VOL. 37, NO. 1 SPRING 2024

BENEFITS LAW JOURNAL

From the Editor

# Leave My 401(k) Alone! Looking for Tax Revenue in All the Wrong Places

By David E. Morse

Willie Sutton robbed banks because "that's where the money is." Today, trillions of dollars flow tax-deferred from workers' paychecks and employer contributions to 401(k)s and other defined contribution (DC) plans, grow with investment income, and eventually circle back to retirees as taxable income. Government accountants and economists assert that the tax deferral "costs" the U.S. Treasury about $185 to $200 billion annually in lost revenue. Some leading scholars argue that this tax subsidy primarily helps the wealthy without much of an increase in retirement savings and that this lost revenue could be put to better use. The argument is facially compelling, especially as a way to replenish the Social Security trust fund before they run dry around 2034, triggering mandatory benefit cuts.[1]

I humbly suggest that taxing 401(k)s to fund Social Security is a bad idea for two reasons: it would decimate workers' retirement savings, and the tax deferral actually does not cost the federal government much, if anything, in lost tax revenues.

## TAX 101

As most know, employer and employee contributions to a 401(k) are made before taxes and the income earned on those contributions – interest, dividends, and appreciation – grows tax-deferred. When the money is withdrawn (generally at retirement), it is then taxed as ordinary income. (As do most analyses, I am ignoring the much less substantial contributions to a Roth, which are made after taxes but whose investment income generally is permanently tax free.) Savings outside of a retirement plan are, of course, after taxes. However, income earned on these savings from dividends and capital gains enjoy significantly reduced rates.

## WHAT IF THE TAX DEFERRAL DISAPPEARED?

Let's say that Congress eliminated the tax deferral so all future employee and employer contributions and investment earnings on retirement plans were immediately taxable. Every employer would be forced to consider whether the expense, time, ERISA fiduciary risk and mind-numbing compliance burdens were still worth the bother of offering a plan. Instead, employers easily could replace their contributions with annual "retirement bonuses" and encourage employees to start saving from their own paychecks. Perhaps companies could arrange for a few investment providers to offer taxable accounts to which workers could direct their bonuses and a portion of their salary. Or maybe employers just would leave workers on their own. Clearly, few, if any, businesses would be willing to run the ERISA gauntlet to offer retirement savings vehicles without any tax advantages. There would be no point and 401(k)s would follow traditional defined benefit plans into the dustheap.

Without a workplace retirement plan, most folks would not save or, at best, would save less. Savings means postponing spending and most humans are very bad at delayed gratification. At the same time, people know that they should be preparing for their future. That is why a workplace retirement plan, especially one that automatically withholds and invests a portion of each paycheck unless the employee chooses not to save, are so successful. Most people – high paid, low-paid, and everyone in between – need the nudge of an employer retirement plan. Employers typically also add their own "matching" and regular contributions, money that goes directly into the plan, avoiding the temptation to spend. And, as everyone hates paying taxes, the tax deferral gives workers an added reason to let their plan account be.

## WHAT IF THE TAX DEFERRAL BECAME "FAIRER"?

While the current system of retirement plan regulations is designed to encourage companies to benefit both high paid and low paid employees, some argue that the dollar limits on contributions are too high. In 2024, the maximum employee 401(k) contribution is $23,000 ($30,500 if over age 50) and the total annual employer/employee DC contribution is $69,000. As a practical matter, these limits only affect management and other key employees. By reducing these limits to more "reasonable" levels, the thinking goes, the Treasury could take in more taxes without harming the rank and file. Good idea, but it will not work. Corporate decisionmakers and the less senior employees advising those decisionmakers, being human, ask what is in it for themselves. Lower limits mean that they will benefit less from the plan, thus making it harder to justify a robust retirement program. Curtailing benefits for high-paid employees generally leads to reduced benefits for all, sometimes to the point of zero benefits.

## DO RETIREMENT PLANS REALLY REDUCE TAX REVENUES?

To answer the question requires predicting the annual saving and retirement spending, investment returns, and tax rates, all adjusted for inflation (a tax payment today is more valuable to Uncle Sam than one received in forty years). The most sophisticated analyses are based on a worker's projected lifetime, using long term trends, but, because tax law fluctuates with the political winds and is impossible to even guess, current tax rates.

Intuitively, as a non-economist, I would expect that there should be little cost to the government as the tax deferral is counterbalanced by the fact that investment income in a retirement plan will eventually be taxed at high ordinary tax rates; income on non-retirement accounts enjoys extremely favorable rates on dividends and capital gains. Yet most experts' math comes out with a significant revenue hit. Why? It turns out a big reason is the discount rate used to put future tax payments at retirement into current dollars. Economists assume that this discount rate and the assumed investment return on savings must be the same. Otherwise, the thinking goes, one could argue that the U.S. government could borrow, invest in the stock market, and arbitrage the deficit away. I get it. But, the reality is that expected investment returns on individuals' lifetime investment will exceed inflation. So, if the investment return exceeds the discount rate, the cost to the government of a tax deferral is reduced

– big time. Thus, using a reasonable discount rate based on expected inflation would remove much, if not all, of the predicted revenue loss from tax-deferred retirement plans.

There is another, less wonky, argument why the tax deferral is good for the government. Workers contribute to the overall economy while retirees, who spend but do not produce, are a drain. As retirees draw down their retirement accounts, they pay taxes. In effect, the postponed tax revenues on retirement plans is also a form of government deferred tax revenue: a win-win for taxpayers and the Treasury.

Removing the tax deferral removes the reason employers and employees want a retirement plan. Without the plan, many will stop saving. Yes, Social Security is a crucial program that must be funded, just not on the back of 401(k)s. Indeed, as the advocates for eliminating the tax deferral correctly argue, all workers should have access to a 401(k) or other program with automatic payroll withholding. One problem with the 401(k) is that almost half of all employees do not have one!

*The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.*

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## NOTE

1. The Case For Using Subsidies For Retirement Plans To Fix Social Security, Andrew Biggs, Alicia Munnell and Michael Wicklein, Center for Retirement Research at Boston College, January 2024.

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