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Equity in the Distribution of Tax Preferences for Pensions: Capping the Amount Allowable in Tax-Preferred Retirement Plans

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EQUITY IN THE DISTRIBUTION OF TAX PREFERENCES FOR PENSIONS: CAPPING THE AMOUNT ALLOWABLE IN TAX-PREFERENCED RETIREMENT PLANS

by

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*John A. Turner***

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I. INTRODUCTION

Tax-preferenced retirement plans are designed to be vehicles for saving for retirement, not massive tax shelters for wealthy individuals. Because tax preferences for retirement savings cause a loss in federal tax

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revenue, and are one of the largest sources of tax expenditures,¹ it has long been a principle in pension policy and tax law in the United States and in other countries to limit the amount of retirement tax preferences an individual can receive. Specifically, U.S. tax law sets limits on the maximum benefit provided by a tax-preferenced defined benefit plan and the maximum contribution to either a tax-preferenced defined contribution plan or individual retirement account (“IRA”).² It was never the intent of Congress, the tax policy, or pension policy communities that tax-preferenced plans should provide a tax preference for wealthy individuals to accumulate massive savings in retirement plans. Indeed, the conventional understanding of providing tax subsidies for the affluent to save for retirement is not to incentivize them to save, since the affluent will save adequately without such incentives, but to induce them to establish plans to capture tax benefits for themselves and then require them to include rank-and-file employees in the plans thus established.³ The purpose of the section 415 limits is to control the tax subsidies for the wealthy so that the tax incentives for them to establish plans do not impose excessive revenue loss to the government treasury.⁴

1. STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015 (JCS-1-12), (2012), <https://www.jct.gov/publications.html?func=startdown&id=4386>.

2. The Code has included express limitations on the amounts that can be contributed to defined contribution plans and the benefits that can be provided under defined benefit plans since I.R.C. § 415 was enacted as part of ERISA in 1974. *See, e.g.*, John A. Turner, *Pensions, tax treatment*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 295 (Joseph J. Cordes et al., 2d ed. 2005), <http://www.taxpolicycenter.org/UploadedPDF/1000541.pdf>; Norman P. Stein, *Simplification and I.R.C. § 415*, 2 FLA. TAX REV. 69 (1994) [hereinafter, Stein, *Simplification and IRC § 415*]. We note that the limits on individual retirement accounts (except for certain employer-sponsored plans that uses individual retirement accounts as the recipient of employer contributions, *see* I.R.C. §§ 408(k) (simplified employee pension) & 415(k)) are lower than those that apply to qualified retirement plans. *Cf.* I.R.C. § 415(c) (\$51,000 in annual additions to defined contribution plans, plus \$5,500 “catch-up” contribution for employees who are at least age 50) and I.R.C. § 219(b)(5) (\$5,500 for contributions to individual retirement accounts plus \$1,000 “catch-up” contribution for individuals who are at least age 50). But individuals may roll over certain distributions from a qualified plan to an individual retirement account so individual retirement accounts can include accumulations in a defined contribution plan or a lump sum commutation of a benefit in a defined benefit plan. I.R.C. § 402(c).

3. *See, e.g.*, Alicia Munnell, THE ECONOMICS OF PRIVATE PENSIONS 51 (1982); Daniel I. Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century*, in SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY (1987).

Despite the limits, some wealthy individuals have been able to use tax-preferred retirement to accumulate extraordinary fortunes. Recent press reports focused on former Governor and presidential candidate Mitt Romney's individual retirement account have drawn new attention to this problem.⁵

This paper addresses foreclosing the use of IRAs to accumulate extraordinary fortunes by suggesting approaches to improving the equity of the distribution of tax preferences for pensions that would limit the size of tax-preferenced retirement savings accumulations. It would make individual retirement accounts and employer-sponsored tax-preferenced retirement accounts conform to the generally-held understanding of their purpose, which is to be a tax-preferenced source of reasonable levels of retirement income rather than a tax shelter for extraordinary wealth accumulation. Although we suggest several approaches, our preferred approach is to set a cap on the maximum amount an individual could hold in tax-preferenced defined contribution plans and IRAs.⁶ Individuals would be required to take distributions when their account exceeds the cap. We suggest that such a cap

4. Senator Russell Long described the purpose of § 415 as follows: [Section 415] makes the tax laws regarding pension plans fairer by limiting the amount of the contributions or benefits that can be provided to any individual under such a plan. The fact that present law does not provide such specific limitations has made it possible for extremely large contributions and benefits to be made under qualified plans for some highly paid individuals. While there is, of course, no objection to large retirement benefits in themselves, it is not appropriate to finance extremely large benefits in part at public expense through the use of special tax treatment.

120 Cong. Rec. S.29946 (Aug. 22, 1974) (statement of Sen. Russell Long).

5. See, e.g., Mark Maremont, *Bain Gave Staff Way to Swell IRAs by Investing in Deals*, WALL ST. J., Mar. 29, 2012, <http://online.esj.com/article.SB1000142052970204062704577223682180407266.html>; Michael Kranish & Beth Healy, *Romney built a golden IRA while he was at Bain*, BOSTON GLOBE, Aug. 11, 2012, http://articles.boston.com/2012-08-11/politics/33138965_1_bain-partners-iras-simplified-employee-pension-plan; Tom Hamburger, *Mitt Romney exited Bain Capital with rare tax benefits in retirement*, WASH. POST, Sept. 2, 2012, http://www.washingtonpost.com/politics/mitt-romney-exited-bain-capital-with-rare-tax-benefits-in-retirement/2012/09/02/1bddc8de-ec85-11e1-a80b-9f898562d010_story.html; Michael J. Graetz, *Mitt Romney's Financial Mysteries*, NEW YORK TIMES, July 30, 2012, http://www.nytimes.com/2012/07/31/opinion/the-mysteries-of-mitt-romneys-financial-records.html?_r=0.

6. This would include amounts in so-called "roll-over" IRAs, i.e., IRAs set up to receive single-sum distributions from qualified retirement plans.

be set at \$5 million, indexed for inflation. The choice of that limit is not, as we explain, arbitrary, but the exact dollar amount of the limit is not, in any event, crucial to the proposal. We also suggest alternative proposals, including limiting (with certain exceptions) investments in tax-preferred retirement accounts to publicly-traded investment products.

This paper includes three sections: first, a discussion of the problem (including how retirement accumulations can grow to the extraordinary levels attained by Mr. Romney); second, a description of our preferred proposal and a discussion of issues related to that proposal; and third, a discussion of some variations and alternatives to the proposal.

II. THE PROBLEM

The primary limits on contributions to and benefits from tax-preferenced (tax qualified) retirement plans (sponsored by employers) are set out in section 415 of the Code. The plan contributions are adjusted to keep pace with the cost of living. In 2013, due to the cost of living adjustment, the limit on an annual benefit received from a defined benefit plan increased from \$200,000 to \$205,000.⁷ For defined contribution plans, the limit on total annual contributions, including both employer and employee contributions, increased from \$50,000 to \$51,000.⁸ In addition, persons 50 and older may contribute an additional \$5,500 annually.⁹ A person whose income is below a certain level, or who does not participate in an employer sponsored qualified retirement plan, can also make deductible contributions to an individual retirement account. Here, the annual contribution limit is \$5,500 annually, increased to \$6,500 for persons at least 50 years of age.¹⁰ Except for Roth retirement accounts, individuals must commence something approaching ratable distributions of their retirement savings once they attain age 70 1/2.¹¹ The time period for the distribution is the life or life expectancy of the individual and a designated beneficiary.

7. I.R.C. § 415(b); IRS Announces Pension Plan Limitations for 2013, IR 2012-77 Oct. 18, 2012, <http://www.irs.gov/uac/IRS-Announces-Pension-Plan-Limitations-for-2013> [hereinafter IRS 2013 Pension Plan Limitations].

8. I.R.C. § 415(c); IRS 2013 Pension Plan Limitations, *supra* note 7.

9. I.R.C. § 414(v); IRS 2013 Pension Plan Limitations, *supra* note 7.

10. I.R.C. § 219(b)(5).

11. I.R.C. § 401(a)(9) (the actual rule does not require an initial minimum distribution until April 15 of the year following the year the employee attains age 70.5). The rules, which are exceedingly complex, are designed to prevent individuals from using tax-preferenced retirement accounts as means of building tax-preferenced estates rather than providing a source of retirement income. *See* DIANE BENNETT ET. AL., TAXATION OF DISTRIBUTIONS FROM QUALIFIED PLANS (2d ed. 1988). Roth

In 2010, the median value of assets of families with retirement savings held in retirement savings accounts was \$44,000. In the age group where the family head was 55 to 64, the median value of assets in retirement accounts was \$100,000.¹² The median balance for the bottom half of income earners is \$0.¹³ By comparison, some wealthy individuals have accumulated tens of millions of dollars in their IRAs and qualified plans. For example, former presidential candidate Mitt Romney has been reported to have \$87 million or more in his IRA.¹⁴ Romney's tax- advantaged retirement plan accumulation is thus roughly 870 times larger than that of a typical American household in his age group that has any tax-preferenced pension savings.

The tax benefit an individual receives from tax-preferenced retirement savings depends largely on how much investment income the account generates. Thus, persons with huge amounts in IRA accounts gain tax benefits disproportionately to mean or median account balances because of the large amount of investment income in their accounts. The tax deferral on amounts contributed to a tax-preferenced pension fund are roughly equivalent to receiving a zero rate of taxation on investment income from after-tax contributions during the period that funds are retained in the plan.¹⁵

vehicles—which are 401(k) and IRA accounts in which a participant chooses to have otherwise pre-tax contributions made post-tax in exchange for tax exemption for distributions—are exempted from most of the minimum distribution rules. I.R.C. § 408A(c)(5). Minimum distribution rules, however, do apply to the successors in interest on the death of the account holder. I.R.C. § 408A(c)(5).

12. Arthur Kennickel et. al., *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, 98 FEDERAL RESERVE BULLETIN 2, (2012), <http://www.federalreserve.gov/Pubs/Bulletin/2012/PDF/scf12.pdf>.

13. See Memo from Dr. Teresa Ghilarducci, Irene and Bernard Schwartz, Chair of Economic Policy and Analysis, New School for Social Research (on file with authors).

14. Some estimates put the value of Mr. Romney's IRA at higher amounts, with the blog TPM indicating that the IRA holds upwards of \$100 million. See Brian Beutler, TPM, August 3, 2012, <http://tpmdc.talkingpointsmemo.com/2012/09/dem-lawmakers-make-example-of-romney-enormous-ira.php>. This may, however, be based on articles such as the following: see William D. Cohan, *The Secret Behind Romney's Magical IRA*, BLOOMBERG, July 15, 2012, <http://bloom.bg/M13PN1>; see also Tom Hamburger, *Mitt Romney exited Bain Capital with rare tax benefits in retirement*, WASH. POST, Sept. 2, 2012 (stating that an estimated value of Mr. Romney's Individual Retirement Account is \$87 million), http://www.washingtonpost.com/politics/mitt-romney-exited-bain-capital-with-rare-tax-benefits-in-retirement/2012/09/02/1bddc8de-ec85-11e1-a80b-9f898562d010_story.html.

15. See, e.g., Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986); Peter Brady, *The Tax Benefits and*

If Mr. Romney were to follow the rule of thumb of withdrawing 4 percent of his account balance every year after he retires, that would provide a tax-preferenced annual benefit of approximately \$3.5 million, which exceeds the median lifetime earnings of the average American worker.¹⁶

As noted, section 415 of the Code was adopted to limit tax-preferenced retirement savings to an amount that will provide a reasonable but not excessive retirement income (and presumably to prevent extreme disparities in the amount of tax-preferenced retirement savings).¹⁷ Yet the existence of Mr. Romney's IRA indicates that at least some wealthy individuals are able to accumulate vast wealth in their tax-preferred retirement plans.¹⁸ The accumulation of vast wealth in IRAs is not permitted

Revenue Costs of Tax Deferral, INVESTMENT COMPANY INSTITUTE (2012), http://www.ici.org/pdf/ppr_12_tax_benefits.pdf.

16. The 4 percent rule is a rule of thumb designed to ensure that individuals will have a small risk of running out of money in old age. The rule, which was popularized and named by Bill Bengen, a financial planner, was based on Monte Carlo simulations showing that a 65-year old could withdraw annually 4 percent of an investment portfolio (half equity, half fixed income), annually increase the withdrawal amount by the rate of inflation, and have a 93 percent chance of dying before exhausting his resources. See Shefali Anand, *Testing the 4%-Per-Year Retirement Rule*, WALL ST. J., March 5, 2012, http://online.wsj.com/article/SB10001424052970203960804577241143142670660.html?mod=WSJ_PersonalFinance_Investing. Note that in many scenarios, this investment strategy will leave a legacy for heirs, something that is not the case in a defined benefit plan if the benefit is taken in its ordinary annuity form.

We also modeled a withdrawal rate of 4 percent annually, without inflation adjustment, for a \$5,000,000 portfolio invested exclusively in safe fixed income securities paying a 2 percent interest rate. In such a case, the investor could make \$200,000 withdrawals for 35 years before fully drawing down his assets. We also employed various on-line annuity calculators that indicated \$5,000,000 would purchase an annual annuity somewhat in excess of \$300,000. See, e.g., https://www.tsp.gov/planningtools/annuities/annuityCalc_results.shtml; <http://www.immediateannuities.com/information/rates.html?rates=32312dbbe21b97e766f2d2f8af3f48ed>.

17. See *supra*, notes 2 and 3.

18. One influential actuary with whom we spoke, a retired director of research for a major national consulting firm, estimated that there might only be approximately 100 people with IRAs as large as Mr. Romney's (interview on file with authors). We also contacted Jack Vanderhei, the Director of Research at the Employee Benefits Institute ("EBI"), who indicated that there is no such data now, but that EBI is currently in the process of creating a data set that can provide at least some relevant data (interview on file with authors). The actuary we spoke with also observed that there are no special reporting requirements for super-sized IRAs. In contrast, there is some relevant data for qualified defined contribution plans,

in the United Kingdom. In the United Kingdom, the Lifetime Allowance sets the maximum pension benefits a person can receive over their lifetime from pensions that receive preferential tax treatment. That limit for 2012 is £1.5 million, or approximately \$2.4 million in lifetime benefits.¹⁹ That limit is the combined limit for all pensions, both defined benefit and defined contribution, that the individual owns.²⁰ Ireland also has such a limit, currently set at 2.3 million euros.²¹ And for a brief period of time, the United States imposed an excise tax on annual distributions above a certain level.²²

We turn now to the question of how, despite the limits in section 415, Mr. Romney's IRA was able to grow so large. Romney's firm, Bain Capital, sponsored a type of employer-plan known as a SEP IRA. Such plans permit a firm to make contributions to individual retirement plans established by the firm's employees up to the section 415 limits, which was \$30,000 for all or most of the years Mr. Romney was employed at Bain.²³ The total contributions made to his IRA was probably at least \$450,000, but certainly

although the reporting for such plans does not include breakdowns of individual accounts.

19. Amounts above the limit are subject to a special tax that is 25 percent of annual distributions above the lifetime limit, with a 55 percent tax on lump distributions in excess of the cap (annual distributions are subject to income tax as well). BBC PENSION SCHEME, NEW BENEFITS HANDBOOK 19-20 (Jan. 2013), http://downloads.bbc.co.uk/mypension/en/new_benefits_handbook_january_2013.pdf. <http://www.bbc.co.uk/mypension/sites/newbenefits/pages/what-is-the-maximum-pension-i-can-earn.shtml>. See also I.R.C. § 4980A.

20. *Id.*

21. See generally, Ireland: PENSION DEVELOPMENT NETWORK, <http://www.pensiondevelopment.org/122/ireland.htm> (last visited November 9, 2013). The figure had been set at 5.4 million Euros but was reduced in 2010.

22. See I.R.C. § 4980A, which imposed a 15 percent tax on annual aggregate benefits distributions in excess of \$150,000 from all qualified plans and IRAs. Section 4980A also imposed a parallel tax on qualified plan and IRA accumulations on death. See generally, Bruce Wolk, *The New Excise and Estate Taxes on Excess Retirement Plan Distributions and Accumulations*, 39 FLA. L. REV. 987 (1987); Daniel I. Halperin & Marla Schnall, *Regulating Tax-Qualified Pension Plans in a Hybrid World*, 58 N.Y.U. ANN. INST. FED. TAX'N, at 5-37 (2000) [hereinafter, Halperin & Schnall, *Tax-Qualified Pension Plans*]; see Stein, *Simplification and I.R.C. § 415*, *supra* note 2. Congress repealed § 4980A effective for distributions after 1996. See Pub. L. 105-34, title X, Sec. 1073(a), 111 Stat. 948 (1997).

23. PENSION SOFT CORPORATION, ROUNDED/UNROUNDED 415(C) LIMITS THROUGH 2014, http://www.pensionsoft.com/references_limits_unrounded_415_c.html (last visited November 9, 2013). It is not clear when Mr. Romney left Bain, but the limit was \$35,000 in 2001 and \$40,000 in 2002.

less than \$1 million, depending on when he left Bain capital and thus stopped contributing.²⁴

There are two possible explanations for how approximately half a million dollars to one million dollars could result in an \$87 million dollar accumulation; the explanations are not mutually exclusive and both may have played a role. The first possible explanation is that the IRA investments provided an extraordinary rate of return on investment (by our calculations it would be in the range of at least 20 percent to almost 30 percent annually over the last 28 years depending on how much Mr. Romney contributed to the plan). The second possible explanation is that the investments, which apparently were not publically traded, were purchased by the IRA for less than their actual value (which would of course be a violation of the limits in current law).²⁵ It should also be said that some have speculated that the investments were “carried interest” amounts in certain limited partnerships that would have been taxable to the IRA as unrelated business income had the IRA held the investment interests directly, but that this tax was avoided through the use of offshore “blocker” entities.²⁶

24. We have not been able to establish the dates he started or stopped contributing from the public information available to us.

25. There has been press speculation about whether the IRA’s investments were undervalued. William D. Cohan, *The Secret Behind Romney’s Magical IRA*, Bloomberg, July 15, 2012, <http://bloom.bg/M13PN1>.

26. Section 513 of the Code imposes a 35 percent tax on most active business income earned by a tax-exempt entity, a tax that is expressly applicable to individual retirement accounts. I.R.C. § 408(e)(1). This would include partnership income allocated to a tax-exempt entity. Some have speculated that Romney may have avoided the tax on unrelated income through the use of blocker corporations, which are entities in tax-haven nations through which the business income is funneled. See Mark Marmont, *Romney’s Unorthodox IRA*, WALL ST. J., Jan 19, 2012, <http://online.wsj.com/article/SB10001424052970204468004577168973507188592.html> (quoting Michael Knolls, who notes that blocker corporations are often used to avoid the tax on unrelated business income). The blocker corporation then pays dividends to the IRA; the dividends are not subject to the tax on unrelated business income. Although a blocker corporation would have spared Romney’s IRA the unrelated business tax, it would have only provided a significant tax benefit only to the extent that the blocker corporation was itself exempt from United States taxation on the income allocable to the blocker corporation and was also subject to a low offshore tax rate, issues beyond the scope of the paper. *But see* Willard B. Taylor, “Blockers,” “Stoppers,” and the Entity Classification Rules, 64 TAX LAW. 1 (2011).

III. THE PROPOSAL: REQUIRED DISTRIBUTIONS FROM ACCOUNTS IN EXCESS OF A CEILING AMOUNT

This paper proposes setting a cap on the amount an individual can hold in tax-preferenced defined contribution plans and IRAs. We suggest a cap of \$5 million, indexed for inflation, although another figure could be substituted. We arrived at the \$5 million amount based on the amount of retirement income an account would provide. Using the rule of thumb that an individual can withdraw 4 percent of assets in retirement without overly risking running out of money during retirement, that maximum amount would permit an annual retirement benefit of \$200,000, far above that received by most Americans but allowing the system to also provide tax-preferenced benefits for upper income Americans.²⁷ This is the same maximum benefit that can currently be paid from a defined benefit plan under the section 415 limitation applicable to such plans.

This proposal provides a simple, bright line solution to the problem of excessive amounts in IRAs and other defined contribution pensions for some Americans. The proposal retains the intent of the pension system to provide tax-preferenced benefits that are sufficient for the retirement needs of most Americans, while limiting the maximum tax preference available and thus the maximum tax expenditure per person participating in the pension system. The proposal would improve the equity in the distribution of tax preferences across income classes and would prevent the use of tax-preferenced pensions as massive tax shelters by wealthy individuals. By international standards, the limit set in this proposal is generous. The limit proposed here of \$5 million is more than twice the limit in the United Kingdom. A proposal for such a limit in Canada would set the limit at \$2 million.²⁸

IV. ISSUES AND CRITICISMS CONCERNING THE PROPOSAL

Below we respond to several issues raised by the proposal, including what we anticipate would be arguments against the proposal.

27. See *supra* note 13.

28. James Pierlot & Siddiqi Faisal, *Why We Need a Lifetime Retirement Saving Limit*, BENEFITS CANADA, (Nov. 10, 2011), <http://www.benefitscanada.com/pensions/governance-law/why-canada%E2%80%99s-aging-workforce-needs-a-life-time-retirement-saving-limit-22662>.

A. *Penalty Against Skillful Investing*

A possible criticism of the proposal is that it would penalize people who are extraordinarily skillful or lucky in their investments and have achieved larger amounts in their IRAs. The response to that criticism is the fundamental point of this paper, which is that it is the intent of Congress to limit the maximum tax preference an individual can receive from a retirement plan, not to award skillful or lucky investment performance. A further response to that criticism is that the ceiling in this proposal has been set at a fairly generous level. The proposed ceiling, which is for individuals, is almost 100 times the median account balance for households in 2010.²⁹ Moreover, the suggestion that the proposal is a penalty is itself misguided; rather, it is just a withdrawal of the benefits of tax deferral. A skillful or lucky investor will still be better off than an unlucky or unskilled investor. They will just lose the ability to leverage their good results with tax benefits aimed to help people have adequate income security in retirement.

B. *Fluctuations in Asset Value*

People might exceed the maximum in some years but fall below it in subsequent years due to fluctuations in the value of assets. The effect of fluctuations in assets could be mitigated by basing the test for exceeding the limit on a multi-year average (for example, three years) of the end-of-year value in the account. People exceeding the limit using that test would be required to withdraw the excess and pay appropriate taxes on the amount. People exceeding the limit in any year would not be permitted to contribute to the account the following year, but would not be required to make withdrawals from the account unless the specified multi-year average exceeded the limit. Alternatively, the rule might require withdrawal only after accounts exceed the limit for a defined period, perhaps three years, or the rule might require withdrawals ratably over a defined period of time. The tax for early withdrawals under any such alternative could possibly be waived, but that issue is not explored here.³⁰

29. U.S. CENSUS BUREAU, *Income, Poverty, and Health Insurance Coverage in the United States: 2011*, at 7 (2012), <http://www.census.gov/prod/2012pubs/p60-243.pdf>.

30. Section 72(t) imposes a 10 percent excise tax on most plan distributions made prior to the year in which the account's owner attains age 59½.

C. *Disincentive for Plan Sponsorship*

Firms might decide not to contribute to plans if their owners are at the cap, resulting in rank-and-file employees losing the opportunity to save for retirement. This may be true in some situations, but the problem—if it is a problem—would be limited to a small number of firms.

D. *A Tax on Ordinary Rates of Return for Certain Individuals*

People who receive the maximum section 415 contributions for each year during their working career might exceed the cap even if their rate of return is not extraordinary by historical standards.³¹ Over a 35-year contribution history, for example, a rate of return of approximately 5.4 percent would produce retirement savings in excess of the suggested \$5 million cap in a world with no inflation. This compares to a negative real rate of return on average for pension funds in the United States between December 2001 and December 2010.³² Jack Bogle, founder of the mutual fund company Vanguard, estimates a decade later that the nominal rate of return on stocks will be between 7 and 7.5 percent over the next decade, and that a balanced portfolio of 60 percent stocks and 40 percent bonds will yield about 6 percent nominal,³³ suggesting that a real rate of return of 5.4 percent would be high.³⁴

31. This suggests that the section 415(c) limit on annual additions to defined contribution plans may be excessive for individuals who make contributions at or near the maximum throughout their career. Professor Dan Halperin and Marla Schnall have suggested that it might be reasonable to lower the section 415(c) limits on annual additions and permit catch-up contributions for older workers, but only if their account balances at an older age are inadequate to supply adequate retirement income. See Halperin & Schnall, *supra* note 22. It might also be possible to expressly coordinate the limits with age, with the limits increasing as the participant ages. In such case, the limit for any particular age would be set as the present value of the age 65 limit. This approach, however, would be more complex than the current system, and might have its own equitable oddities, especially during periods when the discount rate for calculating present value was subject to large annual fluctuations.

32. OECD PENSIONS OUTLOOK 2012, PENSIONS OUTLOOK 2012 MEDIA BRIEF (2012), <http://www.oecd.org/finance/private-pensions/50560110.pdf>.

33. See Carla Fried, *That Retirement Calculator May be Lying to You*, BLOOMBERG, Oct. 03, 2011, <http://www.bloomberg.com/news/2011-10-03/that-retirement-calculator-may-be-lying-to-you.html>.

34. We also note that most people in individual account retirement plans invest through mutual funds, whose actual return is net of fees.

E. Problem Can be Addressed by More Vigorous Enforcement Actions

Some of the individuals who have accumulated great wealth in their IRAs (or employer-sponsored retirement plans) have been able to do so through the purchase of non-publicly traded securities from their employers or others that may have been undervalued, and then had large gains after being purchased for the IRA.³⁵ Some may argue, then, that rather than setting a cap on allowable account values, the issue of undervalued non-publicly traded securities should be addressed through more vigorous enforcement actions by the IRS. While the IRS should certainly police relevant valuation issues, our “cap” proposal addresses the broader issue of excessive tax-sheltered accumulations regardless of the cause. Moreover, more strenuous IRS action relating to valuation of assets purchased by retirement plans or IRAs would probably not completely solve even the problem of overvaluation. For one thing, the issue of the valuation of non-publicly traded securities is complex, with the possibility of disagreements as to proper valuations. To have an effective enforcement program, the IRS would probably need to expand reporting requirements for IRAs and section 401(k) plans so that non-publicly traded investments are disclosed when they are purchased from a party with a meaningful relation or affiliation with the taxpayer; expanded reporting requirements would impose new compliance burdens on taxpayers; and IRS enforcement activities and taxpayer responses to such activities might have significant costs. In contrast, the proposal advanced here is simple and clear cut and would be relatively easy to enforce. Since it is plausible for a person to exceed the cap by contributing the maximum amount every year, though few people do that, focusing on valuation alone will not address our main concern, which is excessive tax benefits.

F. Proposal Would Have Modest Revenue Impact

The proposal would presumably affect relatively few individuals and bring in relatively little in increased tax revenue to the federal and state governments. That point may be correct, but the primary motivation for the proposal is not only to increase aggregate tax revenue, which it would do to at least some extent, but to improve the equity of the distribution of tax preferences. The proposal would address the perception that some wealthy

35. See Tom Hamburger, *Mitt Romney exited Bain Capital with rare tax benefits in retirement*, WASH. POST, Sept. 2, 2012, http://www.washingtonpost.com/politics/mitt-romney-exited-bain-capital-with-rare-tax-benefits-in-retirement/2012/09/02/1bddc8de-ec85-11e1-a80b-9f898562d010_story.html.

individuals are taxed on much more favorable terms than typical Americans, and it will produce some, revenue and perhaps meaningful, amount of revenue.³⁶

G. *The Proposal and Defined Benefit Plans*

Section 415 provides separate limits for defined benefit plans and defined contribution plans. An employer may thus sponsor both types of plans, and individual employees may receive both a defined benefit (currently up to \$200,000 per year, commencing at age 62), and a defined contribution accumulation based on annual contributions (currently set at \$50,000, with an additional \$5,500 contribution for individuals who are 50 or older). The proposal we have outlined would not apply to defined benefit plans, which raises several issues.

The first issue is that the maximum defined benefit has a value of approximately \$5 million dollars, which means that an individual who maximizes his participation in both types of plans could accumulate approximately \$10 million in tax-advantage assets. One response to this would be to subject accumulations of both types of plans to separate caps but also to an overall combined cap, which might be set, for example, at \$7.5 million.³⁷ This would not, however, solve the discrimination problem, for the person with both a defined benefit and a defined contribution plan would still be able to accumulate more than a person who had only a defined contribution plan. But this is precisely the consequence of the current structure of section 415, which permits a person who participates in both a defined contribution and a defined benefit plan to accumulate more assets than a person could accumulate using only one plan type. And one can argue that the resulting discrimination is good to the extent it provides an incentive for a firm to offer employees both types of plans, defined contribution and defined benefit.

The proposal could also be modified to having a single cap but it would include adding the value of benefits accrued in a defined benefit plan

36. As noted, we do not have data showing how many large aggregate retirement account balances exist. *See supra* note 18. We suspect, however, that there are not many, so it seems probable that the proposal will produce some but not substantial revenues.

37. In lieu of setting a separate cap for defined benefit plans, the section 415(c) limit could apply to the benefit to be paid by the defined benefit plan rather than subject the present value of a defined benefit to a dollar cap. But under section 415 today, the subsection (b) limits applies separately to the defined benefit plan of each employer that an individual works for, so some individuals might have more than one maximum defined benefit.

to the accumulations in defined contribution plans and IRAs, which is the approach used in the United Kingdom. The Code includes assumptions for converting a benefit into a lump sum, so such a conversion would not be a source of major technical difficulty.³⁸

If the proposal is not modified to apply to defined benefit plans, one can object to it on the grounds that it will discourage participants from taking benefits from defined benefit plans as a lump sum (rather than an annuity) and rolling the lump sum into an individual retirement account (which would be subject to the cap). One can respond by noting that providing incentives for people to keep benefits in the annuity form ordinarily paid by defined benefit plans rather than taking a lump sum benefit is a positive rather than negative feature of the proposal. But the proposal could be modified to exempt rollover IRAs where the rollover came from a defined benefit plan.

V. ALTERNATIVE APPROACHES

There are other possible approaches to limiting the growth of accumulations. One such approach, which we do not advocate because of its complexity, would be a tax on retirement plan accumulations above an aggregate cap. If the cap were set at \$5 million, any accumulation above that level would be subject to a tax, either the individual's marginal tax rate or a special excise tax. This approach, however, would necessitate a complex statutory scheme because (i) individuals would then need to be credited with basis in their account to reflect amounts on which tax was already paid; (ii) rules would have to be devised to determine how basis should be recovered on plan distributions; (iii) rules would have to be devised to determine how basis should be allocated between Roth and non-Roth accounts; (iv) rules would have to be developed to treat losses that occur after the account has paid tax because it exceeded the cap; and (v) rules might have to be developed to integrate an individual's overall tax situation and the tax on the plan. In contrast, the proposal that we advocate is relatively straightforward and easy to implement.

In a 2000 paper, Professors Daniel Halperin and Marla Schnall presented an interesting and elegant variation on an in-plan tax that would avoid basis complications.³⁹ Their paper suggested defining maximum accumulation levels for individual account owners at different ages and "taxing the investment income of the trust derived from the excess assets and

38. One concern might be volatility of the discount rate, although this concern could be addressed by some sort of smoothing of the discount rate over a period of time.

39. See Halperin & Schnall, *Tax-Qualified Pension Plans*, *supra* note 22.

then fully taxing the distribution.” Assuming uniform tax rates, this approach ultimately treats the excess investment income identically to the way it would have been treated if it were earned outside of a plan. But the authors acknowledged the difficulties of identifying excess assets at ages prior to normal retirement age. As an alternative that avoids this difficulty, they proposed taxing investment return above a defined rate of return, with the defined rate set at the return necessary to reach a targeted benefit amount (perhaps equal to the section 415 limit for defined benefit plans) at retirement age. But here they acknowledged that adjustments would have to be made for accounts where maximum contributions had not been made and thus concludes that such a tax would “be difficult to implement.”⁴⁰

It would also be possible to take an approach that focused on permissible investments for owner-directed plan accounts. In particular, owners of self-directed accounts could be limited to publicly traded investments,⁴¹ with the exception that participants could invest in the non-publicly traded stock of their employer, subject to the statutory limits relating on diversification.⁴² This would not, of course, limit a person’s ability to

40. *See id.*

41. There may be issues in placing clear definitional limits on the meeting of publicly-traded investments, but these issues seem to us of a type with which legislators and regulators often grapple, even if imperfectly. There may also be issues of the impact on certain investment markets if individual account plans are barred from holding certain types of investments, particularly if any such restrictions required plans to divest certain current holdings. As to the former issue, presumably people who have access to such investments within a plan will also have access to such investments outside the plan, so the effect on markets might not be all that pronounced. Moreover, this proposal would not apply to plans with pooled accounts, although even here there may be questions as to what is meant by a pooled account in the case of, for example, an individual retirement account or a section 401(k) plan that covers only one or a small number of individuals. Again, though, these seem to be issues that could be dealt with by regulations, again, even if imperfectly.

42. An additional exception might be created for non-publicly traded investment opportunities that are available to all participants in a plan without regard to minimum investment requirements. One exception to such an exception, however, is that some such investments may carry too much risk for some participants and thus might result in people ill-equipped to manage the risks making such investments. This may in itself be a reason not to create such an exception. Moreover, if the purpose of a rule limiting individually-directed accounts to publicly traded investments is to limit the ability of wealthy tax-motivated investors to use the tax-deferral of qualified plans to provide tax deferral for investments not generally available to most investors, then it might be advisable to limit such an exception to plans that cover a large number of rank-and-file participants. And such an exception would not prevent the creation of Midas-touch IRAs; it would just

invest in privately-offered investments, such as the investments Mr. Romney's IRA purchased from Bain, but would require that they be made outside the plan where there would not be valuation problems and where the income they produce would be subject to annual taxation.

It would also prevent the use of privately-held blocker corporation to avoid the tax on unrelated business income. (Of course, the wealthy could still invest in offshore corporations, but would not be able to employ the tax-exempt status of an IRA or qualified plan to shelter unrelated business income from tax.) More generally, the approach might also improve the overall equity of retirement plans at the margins, since affluent individuals would not have special opportunities to leverage the tax benefits of tax-preferred retirement accounts through investment opportunities only available, or at least only readily available, to the wealthy.

VI. A NOTE ABOUT ROTH IRAS

The proposals in this paper do not distinguish between assets in a traditional retirement account and assets in a Roth IRA or Roth 401(k). Clearly, \$5 million in assets in a Roth IRA are worth more to the individual than \$5 million in assets in an IRA because no future taxes are due on assets in the Roth IRA. This proposal does not address that issue, but we note that the proposal is consistent with other aspects of the current treatment of Roth and regular retirement vehicles where the limits on allowable contributions are the same.⁴³

VII. CONCLUSION

This paper proposes setting a cap on the amount an individual can hold in tax-preferenced defined contribution plans and IRAs of \$5 million, indexed for inflation. This simple proposal would improve the equity of the distribution of tax preferences in the pension system. The discussion has not fully detailed how the proposal might be implemented, but has instead

require that few rank-and-file employees also be able to participate in special investment opportunities. Rules designed to deal with these concerns might be difficult for regulators to create and enforce. Thus, these concerns seem to auger against such an exception if a prohibition against non-publicly traded assets were implemented.

43. We do not, however, mean to suggest that we endorse the treatment of Roth vehicles. See Daniel Halperin, *I Want a Roth IRA for Xmas*, 81 TAX NOTES 1567 (1998); Daniel Halperin, *Fun and Games with the Roth IRA*, 112 TAX NOTES 167 (2006).

focused on the concept and the broad outlines of the proposal. The proposal is in keeping with the intent of Congress and the tax and pension policy communities to limit the maximum tax preference an individual can receive on a pension plan. It is similar in concept to a limitation in pension law in the United Kingdom. The proposal would be relatively easy to enforce. The proposal would result in an increase in taxes paid by some wealthy people, without an increase in marginal tax rates.

The paper also briefly discusses some alternative approaches that merit consideration. Each of the proposals would increase tax equity and would address the perception that wealthy individuals in the United States enjoy special tax preferences that are not open to most Americans. It would also raise some additional tax revenues in a time of budgetary stress.

VIII. POSTSCRIPT

The President's 2014 budget proposal includes a proposed cap on future contributions to defined contribution plans and accruals to defined benefit plans.⁴⁴ The President's proposal, which bears some but in many ways superficial similarity to the proposal we make in our paper, would prohibit future contributions and benefit accruals for an individual for whom the present value of the aggregate of all tax-benefited retirement plans exceeds the present value of the section 415(b) limits, using as a discount rate the interest rates prescribed in section 417(e). This postscript describes the President's proposal and compares it to the proposal in this paper.

The description of the President's by the Department of Treasury makes clear that the cap would apply to every taxpayer regardless of age, with each employer and former employer with a defined benefit plan being required to report the present value of the accruals to the taxpayer, and each IRA custodian, employer and former employer being required to report the account accumulation, on an annual basis. Using the current section 417(e) discount rate—about 4 percent—the Department of Treasury notes that the maximum value of all tax-benefited retirement savings for a 65-year old would be approximately \$3.4 million dollars. A report prepared by the Employee Benefits Research Institute calculates that the maximum present value for a 25-year old would be \$800,000, but that an increase in the

44. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS, 165 (April 2013), <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>.

discount rate to 8 percent would reduce the maximum present value to \$132,000.⁴⁵

The Department of Treasury estimates that this proposal would raise \$9 billion in a ten-year budget window.

The President's proposal differs in several fundamental ways from the proposal in this paper, although both proposals are intended to reduce the tax expenditure for qualified plans by pruning back the benefits for affluent taxpayers and thus to recalibrate the distribution of the qualified plan tax expenditure among different income groups. The key differences between the proposals are the following:

(1) The proposal made in this paper is an attempt to scale back the amount that can be held in tax-preferred individual accounts in qualified plans and individual retirement accounts. The President's proposal, in contrast, would place limits on the aggregate value of individual accounts and accruals in defined benefit plans and would limit that total value to the present value of the separate limit on defined benefit plans. This would reverse a 1996 Congressional judgment that taxpayers should be able to participate fully in both types of plans and would be a far more dramatic reduction of the total limit than the proposal made in this paper.

(2) The proposal in this paper would require that a taxpayer take distributions when her aggregate individual accounts exceed the limit, while the President's proposal would only prohibit future contributions. Thus, the President's proposal would not reduce large account balances in place at the time the proposal were adopted and would continue to permit future large account balances to grow through returns on investment. We note that because the proposal in this paper would affect large account balances in existence at the time of passage, it would probably raise larger amounts of revenue in early years than the President's proposal, but because it would affect fewer taxpayers and generally provides a higher maximum limit, would probably raise less revenue in the long run than the President's proposal.

45. See Jack VanDerhei, *The Impact of a Retirement Savings Account Cap*, EBRI ISSUE BRIEF NO. 389, 5 (Aug. 2013), http://www.ebri.org/pdf/briefspdf/EBRI_IB_08-13.No389.RetSvgsCap.pdf.

