at one organization who ran illustrations translating the MPA into an account balance at earlier ages. Their findings are reflected in the table below. The first column of dollar figures shows the account balance equivalent of the cap at various ages, based on today's interest rates. The second column of dollar figures shows the account balance equivalent of the cap at the same ages, based on a 25-year average of interest rates. That second column shows that if interest rates return to historically normal levels, the "$3 million" cap is, for example, a $290,564 cap at age 35. This illustrates very clearly the concern that the Administration's cap would affect far more individuals than had been expected.

Caps by Current Age to Secure $205,000 Joint and 100% Survivor Annuity Commencing at Age 62 (spouse same age as participant)		
	Total Cap on Current Value of DB Plan, 401(k) Plan, IRA and any other retirement accounts	Total Cap on Current Value of DB Plan, 401(k) Plan, IRA and any other retirement accounts
Age today	**At Today's Interest Rates**[5]	**At Historic Interest Rates**[6]
25	$595,472	$135,098
30	$745,915	$198,110
35	$934,573	$290,564
40	$1,171,300	$426,272
45	$1,525,935	$645,126
50	$1,986,420	$971,800
55	$2,524,207	$1,433,583
60	$3,203,755	$2,111,214
62	$3,496,000	$2,450,055
65	$3,309,135	$2,363,208

Similarly, very preliminary analysis by the Employee Benefits Research Institute, which has data on some of the plans and accounts that would be covered (but certainly not all), confirms that the proposal would have a significant impact on younger workers.[7]

- ***What happens when the MPA is reached?***

If an individual's account balances, aggregated across all covered plans and accounts, exceeded the MPA, the individual would not be permitted to make additional contributions to covered retirement plans and accounts in the subsequent year.[8] And dramatically, if the individual were still working, the individual would not be allowed to receive any additional *employer* contributions in a defined contribution plan or receive any additional accruals under a DB plan.

The Greenbook states that an individual who reaches the MPA could resume making contributions in only two situations: (a) if the investment performance did not keep pace,[9] such that the updated calculation of the equivalent annuity is less than the maximum annuity for defined benefit plans, or (b) if the maximum DB plan limit

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[5] Based on November 2012 PPA minimum lump sum interest rates (.97%, 3.5%, 4.6%) and 2013 PPA Mortality (used for DB Plan lump sums determined in 2013).

[6] Based on 25-year average rates as enacted in Moving Ahead for Progress in the 21st Century Act (MAP-21), (Pub. L. No. 112-141, July 6, 2012). Unadjusted Sept. 30, 2012 rates (5.81%,7.23%, 7.95%) and 2013 PPA Mortality.

[7] *Supra*, note 4.

[8] Any such contribution would be subject to rules that are similar to those that currently apply to excess contributions to IRAs and DC plans – *i.e.*, the taxpayer would have to include the excess in income and would have a period of time to withdraw the excess from the account or plan and, if not corrected, the excess and attributable earnings would be taxed when distributed, without any adjustment for basis.

[9] As a technical matter, this would occur if the taxpayer's investment return was less than that in the actuarial equivalence calculation applied to the accumulated account balance.

increases as a result of the cost of living adjustment, which would lead to an increase in the maximum permitted accumulation. But in any event, the "grandfathered" balance in the individual's plans and accounts would continue to grow tax-deferred – that is, there would be no immediate taxation of any portion of the account balance.

- ***How would the individual know if she were to reach the MPA? How would her employer know?***

To facilitate compliance, plan sponsors and IRA trustees (and perhaps annuity providers) would be required to report each participant's account balance and contributions as of year-end, presumably to the participant/accountholder. The IRS would need to publish annual tables showing the age 62 qualified joint and survivor annuity equivalent of different account balances to enable an individual to calculate if she reached the MPA. One might expect this calculation would be done as part of the Form 1040. Although unclear, it would appear that the individual would be required to report to her employer that she had reached the MPA and contributions and accruals must cease.

For qualification purposes, plan sponsors might be required to amend plans to preclude further contributions or accruals when the MPA is reached. It is possible, though far from clear, that the plan sponsor could provide the missed contribution or accrual in another form (*e.g.*, a cash payment or deferred benefit under a nonqualified plan).

Meanwhile, several timing issues create significant complexity. Because an individual's tax return is not due until April 15, contributions and accruals may have already commenced for the year. DB plans in particular would have issues complying with the reporting obligations. It appears that a DB plan would need to provide each participant a calculation of the participant's benefit expressed as a 100% joint and survivor annuity commencing at age 62 shortly after the end of the calendar year, and before April 15. This is an enormous actuarial undertaking, and particularly difficult for plans that do not operate on a calendar year basis. Many DB plans lack automated calculations – and in fact, a benefit calculation involves significant review by an experienced actuary. And since the limitation is imposed on a calendar-year basis, we would anticipate additional challenges for plans that lack a December 31 plan year.

- ***Why has this proposal surfaced in the 2014 Budget?***

The proposal's political genesis appears to be from public reports during the presidential campaign that Governor Mitt Romney held more than $100 million in his IRA. The President has taken an increasingly populist stance, and the proposal fits squarely within the message that upper-income individuals receive outsize tax benefits. Democrats in Congress have echoed this call; in fact, Senate Democrats reportedly considered including a similar proposal earlier this year as part of a proposed legislative package to avert the sequester (but ultimately did not since the package's "Buffett Rule" was deemed to have a more straightforward message). But we understand that the envisioned Senate proposal in all likelihood would have set the cap at a fixed dollar amount (such as $3 million, with an inflation adjustment), rather than by cross-reference to an existing Code limitation, and also that DB plan accruals would not be included in determining whether an individual reached the cap.

- ***What is the Administration's rationale?***

In its Overview section, the Budget states that it "ends a loophole that lets wealthy individuals circumvent contribution limits and accumulate millions in tax-preferred retirement accounts." Later, a section of the Budget entitled "Providing Middle Class Tax Cuts and Rebalancing the Tax Code through Tax Reform" further explains that while "Individual Retirement Accounts and other tax-preferred savings vehicles are intended to help middle class families save for retirement … under current rules, some wealthy individuals are able to accumulate many millions of dollars in these accounts, substantially more than is needed to fund reasonable levels of retirement saving." The Greenbook offers that:

> The current law limitations on retirement contributions and benefits for each plan in which a taxpayer may participate do not adequately limit the extent to which a taxpayer can accumulate amounts in a tax-favored arrangement through the use of multiple plans. Such accumulations can be considerably in excess of amounts needed to fund reasonable levels of consumption in retirement and are well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts. Requiring a taxpayer who, in the aggregate, has accumulated very large amounts within the tax-favored retirement system to discontinue adding to those accumulations would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels, while still providing substantial tax incentives for reasonable levels of retirement savings.

- ***Does this proposal address the policy concerns surrounding outsized retirement accounts?***

If at least part of the impetus for this new cap is the perception that some high-income individuals, such as Governor Romney, "game" the system and build vast retirement accounts that are ultimately used for estate planning purposes, we do not think this proposal is squarely on point. While details of Governor Romney's IRAs are not fully known, it is likely that the significant balance in his IRA was the result of stock of an entity that showed exponential growth while held in a 401(k) or similar vehicle, and later rolled over into an IRA. Put another way, we can surmise that Governor Romney made contributions to his 401(k) or IRA that were invested in start-up or other businesses that showed returns well beyond ordinary market returns.

But this is a different policy issue – the original assets were not valued properly. Policymakers have long had a concern about 401(k) and IRA contributions invested in hard-to-value assets. That issue was the focus of a letter that Congressional Democrats sent the Treasury and Labor Departments in August 2012. On March 25, IRS responded by spelling out plans to "institute a compliance program involving Individual Retirement Account requirements" and providing "education and outreach" to participants."

■ ***How much revenue would this raise for the Treasury?***

The Administration estimates that the proposal would raise $9 billion over the 10-year budget window. Again, based on off-the-record conversations with Hill sources, the proposal Senate Democrats considered for their sequester avoidance package (which would have set the limit at $3 million plus inflation and would not have included DB plans) would have raised far less revenue – perhaps as little as $2 billion.

■ ***What are the proposal's prospects for enactment?***

Based on preliminary conversations we have had, it seems that few Members of Congress and their staffs have appreciated the proposal's complexity, particularly that for most individuals, the limit would be far lower than the "advertised" $3 million. When informed of that aspect, many have responded that *if* there were to be an MPA – and there is hardly agreement on this point – the Administration's proposal sets the MPA far too low and the computation is far too complex. Along these lines, at a Senate Finance Committee hearing on the President's Budget, Senator Ben Cardin (D-MD) expressed his concern to Treasury Secretary Jack Lew that this proposal "will lead to less people putting away money for retirement, not more" and asked: "Where's the sensitivity of this administration to helping people save for retirement?"

In our view, the retirement security community is likely to make a compelling case against this proposal, not only because of the proposal's arbitrary cap, but also on account of its imposition of needless complexity on employers and participants; the likelihood that many business owners who themselves reach the cap[10] would be chilled from maintaining a plan for their employees; and, where an individual is covered by both DB and DC plans, the proposal could potentially create "competition" between plans.[11]

Although there is no clear path forward for this proposal, we will watch closely for its emergence as the tax reform process unfolds and, even sooner, when Congress develops and considers legislation (before the end of June) to raise the debt ceiling. That legislation will likely create pressure to identify revenue-raising offsets to be paired with spending cuts.

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[10] Under Code Section 415(c), the maximum total contribution permitted to a DC plan in 2013 is $51,000 (including elective deferrals, employer matching, and profit sharing contributions). Participants who save at or near this current limit, and who generate even modest returns, will find themselves reaching the MPA well before retirement.

[11] Indeed, this is the first proposal we have seen to limit retirement tax incentives that would touch DB plans; the other leading proposals [20/20, 28% cap, etc.] apply only to DC plans/IRAs.