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Reconsidering the Tax Treatment of Pensions and Annuities

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INTRODUCTION

A number of recent proposals would curtail the current federal income tax benefits for annuities, pensions, and individual retirement accounts (IRAs). For example, in his 2014 Federal Budget, President Barack Obama proposed an overall cap on the total amount that individuals could accumulate in their tax-favored retirement plans.[1] More specifically, once an individual had accumulated enough to provide an annuity of $205,000 a year starting at age sixty-two (about $3.4 million in 2013), the proposal would prohibit further contributions.[2] Similarly, in 2010, the National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and former Senator Alan Simpson) proposed an annual cap on retirement contributions.[3] The proposal would cap the total employer and employee retirement plan contributions at the lesser of 20% of the employee's compensation or $20,000.[4] This Article considers the merits of these and other proposals to limit the tax benefits for annuities, pensions, and IRAs.

Part I of this Article explains how the current tax system provides favorable tax treatment for annuities, pensions, and IRAs. Part II then discusses a number of proposals to curtail that

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1 U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 165–66 (2013), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

2 *Id.*

3 NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 31 fig. 7 (2010), *available at* http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

4 *Id.*

favorable tax treatment. Finally, Part III considers the important issues raised by those proposals.

I. THE CURRENT FEDERAL TAX SYSTEM PROVIDES FAVORABLE TAX TREATMENT FOR ANNUITIES, PENSIONS, AND INDIVIDUAL RETIREMENT ACCOUNTS

Under the current federal income tax system, investment income is generally subject to federal personal income tax rates of up to 39.6% in 2014;[5] however, dividend income and capital gains are generally taxed at no more than a 20% rate.[6] This Part explains how the current tax system also provides favorable tax treatment for annuities, pensions, and IRAs.[7]

A. Annuities

An annuity is a financial instrument (e.g., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life.[8] Pertinent here, annuities are often used to provide lifetime retirement income.[9] For example, for a sixty-five-year-old man who purchased a $100,000 immediate, level-payment lifetime annuity, without inflation protection, as of January 1, 2014, the annual payout would be around $6864 or 6.86% of the annuity's purchase price.[10] Because women tend to live longer than men, the annual payout for a sixty-five-year-old woman who elected an immediate, level-payment lifetime annuity, as of January 1, 2014, would be just $6408 or 6.41% of the annuity's purchase price.[11]

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5 I.R.C. § 1 (2012); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

6 I.R.C. § 1(h).

7 There are tax advantages associated with many other investments. For example, home mortgage interest is generally deductible, and gains from the sale of a personal residence are often excludable. I.R.C. §§ 163(a), 121. Interest on state and local bonds is exempt from tax. I.R.C. § 103. Insurance proceeds payable by reason of the death of the insured are exempt from tax. I.R.C. § 101(a). Also, gains are not typically taxed until they are realized. I.R.C. §§ 61(a)(3), 1001(a). Moreover, if property is held until death, the basis in the property often "steps up" to its fair market value, which means that the appreciation is never taxed. I.R.C. § 1014(a).

8 *See* JOSEPH BANKMAN, DANIEL N. SHAVIRO & KIRK J. STARK, FEDERAL INCOME TAXATION 117 (16th ed. 2012). The person holding an annuity is called an annuitant. *Id.*

9 *See, e.g.*, Farrell Dolan, *Applying the 4-Box Strategy to Retirement Income Planning: Generating a Lifetime of Income*, LIMRA'S MARKETFACTS Q., Fall 2009, at 84, 88, *available at* http://pjwalkercommunications.com/wp-content/uploads/2010/02/Market-Facts.pdf; Darla Mercado, *Making the Case for Annuities*, INVESTMENTNEWS (Mar. 25, 2012, 12:01 AM), http://www.investmentnews.com/article/20120325/REG/303259969&issuedate=20120323&sid=RI0326.

10 *Immediate Annuities Update*, ANNUITY SHOPPER, Jan. 2014, at 9, 18 tbl.5, *available at* www.immediateannuities.com/pdfs/as/annuity-shopper-2014-01.pdf ($6864 = $572 × 12).

11 *Id.* ($6408 = $534 × 12).

The income tax system provides very favorable tax treatment of investments in annuities.[12] Although the value of an annuity investment grows over time, no tax is imposed until annuity distributions commence. In short, there is no tax on the so-called "inside buildup" until the "annuity starting date." Even then, the annuitant can exclude a fraction of each benefit payment from income. That fraction (the "exclusion ratio") is based on the amount of premiums or other after-tax contributions made by the individual. The exclusion ratio enables the individual to recover her own after-tax contributions tax-free and to pay tax only on the remaining portion of benefits which represents income.

This deferral of taxation until benefits are actually received is a very valuable tax benefit (i.e., compared to say, a regular bank account where the interest income is taxed on an annual basis[13]). For example, according to the Joint Committee on Taxation, the exclusion of investment income on annuity (and life insurance) contracts will result in a tax expenditure of more than $30 billion in Fiscal Year 2015 and more than $150 billion over five years.[14]

B. Pension Plans and Individual Retirement Accounts (IRAs)

The United States has a voluntary pension system, and employers have considerable choice about whether and how to provide pension benefits to their employees.[15] However, when employers do provide pensions, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).[16]

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12 *See* I.R.C. § 72.

13 I.R.C. § 61(a)(4).

14 STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017, at 35 tbl.1 (Comm. Print 2013), *available at* https://www.jct.gov/ publications.html?func=startdown&id=4503; *see also infra* Table 2.

15 *See, e.g.*, Jonathan Barry Forman & George A. (Sandy) Mackenzie, *The Cost of "Choice" in a Voluntary Pension System*, N.Y.U. REV. EMP. BENEFITS & EXECUTIVE COMPENSATION, 2013, at 6-1, 6-3.

16 Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 864 (codified as amended at 29 U.S.C. §§ 1001–1461 (Supp. III 1997) and in scattered sections of the Internal Revenue Code, 26 U.S.C.); *see also* STAFF OF THE JOINT COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE TAX TREATMENT OF RETIREMENT SAVINGS 2 (Comm. Print 2012), *available at* https://www.jct.gov/ publications.html?func=startdown&id=4418 ("These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to . . . [ERISA].").

1. Retirement Savings are Tax-Favored

Most retirement savings qualify for even more generous tax treatment than annuities. For example, employer contributions to a pension are not taxable to the employee;[17] the pension fund's earnings on those contributions are tax-exempt;[18] and retirees pay tax only when they receive distributions of their pension benefits.[19] Nevertheless, the employer is allowed a current deduction for its contributions (within limits).[20]

More specifically, pension benefits may be fully taxable or partially taxable, depending on whether the employee made any after-tax contributions. For example, an employee's pension benefits will be fully taxable if the employee's employer contributed all of the cost for the pension without any of the cost being included in the employee's taxable wages.[21]

On the other hand, if an employee made after-tax contributions to a pension, she can exclude a fraction of each benefit payment from income.[22] As with regular annuities, that fraction—the "exclusion ratio"—is based on the amount of premiums or other after-tax contributions made by the employee, and this approach enables the employee to recover her own after-tax contributions tax free and to pay tax only on the remaining portion of benefits which represents income.[23]

Taxpayers who begin receiving annuity payments from a pension plan after November 18, 1996, generally use the Simplified Method to figure the tax-free part of the payments.[24] Under the Simplified Method, the Internal Revenue Code provides a table with a fixed number of anticipated payments that depends upon the annuitant's age as of the annuity starting date. The taxpayer then divides the total cost over the applicable number of anticipated payments and excludes the amount so determined each year. For example, if the annuity is payable over the life of a single individual, the number of anticipated payments is determined as follows:

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17 I.R.C. § 402.

18 I.R.C. § 501(a).

19 I.R.C. §§ 72, 402. *See generally* I.R.S. Publication No. 575 (Jan. 2, 2014), *available at* http://www.irs.gov/pub/irs-pdf/p575.pdf.

20 I.R.C. § 404.

21 I.R.S. Publication No. 575, *supra* note 19, at 11. Pension benefits would also be fully taxable if the participant has already received all of her previously taxed contributions tax free in previous years. *Id.*

22 I.R.C. §§ 72, 402.

23 *See supra* Part I.A.

24 I.R.S. Publication No. 575, *supra* note 19, at 11–15.

Age at annuity starting date	*Number of anticipated payments*
55 or under	360
56–60	310
61–65	260
66–70	210
71 or older	160

If the annuity is payable over two lives, the number of anticipated payments is determined as follows:

Combined ages at annuity starting date	*Number of anticipated payments*
110 or under	410
111–120	360
121–130	310
131–140	260
141 or older	210

Also, since 2006, employers have been permitted to set up so-called "Roth 401(k) plans."[25] Contributions to these plans are not excludable, but neither the plan's investment returns nor distributions are taxable.

Favorable tax rules are also available for IRAs.[26] Almost any worker can set up an IRA with a bank or other financial institution. In 2014, individuals without pension plans can contribute and deduct up to $5500 to a regular IRA, although individuals over age 50 can contribute and deduct another $1,000 (for a total of up to $6500); and spouses can contribute and deduct similar amounts.[27]

Since 1998, individuals have been permitted to set up Roth IRAs.[28] Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax free. Like regular IRAs, however, Roth IRA earnings are tax exempt.

25 I.R.C. § 402A; *see infra* note 41 and accompanying text.

26 I.R.C. § 219; I.R.S. Publication No. 590 (Jan. 5, 2014), *available at* http://www.irs.gov/pub/irs-pdf/p590.pdf.

27 *See* I.R.S. News Release IR-2013-86 (Oct. 31, 2013), *available at* http://www.irs.gov/uac/IRS-Announces-2014-Pension-Plan-Limitations;-Taxpayers-May-Contribute-up-to-$17,500-to-their-401(k)-plans-in-2014.

28 I.R.C. § 408A.

Finally, since 2002, certain low- and moderate-income individuals have been able to claim a non-refundable tax credit of up to $1000 for certain qualified retirement savings contributions.[29] The credit equals a percentage (50%, 20%, or 10%) of up to $2000 of contributions.[30] In effect, the credit acts like an employer match: the government matches a portion of the employee's contributions.

2. Types of Pension Plans

Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

a. Defined benefit plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement.[31] For example, a plan might provide that a worker's annual retirement benefit (*B*) is equal to 2% times the number of years of service (*yos*) times final average compensation (*fac*) ($B = 2\% \times yos \times fac$). Under this traditional, final-average-pay formula, a worker who retires after thirty years of service with final average compensation of $50,000 would receive a pension of $30,000 a year for life ($\$30{,}000 = 2\% \times 30\ yos \times \$50{,}000\ fac$).[32] While many defined benefit plans allow for lump sum distributions, the default benefit for defined benefit plans is a retirement income stream in the form of a lifetime annuity.[33]

b. Defined contribution plans

Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker's compensation, which it contributes to an individual investment

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29 I.R.C. § 25B.

30 *Id.*

31 Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, 25 OKLA. CITY U. L. REV. 379, 385 (2000). To provide that benefit, the employer typically makes payments into a trust fund, contributed funds grow with investment returns, and eventually the employer withdraws funds from the trust fund to pay the promised benefits. *Id.* Employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. *Id.* at 385–86.

32 *Id.* at 386. Final average compensation is often computed by averaging the worker's salary over the last three or five years prior to retirement. *Id.* Alternatively, some plans use career-average compensation instead of final-average compensation. Under a career earnings formula, benefits are based on a percentage of an average of career earnings for every year of service by the employee. *Id.*

33 In the United States, defined benefit plans are generally designed to provide annuities, i.e., "definitely determinable benefits . . . over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 2014).

account for the worker.[34] For example, contributions might be set at 10% of annual compensation.[35] Under such a plan, a worker who earned $50,000 in a given year would have $5000 contributed to an individual investment account for her ($5000 = 10% × $50,000).[36] Her benefit at retirement would be based on all such contributions plus investment earnings.[37] Unlike traditional defined benefit plans, defined contribution plans usually make distributions in the form of lump-sum or periodic distributions rather than lifetime annuities.

There are a variety of different types of defined contribution plans, including money purchase pension plans, profit-sharing plans, stock bonus plans, target benefit plans, and employee stock ownership plans (ESOPs).[38] Profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account, according to Internal Revenue Code section 401(k). Consequently, these plans are often called "401(k) plans," and they are the most popular type of retirement plan in the United States.[39] The maximum annual amount of such elective deferrals that can be made by an individual in 2014 is $17,500, although workers over the age of 50 can contribute another $5500 (for a total of up to $23,000).[40] Similar limits apply to Roth 401(k) plans.[41]

c. Hybrid retirement plans

So-called "hybrid" retirement plans mix the features of defined benefit and defined contribution plans.[42] For example, a cash balance plan is a defined benefit plan that looks like a defined contribution plan.[43]

34 Forman & Nixon, *supra* note 31, at 386.

35 *Id.*

36 *Id.*

37 *Id.* Defined contribution plans are also known as "individual account" plans because each worker has her own account, as opposed to defined benefit plans, where the plan's assets are pooled for the benefit of all of the employees. *Id.*

38 *See, e.g.*, U.S. Bureau of Labor Statistics, *Six Ways to Save for Retirement*, PROGRAM PERSP., Mar. 2011, at 1, 1–2, *available at* http://www.bls.gov/opub/perspectives/program_perspectives_vol3_issue3.pdf.

39 *See*, *e.g.*, U.S. Bureau of Labor Statistics, *BLS Examines Popular 401(k) Retirement Plans*, PROGRAM PERSP., Nov. 2010, at 1, 1, *available at* http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue6.pdf.

40 I.R.S. News Release IR-2013-86, *supra* note 27.

41 *Id.*; I.R.C. § 402A (2012).

42 Forman & Nixon, *supra* note 31, at 387.

43 *Id.* Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical). *Id.* A simple cash balance plan might allocate 10% of salary

C. The Economics of Tax Deferral

The basic tax advantage of annuities, pension plans, and IRAs is tax deferral. For example, Table 1 shows the value of the tax advantages associated with saving in a regular pension plan (or IRA), as compared with saving in a regular savings account.[44] A regular savings account is funded with deposits that come from after-tax income and accumulate only at an annual after-tax interest rate—that is, the interest or investment income earned in such an account is taxed annually. The table assumes that a person age forty-five has $1000 in wages and wishes to save it for fifteen years for purposes of retirement at age sixty. The market interest rate during the full fifty years is assumed to be 8%.

TABLE 1. TAX ADVANTAGES OF A $1000 CONTRIBUTION TO A REGULAR PENSION PLAN

	Example 1: Tax Rate of 15% in Working Years		**Example 2**: Tax Rate of 40% in Working Years	
	Regular Account	Qualified Plan	Regular Account	Qualified Plan
Contribution	$1000	$1000	$1000	$1000
Tax on contribution	150	___	400	___
Deposit	850	1000	600	600
Value at withdrawal	2280	3172	1212	3172
Retirement tax rate (%)	___	15	___	40
Tax on withdrawal	0	476	0	1269
Net withdrawal	2280	2696	1212	1903
Gain over regular account	___	416	___	691
Percent gain	___	18	___	57
Alternative retirement tax rate (%)	___	0	___	30
Tax on withdrawal	0	0	0	952
Net withdrawal	2280	3172	1212	2221
Gain over regular account	___	892	___	1008
Percent gain	___	39	___	83

Sources: CONG. BUDGET OFFICE, TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 4 tbl.1 (1987), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/50xx/doc5011/doc05-entire.pdf; JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 336 (4th ed. 2006).

to each worker's account each year and credit the account with 5% interest on the balance in the account. Under such a plan, a worker who earned $50,000 in a given year would get an annual cash balance credit of $5000 ($5000 = 10% × $50,000), plus an interest credit equal to 5% of the balance in her hypothetical account as of the beginning of the year. *Id.* at 386.

44 CONG. BUDGET OFFICE, TAX POLICY FOR PENSIONS AND OTHER RETIREMENT SAVING 4 tbl.1 (1987), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/50xx/doc5011/doc05-entire.pdf; JOHN H. LANGBEIN, SUSAN J. STABILE & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 336 (4th ed. 2006).

Consider Example 2 in Table 1. The example assumes that the employee is a high-income individual in the 40% income tax bracket when working and when retired. If the $1000 is paid directly to the employee, the employee would immediately pay $400 in tax and deposit $600 after tax into the savings account. That $600 savings account would earn 8% interest, but the after-tax rate of return would be just 4.8%. The $600 in the account compounded at 4.8% interest over fifteen years would yield $1212, which could be withdrawn tax free.

If the employer had instead contributed that $1000 to a regular pension plan, the full $1000 would have compounded at the 8% pretax rate and yield $3172 at the end of fifteen years. Upon withdrawal, that $3172 would all be taxed at the employee's 40% income tax rate, leaving the employee with $1903 after tax. That is a net gain of $691 (57%) over the regular savings account.

The examples in Table 1 show the economic advantages of regular pension plans and IRAs over regular savings accounts. The tax advantages are greatest for those in the highest tax brackets in their working years. There are also even greater advantages to deferring income for longer periods.

Contributions to Roth IRAs and Roth 401(k) plans are made after-tax; however, withdrawals are tax free. Accordingly, these arrangements offer essentially the same tax economic benefits as qualified plans and traditional IRAs. For example, following Example 2 in Table 1, assume that an employee in the 40% tax bracket paid $400 tax on $1000 of earnings and contributed the remaining $600 to a Roth IRA with an 8% tax-free interest rate. After fifteen years, that investment would be worth $1903, exactly what the employee would have had with the regular pension plan.

D. Current Estimates of the Tax Expenditures Associated with Annuities, Pensions, and IRAs

As more fully discussed in Part III below, the special tax rules for annuities, pensions, and IRAs are routinely identified as "tax expenditures" in the tax expenditure budgets prepared annually by the Office of Management and Budget and by the Joint Committee on Taxation.[45] Policymakers often use these tax expenditure estimates as a rough guide to the cost of these

[45] OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 205 tbl.14-1 (2014); STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14.

special income tax provisions.[46] For example, Table 2 reproduces the Office of Management and Budget's 2015 Federal Budget estimates of the revenue losses attributable to the special income tax benefits for annuities, pensions, and IRAs.[47] All in all, these tax expenditures are quite large. In fact, two of these items are among the top ten largest tax expenditures each year, and five are in the top twenty.[48]

TABLE 2. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES FOR FISCAL YEARS 2015–2019

	2015	2016	2017	2018	2019	2015–19
Exclusion of interest on insurance & annuities	23,040	24,690	26,370	28,180	30,090	132,370
Net exclusion of pension contributions & earnings:						
Defined benefit plans	42,340	44,750	47,270	49,160	51,440	234,960
Defined contribution plans	61,050	77,020	88,740	92,770	94,820	414,400
IRAs	17,480	18,540	19,630	20,650	21,720	98,020
Savers tax credit	1210	1260	1300	1280	1300	6350
Self-Employed plans	25,530	28,100	30,890	33,860	37,150	155,530

Source: OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 205 tbl.14-1 (2014).

II. MANY PROPOSALS WOULD CURTAIL THE FAVORABLE TAX TREATMENT FOR ANNUITIES, PENSIONS, AND INDIVIDUAL RETIREMENT ACCOUNTS

This Part summarizes a variety of recent proposals to limit the tax benefits associated with annuities and pensions.[49] Some of these proposals have been around for decades, and some are relatively recent.

46 "Admittedly, however, tax expenditure estimates do not necessarily equal the increase in Federal revenues that would result from repealing the special provisions." Jonathan Barry Forman, *Comparing Apples and Oranges: Some Thoughts on the Pension and Social Security Tax Expenditures*, 5 EMP. RTS. & EMP. POL'Y J. 297, 308 n.50 (2001).

47 OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, *supra* note 45, at 205 tbl.14-1, 206, 208.

48 *Id.* at 216 tbl.14-3.

49 *See also Tax Reform Options: Promoting Retirement Security: Hearing Before the S. Comm. on Finance*, 112th Cong. (2011), *available at* http://www.finance.senate.gov/hearings/hearing/?id=ba387157-5056-a032-5252-c7bf71fc6c90; Jack VanDerhei, *Tax Reform Options: Promoting Retirement Security*, EMP. BENEFIT RES. INST., Nov. 2011, at 1, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_11-2011_No364_RetTaxRfm2.pdf.

A. Include Investment Income from Annuities (and Life Insurance) in Taxable Income

Perhaps the oldest tax reform proposal that still has currency is the suggestion that we should include the investment income from annuities (and life insurance) in taxable income.[50] Under a comprehensive income tax (i.e., a theoretically pure income tax), individuals would pay tax on the sum of the wages, interest, dividends, and other forms of economic income that they earn.[51] As more fully explained below, this proposal would extend comprehensive income tax treatment to annuities (and life insurance) by taxing the inside buildup in those policies.[52]

Portions of the premiums paid for annuities are invested and earn interest, dividends, and other types of investment income. That investment income—the inside buildup—is generally not taxable until the annuitant begins receiving annuity distributions. A similar deferral of tax occurs on investments in whole-life insurance policies.[53] Under a pure income tax, investors in these insurance products would be taxed on those investment earnings annually, just like investors in bank accounts, taxable bonds, and mutual funds. According to the Joint Committee on Taxation, including the investment income

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50 *See*, *e.g.*, CONG. BUDGET OFFICE, PUB. NO. 4664, OPTIONS FOR REDUCING THE DEFICIT: 2014 TO 2023, at 126 tbl. (2013), *available at* www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-3.pdf; DAVID F. BRADFORD & THE U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 178 (2d ed. 1984).

51 The classic economic definition of income (also known as the Haig-Simons definition of income) is as follows:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain *to* someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921). *See generally* BROOKINGS INST., COMPREHENSIVE INCOME TAXATION (Joseph A. Pechman ed., 1977); BROOKINGS INST., WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 50–51 (Joseph A. Pechman ed., 1980); Henry Aaron, *What Is a Comprehensive Tax Base Anyway?* 22 NAT'L TAX J. 543 (1969); DAVID F. BRADFORD & THE U.S. TREASURY TAX POLICY STAFF, *supra* note 50.

52 *See* CONG. BUDGET OFFICE, *supra* note 50.

53 *Id.* A whole-life insurance policy provides life insurance coverage throughout the insured's whole life, as opposed to term-life insurance, which provides coverage for a specified period. *Id.*

from annuities and life insurance in taxable income would raise $24 billion in Fiscal Year 2015 and $210 billion over ten years.[54]

B. Cap the Total Accumulation of Retirement Benefits

In his 2014 Federal Budget, President Barack Obama proposed an overall cap on the total amount that individuals could accumulate in their tax-favored retirement plans.[55] More specifically, once an individual had accumulated enough to provide a joint and survivor annuity of $205,000 a year, starting at age sixty-two, the proposal would prohibit further contributions under such plans. The maximum annuity cap was designed to equal the maximum annuity that can be paid by a qualified defined benefit plan ($205,000 in 2013 and $210,000 in 2014),[56] and the Treasury estimated that the maximum permitted accumulation for an individual in 2013 was around $3.4 million.[57]

Pertinent here, during the 2012 Presidential race, Governor Mitt Romney was reported to have accumulated $87 million in his IRA,[58] and proposals like this seem to be intended to curtail such large accumulations. The Joint Committee on Taxation estimates that this Obama Administration proposal would raise $210 million in Fiscal Year 2015 and $3.8 billion over ten years.[59]

In fact, the Obama Administration's proposal calls for a combined limit on defined benefit plans and individual account plans (i.e., defined contribution plans and IRAs). That is, further contributions would be limited for participants whose total individual account balances *plus* their defined benefit plans would be sufficient to provide the maximum allowable annuity (e.g., $210,000 a year for a sixty-two-year-old in 2014). To avoid

54 *Id.*; *see also supra* Table 2 (showing slightly different tax expenditure estimates, $23 billion in Fiscal Year 2015 and $132 billion over five years).

55 U.S. DEP'T OF THE TREASURY, *supra* note 1, at 166; STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., DESCRIPTION OF CERTAIN REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL 144 (Comm. Print 2013), *available at* https://www.jct.gov/publications.html?func=startdown&id=4538. "[T]ax-favored retirement plans include traditional IRAs (including SEPs and SIMPLE IRAs), Roth IRAs, qualified retirement plans [(e.g., I.R.C. § 401(k) plans)], [I.R.C. §] 403(b) plans, and governmental [I.R.C. §] 457(b) plans." *Id.*

56 I.R.C. § 415(b)(1)(A) (2012); I.R.S. News Release IR-2013-86, *supra* note 27.

57 U.S. DEP'T OF THE TREASURY, *supra* note 1, at 166.

58 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.

59 STAFF OF THE JOINT COMM. ON TAXATION, 113TH CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2014 BUDGET PROPOSAL [1], at 8 (Comm. Print 2013), *available at* https://www.jct.gov/publications.html?func=startdown&id=4520.

the complexity that can result from administering such a combined limit on individuals who participate in both defined benefit and individual account plans,[60] John Turner and his colleagues have suggested that it would be simpler to have a separate $5 million cap just for individual account plans.[61] Turner and his colleagues further recommend that individuals with balances in excess of that $5 million cap should be required to take taxable distributions from their plans equal to the excess over that $5 million cap.[62]

C. Cap Contributions at the Lesser of 20% of Compensation *or* $20,000

In 2010, the National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and Senator Alan Simpson) suggested an annual cap on retirement contributions.[63] The proposal would cap the total employer and employee retirement plan contributions at the lesser of 20% of the employee's compensation or $20,000.[64] This so-called "20/20" proposal, which would limit the ability of high-income individuals to use retirement tax expenditures, was offered as a part of the Commission's larger plan to raise revenue in order to cut deficits and reduce marginal tax rates.

Needless to say, the 20/20 proposal has had plenty of critics.[65] Critics are particularly concerned that capping contributions would limit the incentives that business owners

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60 *See, e.g.*, I.R.S. Notice 99-44 (1999), *available at* www.irs.gov/pub/irs-drop/n-99-44.pdf; ANN TRICHILO & MARTY PIPPINS, INTERNAL REVENUE SERV., CHAPTER 8B—ISSUES RELATED TO THE REPEAL OF IRC SECTION 415(e) (2002), *available at* http://www.irs.gov/pub/irs-tege/epch8b02.pdf (discussing the repeal of former I.R.C. section 415(e), which had provided complicated limits on individuals who participated in both defined benefit and defined contribution plans); Louis T. Mazawey, *Practical Ways to Deal with the Repeal of Section 415(e)*, 16 PRAC. TAX LAW. 41 (2001), *available at* http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/PTL_MAZAWEY-01-924_thumb.pdf.

61 *See, e.g.*, John A. Turner, David D. McCarthy & Norman P. Stein, *Defined Contribution Plans with Very Large Individual Account Balances*, 1 J. RETIREMENT 113, 120 (2014).

62 *Id.*; *see also* Brendan McFarland & Sylvester J. Schieber, *Proposed Lifetime Pension Limits: Less than Meets the Eye*, TOWERS WATSON (Mar. 18, 2014), http://www.towerswatson.com/en/Insights/Newsletters/Americas/Insider/2014/proposed-lifetime-pension-limits-less-than-meets-the-eye.

63 NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, *supra* note 3.

64 *Id.*; *see also* Jack VanDerhei, *Capping Tax-Preferred Retirement Contributions: Preliminary Evidence of the Impact of the National Commission on Fiscal Responsibility and Reform Recommendations*, EMP. BENEFIT RES. INST., July 2011, at 2, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_07_July-11.TaxCap_UnionHI.pdf.

65 *See, e.g.*, AM. BENEFITS COUNCIL, "20/20" CAP ON RETIREMENT SAVINGS WOULD UNDERMINE RETIREMENT SECURITY (2012), *available at* http://www.americanbenefitscouncil.org/documents2012/401k-limits_2020-talkingpoints110612.pdf.

and managers would have to offer retirement plans that today cover so many rank-and-file workers.

Along the same lines, the Congressional Budget Office recently outlined a proposal to reduce the current limits on annual contributions to retirement plans.[66] Under the proposal, the maximum individual contribution would be limited to $15,500 per year for 401(k)-type plans and $5000 per year for IRAs; and the proposal would also limit the total of employee and employer contributions to defined contribution plans to $46,000.[67] This proposal would raise $6.7 billion in Fiscal Year 2015 and around $89 billion over ten years.[68]

D. Move Towards (or Away from) the Roth Model

A number of reform proposals have called for the pension system to move either towards or away from the Roth model. Recall that with a traditional IRA, individuals can deduct their contributions, but distributions are taxable; on the other hand, with a Roth IRA, contributions are not deductible, but distributions are tax-free.[69] If the tax rate is the same at both times, these two tax benefits are equivalent. In the real world, however, tax rates are not the same at both times, and critics of the Roth approach generally note that giving taxpayers a choice almost certainly means that the Treasury will lose revenue as taxpayers choose which approach is best for them. On the other hand, supporters of the Roth approach often see Roths as a way of encouraging low-income workers to save for retirement. Allowing individuals to convert their traditional IRAs into Roth IRAs by recognizing income now has also been a way to raise revenue during the near-term five- and ten-year budget windows that Congress uses to reach its revenue targets.[70]

House Ways and Means Committee Chairman Dave Camp's recent tax reform proposals come down in favor of Roths, apparently as a way of raising revenue in order to lower

66 CONG. BUDGET OFFICE, *supra* note 50, at 133–34.

67 *Id.* Under current law, the total of employer and employee contributions to a defined contribution plan cannot exceed $52,000 in 2014. I.R.C. § 415(c)(1)(A) (2012); I.R.S. News Release IR-2013-86 , *supra* note 27.

68 CONG. BUDGET OFFICE, *supra* note 50, at 133–34.

69 *See supra* notes 26–28 and accompanying text.

70 *See, e.g.*, Richard Rubin & Margaret Collins, *Tax Break for Roth IRA Conversion Attracted 10% of High Earners*, BLOOMBERGBUSINESSWEEK (Jan. 4, 2014), http://www.businessweek.com/news/2014-01-04/tax-break-for-roth-ira-conversion-attracted-10-percent-of-high-earners; Deborah L. Jacobs, *Why--and How--Congress Should Curb Roth IRAs*, FORBES (Mar. 26, 2012), http://www.forbes.com/sites/deborahljacobs/2012/03/ 26/why-and-how-congress-should-curb-roth-iras; Leonard E. Burman, *Roth Conversions as Revenue Raisers: Smoke and Mirrors,* 111 TAX NOTES 953 (2006).

marginal tax rates. Under one of his tax reform proposals, "the income eligibility limits for contributing to Roth IRAs would be eliminated"; at the same time, however, "new contributions to traditional IRAs" would be prohibited.[71] The proposal would increase revenues by $14.8 billion over the next ten years.[72] Similarly, under another provision, employees would generally be able to contribute no more than half of the maximum elective deferral amount ($8750 = 1/2 of $17,500 in 2014) into a traditional 401(k) plan; anything more would have to go into a Roth 401(k); and this proposal would raise $143.7 billion over the next ten years.[73]

President Barack Obama recently proposed that the government offer no-fee starter retirement savings accounts known as "myRAs" (short for "My Retirement Accounts") that would be taxed like Roth IRAs: earnings generally could be withdrawn tax free after age fifty-nine-and-a-half.[74] Participants in these new accounts would earn interest at the same variable interest rate as the federal employees' Thrift Savings Plan (TSP) Government Securities Investment Fund.[75]

President George W. Bush also favored Roth-style retirement accounts. From 2004 through 2009, his Federal Budgets recommended consolidating traditional and Roth IRAs into so-called Retirement Savings Accounts (RSAs) that would be taxed liked Roth IRAs.[76]

On the other hand, President Obama's 2015 Budget would limit the tax deferral benefits of Roth plans by requiring them to follow the same required minimum distribution (RMD) rules that apply to other retirement accounts.[77] That is, like qualified plans and regular IRAs, individuals would generally have to begin taking RMDs from when they reach age seventy-and-a-half.[78]

71 HOUSE COMM. ON WAYS & MEANS, 113TH CONG., TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY 36 (2014), *available at* http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_sumary_final_022614.pdf.

72 *Id.* at 37.

73 *Id.* at 39–40.

74 *See* U.S. DEP'T OF THE TREASURY, MYRA: A SIMPLE, SAFE, AFFORDABLE RETIREMENT SAVINGS ACCOUNT (2014), *available at* http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf.

75 *Id.*

76 STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 16 at 59.

77 OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 26–27 (2014), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/budget.pdf.

78 U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 251–52 (2014), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf.

The proposal would raise $484 million over ten years.[79] This change could make Roth accounts and Roth conversions much less attractive.[80]

E. Replace the Current Exclusion with a Refundable Tax Credit

Over the years, there have been a number of proposals to replace the current exclusions (and deductions) for retirement savings with tax credits. For example, in 2011, William Gale of the Brookings Institution suggested that we replace the current system of exclusions and deductions with a flat-rate refundable tax credit, given to the employee, with that credit being directly deposited in the employee's retirement account.[81] For example, instead of allowing an employee to exclude or deduct her retirement contributions, a 30% credit would be deposited into her individual account. The Urban-Brookings Tax Policy Center estimates that this proposal would be revenue-neutral over ten years: it would take tax benefits from high-income households and increase benefits for low- and moderate-income households.[82]

Along these lines, over the years, there have been a variety of proposals to limit the value of certain tax expenditures. For example, the tax system could limit the value of itemized deductions and exclusions to, say, 28% of their total value.[83] Then, taxpayers in income tax brackets with statutory rates above 28% would receive less benefit from itemized deductions and exclusions than under current law, while taxpayers in lower tax brackets would be unaffected by the change. This type of 28% limit could be applied to the exclusion for 401(k)-type contributions and to the deduction for IRA contributions.

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79 *Id.* at 284.

80 *See* Jeffrey Levine, *Required Minimum Distributions for Roth IRAs?*, FIN. PLAN. (Mar. 5, 2014), http://www.financial-planning.com/blogs/required-minimum-distributions-for-roth-2688468-1.html.

81 WILLIAM G. GALE, TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY 5 (2011), *available at* http://finance.senate.gov/imo/media/doc/Testimony%20of%20William%20Gale.pdf (testimony submitted to the United States Senate Committee on Finance).

82 *Id.* at 6.

83 *See* U.S. DEP'T OF THE TREASURY, *supra* note 78, at 154–55; CONG. BUDGET OFFICE, *supra* note 50, at 121. Similarly, President George Bush's recent Advisory Panel on Federal Tax Reform recommended replacing most itemized deductions with a 15% tax credit. THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 102 (2005), *available at* http://www.taxpolicycenter.org/taxtopics/upload/Tax-Panel-2.pdf.

III. PROPOSALS TO IMPOSE TOUGH LIMITS ON THE TAX BENEFITS FOR ANNUITIES, PENSIONS, AND IRAS WOULD RAISE REVENUE THAT COULD BE USED TO SUBSIDIZE LOW- AND MODERATE-INCOME HOUSEHOLDS

Advocates of imposing tougher limits on the tax benefits for annuities, pensions, and IRAs tend to be interested in raising revenue for deficit reduction, for cuts in marginal tax rates, or for subsidies for low- and moderate-income households. This Part discusses some of the underlying issues.

A. The Favorable Tax Rules for Annuities, Pensions, and IRAs Are Costly

As already mentioned, under a theoretically pure income tax, individuals would pay tax annually on all of their investment income.[84] Of course, the federal income tax deviates from that comprehensive income tax ideal in a number of ways. In fact, the current federal tax system is really a hybrid income-consumption tax system in which some investments are taxed on the income tax model and others are taxed under the consumption tax model (i.e., as taxpayers spend their money).[85] Pertinent here, for example, the current taxation of pensions deviates from the income tax ideal in that employer contributions are typically excluded from gross income, and pension fund earnings are exempt from tax.

In that regard, the Congressional Budget and Impoundment Act of 1974 requires the federal government to keep track of the revenue "lost" as a result of deviations from an ideal income tax through so-called tax expenditure budgets.[86] More specifically, the Congressional Budget and Impoundment Act of 1974 defines "tax expenditures" as: "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability . . . ."[87]

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84 *See supra* note 51 and accompanying text.

85 UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 1 (Henry J. Aaron, Harvey Galper, & Joseph A. Pechman eds., 1988); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1152 (1992). In general, wages, interest, dividends, and other forms of income are taxed when received, regardless of whether or not saved. On the other hand, pension benefits are taxed under the consumption tax model.

86 Congressional Budget and Impoundment Act of 1974, Pub. L. No. 93-344, § 101(c), § 102(a), 88 Stat. 297, 300.

87 *Id.* § 3(a)(3), 88 Stat. at 299 (codified at 2 U.S.C. § 622(3) (2012)). For a historical analysis, see Jonathan B. Forman, *Origins of the Tax Expenditure Budget*, 30 TAX NOTES 537, 537–45 (1986).

Thus, the definition of a tax expenditure draws a distinction between the ideal provisions of an income tax and the special or preferential provisions that are exceptions to that ideal structure. For example, according to the Joint Committee on Taxation:

> [T]he normal structure of the individual income tax includes the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, and deductions for investment and employee business expenses. Most other tax benefits to individual taxpayers are classified as exceptions to normal income tax law.[88]

As we have seen, these exceptions from an ideal income tax are routinely identified as tax expenditures by the Office of Management and Budget and the Joint Committee on Taxation.[89] The Congressional Budget Act of 1974 does not, however, actually specify the ideal structure of a tax law, so deciding which provisions are special or preferential is necessarily a matter of judgment, over which there is often much debate.[90]

Pertinent here, many tax experts would prefer if tax expenditure estimates were based on a consumption tax ideal rather than an income tax ideal.[91] Under a consumption tax, savings are not supposed to be taxed until they are spent (i.e., consumed). Consequently, using a consumption tax ideal would lead to a quite different set of tax expenditure estimates. Indeed, the tax expenditure associated with pensions would be zero (or, to the extent of any "over-taxation" of pensions, negative).[92]

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88 STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14, at 3.

89 *See, e.g.*, OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, *supra* note 45, at 203, 205 tbl.14-1; STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 14, at 2.

90 *See, e.g.*, Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244, 245 (1969); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528, 530 (1969); Boris I. Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth*, 22 NAT'L TAX J. 538, 538 (1969).

91 *See* Jonathan B. Forman *The Impact of Shifting to a Personal Consumption Tax on Pension Plans and Their Beneficiaries*, *in* TAX REFORM: IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS 51, 56–57 (Dallas L. Salisbury ed., Employee Benefit Research Institute 1997); *see also* PETER BRADY, INV. CO. INST., THE TAX BENEFITS AND REVENUE COSTS OF TAX DEFERRAL 6 (2012), *available at* http://www.ici.org/pdf/ppr_12_tax_benefits.pdf (suggesting that current tax expenditure budgets vastly overstate the tax costs of retirement savings).

92 *See, e.g.*, OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004 app. at 140 tbl.2 (2003), *available at* http://www.gpo.gov/fdsys/pkg/BUDGET-2004-PER/pdf/BUDGET-2004-PER.pdf. Pertinent here, see Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315, 315 (1988); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225, 239 (1991); Edward A. Zelinsky, *Qualified Plans and*

Certainly, the government has the power to eliminate or curtail the tax benefits for annuities, pensions, and IRAs; but should it? As we have seen, there are already a number of limits on contributions and benefits (e.g., the $17,500 annual cap on 401(k)-type contributions). The question is really whether it makes sense to toughen the current limits and/or impose new limits on deferred savings. Proponents of comprehensive income taxation tend to favor such tougher caps, while proponents of consumption taxation tend to oppose tougher caps.

To be sure, a good deal of revenue could be raised from curtailing the current tax benefits for annuities, pensions, and IRAs. And certainly that revenue could be used for deficit reduction, for cuts in marginal tax rates, or for additional retirement savings subsidies for low- and moderate-income households. Those are all worthwhile uses for additional revenue, but if raising revenue is the goal, it is not clear that curtailing the tax benefits for savings is the best way to raise revenue. While the retirement savings tax benefits are among the largest tax expenditures in the tax expenditure budget,[93] curtailing them might undermine our already fragile retirement system.

Historically, Congress has often let revenue needs drive pension policy.[94] Instead, it should be driven by genuine concerns about how to ensure that our pension system will provide adequate retirement incomes for all American workers.[95]

B. The Favorable Tax Rules for Annuities, Pensions, and IRAs Could Be Better Targeted to Help Low- and Moderate-Income Households

Many proponents of curtailing the tax benefits for annuities, pensions, and IRAs believe that those benefits could be better targeted to help low- and moderate-income households.[96] In that regard, there is no question that these tax expenditures are

Identifying Tax Expenditures: A Rejoinder to Professor Stein, 9 AM. J. TAX POL'Y 257, 257 (1991).

93 *See supra* note 48 and accompanying text.

94 *See, e.g.*, David A. Pratt, *Pension Simplification*, 35 J. MARSHALL L. REV. 565, 566 (2002).

95 *See, e.g.*, G.A. (Sandy) Mackenzie & Jonathan Barry Forman, *Reforming the Second Tier of the U.S. Pension System: Tabula Rasa or Step by Step?*, 46 J. MARSHALL L. REV. 631, 633 (2013).

96 *See, e.g.*, Turner, McCarthy & Stein, *supra* note 61; GALE, *supra* note 81; Chuck Marr, Nathaniel Frentz & Chye-Ching Huang, *Retirement Tax Incentives Are Ripe for Reform: Current Incentives Are Expensive, Inefficient, and Inequitable*, CENTER ON BUDGET & POL'Y PRIORITIES (Dec. 13, 2013), http://www.cbpp.org/cms/index.cfm?fa=view&id=4063; TERESA GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 54–57 (2008).

skewed in favor of high-income households. For example, Table 3 shows that the top quintile of households receive roughly two-thirds of the tax benefits from the exclusion of pension contributions and earnings.[97] Meanwhile, the bottom quintiles get hardly any tax benefits.

TABLE 3. DISTRIBUTION OF THE EXCLUSION OF NET CONTRIBUTIONS AND EARNINGS, BY INCOME GROUP, 2013

	Lowest quintile	Second quintile	Middle quintile	Fourth quintile	Highest quintile	All quintiles
Share	2	5	9	18	66	100
Share of after-tax income	0.4	0.7	0.8	1.2	2.0	1.4

Source: CONG. BUDGET OFFICE, PUB. NO. 4308, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM 15 tbl. 2 (2013), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf.

Accordingly, curtailing the tax benefits for retirement contributions and/or benefits likely would reduce the proportion of tax expenditures that goes to high-income households and increase the relative proportion that goes to low- and moderate-income households. Alternatively, replacing the current system of exclusions and deductions with refundable tax credits could also improve the distribution of benefits. However, to the extent that these changes would limit the incentives that business owners and managers have to offer retirement plans, overall coverage might decline. All in all there are tradeoffs, and the focus should be on designing a low-cost pension system that will provide adequate retirement incomes for all American workers.[98]

C. The Current System Is Already Too Complicated and Needs to Be Simplified

One of the major problems with the current retirement savings system is its incredible complexity. In addition to the wide variety of annuity options, there are a plethora of

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97 CONG. BUDGET OFFICE, PUB. NO. 4308, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM 15 tbl.2 (2013), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf; *see also Distribution of Tax Expenditures for Housing, Health and Retirement Savings*, TAX POL'Y CENTER, http://www.taxpolicycenter.org/taxtopics/Tax_Expenditures_tables.cfm (last visited Feb. 20, 2014); *T13-0295 Tax Benefit of Certain Retirement Savings Incentives (Cash-flow Approach)*, TAX POL'Y CENTER (Dec. 18, 2013), http://www.taxpolicycenter.org/ numbers/displayatab.cfm?DocID=4041.

98 *See, e.g.*, Forman & Mackenzie, *supra* note 15, at 6-43.

retirement plans including traditional defined benefit plans, cash balance plans, money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, employee stock ownership plans (ESOPs), SIMPLE plans, SEPs, IRAs, and Roth IRAs. Every one of these plans has a different set of rules and regulations, limits on contributions, vesting rules, and tax advantages. The net result is bewildering complexity for everyone. As a result, many analysts have called for simplification.[99]

Pertinent here, we already have numerous limits on retirement contributions and benefits, and extensive regulations that govern annuities, pensions, and IRAs. As Congress thinks about adding new limits and toughening existing ones, one hopes that it also takes the opportunity to reform and simplify the current system.

CONCLUSION

In recent years, there have been a number of proposals to curtail the favorable tax treatment that is currently available for annuities, pensions, and IRAs. Advocates of imposing tougher limits on the tax benefits for annuities, pensions, and IRAs tend to be interested in raising revenue for deficit reduction, for cuts in marginal tax rates, or for subsidies for low- and moderate-income households. These are worthy goals; however, as Congress thinks about limiting the tax incentives for annuities, pensions, and IRAs, it needs to be careful not to undermine our already fragile retirement system.

99 *See, e.g.*, Pratt, *supra* note 94; Forman & Mackenzie, *supra* note 15; David A. Pratt, *Focus on . . . Pension Simplification*, 9 J. PENSION BENEFITS 8 (2002); Pamela Perun & C. Eugene Steuerle, Reality Testing for Pension Reform 2 (May 6, 2003) (unpublished manuscript), *available at* http://www.urban.org/UploadedPDF/410797_reality_testing_pension_reform.pdf.