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Advisory from EBRI

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FY 2014 Obama Budget Proposal (Updated):

The Impact of a Retirement Savings Account Cap

WASHINGTON—This week President Obama unveiled his Fiscal Year 2014 budget proposal, which includes a cap on retirement savings.

As expected, the White House budget calls for legislation that would prohibit individuals from accumulating over $3 million in individual retirement accounts (IRAs) and other tax-preferred defined contribution retirement accounts, such as 401(k) plans. With the release of the full budget details on April 10, it is clear that the proposed cap would apply not only to individual accounts (such as IRAs and 401(k)s) but to defined benefit (DB) pension accruals as well.

How many individuals might be affected by that cap? EBRI analysis (below) examines how this proposal would affect individuals with IRAs and 401(k)s. Since the earlier EBRI analysis did not contemplate the inclusion of defined benefit accruals, it seems likely that the number of individuals affected will increase.

For your reference, the White House budget proposal is online here.

The applicable text is found on page 33:

> ***Limit the total accrual of tax-favored retirement benefits***.—The Administration proposes to limit the deduction or exclusion for contributions to defined contribution plans, defined benefit plans, or IRAs for an individual who has total balances or accrued benefits under those plans that are sufficient to provide an annuity equal to the maximum allowable defined benefit plan benefit. This maximum, currently an annual benefit of $205,000 payable in the form of a joint and survivor benefit commencing at age 62, is indexed for inflation, and the maximum accumulation that would apply for an individual at age 62 is approximately $3.4 million. The proposal would be effective for taxable years beginning after December 31, 2013.

Also linked for your information is the FY 2014 Analytical Perspectives on the Budget of the U.S. Government from the Office of Management and Budget (online here), as well as some additional description of the proposal and its potential implementation from the Treasury Greenbook, which provides a more detailed explanation of the proposal, online here.

IRA and 401(k) Impact

In the EBRI IRA database at year-end 2011, approximately 0.03 percent of the approximately 20.6 million accounts had more than $3 million in assets. About 0.06 percent of the total account holders (some individuals own more than one account), and about 0.11 percent of account holders who are age 60 or older surpass the threshold. As shown in Figure 1, of the individuals with IRA balances above $3 million, 37 percent were age 70 or older and another 20 percent were age 65–69 (50 percent and 26 percent, respectively, for those with known ages in the database).

Some employment-based retirement accounts, such as 401(k) plans, would be affected as well. An analysis based on the projected year-end 2012 account balances on all participants in the EBRI/ICI 401(k) database with account balances at year-end 2011 and contributions in that year finds that approximately 0.0041 percent of those 401(k) accounts had $3 million or more in assets by year end 2012.

Impact on Multiple Accounts

Individual savers increasingly find themselves having not only a 401(k), but an IRA as well, and in many cases multiple savings accounts. Taking into account combined IRA and 401(k) balances, a review of the integrated EBRI IRA/401(k) database as of year-end 2011 for individuals age 60 or older who had at least one IRA or 401(k) in 2010 and at least one IRA or 401(k) in 2011 finds that about 0.107 percent of these individuals had balances totaling $3 million or above.

It should be noted that these numbers are at a particular point in time, based on the most current data available. Those balances will change over time, and inflation is expected to increase the level of the cap. The Employee Benefit Research Institute's Retirement Security Projection Model (RSPM) allows us to estimate what the potential **future** impact could be, particularly for younger workers not currently on the cusp of retirement.

Projected Future Impact(s)

Looking at participants in the EBRI/ICI 401(k) database with account balances at the end of 2011 and contributions in that year, assuming no change in asset allocation over their future career, real returns of 6 percent on equity investments, and 3 percent on nonequity investments, 1 percent real wage growth, and no job turnover, just under one percent (0.9 percent) of those 401(k) account balances would be affected by a $3 million cap (adjusted for inflation).

With the expanding availability and utilization of retirement plan investment choices like target-date funds, one might well assume that future asset allocations will be adjusted in accordance with age. Taking age adjustments into account in asset allocation, while leaving the other assumptions noted above in place, EBRI finds that 1.2 percent of those aged 26–35 in the sample would be affected by the adjusted $3 million cap by the time they reach age 65 (see Figure 2).

Changes in the Cap Level

However, it's not enough to examine just those balances that are at a specific point in time. The retirement plan account savings cap in the White House budget proposal is reportedly tied, not to a hard dollar limit, but rather one that would finance, in 2013, an annuity of $205,000 per year in retirement, the current IRC 415(b) annual benefit limit for defined benefit pension plans. The corresponding account balance threshold would fluctuate over time, based on discount rates—

and that means that the number of accounts that could exceed the threshold in the future could be significant. For example, based on a time series of annuity purchase prices for males age 65 going back to late 2006, the actuarial equivalent of the $205,000 threshold could be as low as $2.2 million.[1] At that level, nearly three percent (2.99 percent) of 401(k) accounts are projected to be impacted. Of course, a higher interest rate environment could result in an even lower cap threshold.

Impact on Younger Workers

Time, which allows savings to accumulate in these accounts, tends to increase the probability that younger workers will reach the inflation adjusted limits by the time they reach age 65, with 2.2 percent of those currently ages 26–35 affected by the $3 million cap (adjusted for inflation), compared with just 0.1 percent of those ages 56–65. At the $2.2 million level cited above, 6.0 percent of younger retirement savers would be affected by age 65, compared with 0.3 percent of those ages 56–65. Additionally, when age adjustments are factored into asset allocation, 4.2 percent of those aged 26–35 would be affected by a $2.2 million cap. Those closer to retirement would be less likely to exceed the threshold by the time they reach age 65.

The impact of the proposed cap also varies by age and tenure. For example, as is shown in Figure 3, at the $3 million level (adjusted for inflation), 1.4 percent of workers currently ages 26–35 with five to nine years of tenure would be affected, while as Figure 4 illustrates, 5.2 percent of workers in that age and tenure cohort would be affected by a $2.2 million cap (adjusted for inflation).

Future Analysis

As with all budget proposals, most of the instant analysis focuses on the numbers. Our objective here was simply to answer the immediate question: How many individuals might be affected by such a cap on retirement savings accounts? Of necessity, it does not yet consider the administrative complexities of implementation and monitoring such a cap, nor does it take into account the potential response of individual savers and their employers to such a change in tax policy. The latter consideration is of particular importance in considering the implications of tax policy changes to the current voluntary retirement savings system.

Once details of the proposal are available, EBRI will perform additional analysis on these additional considerations that are extremely important to a comprehensive appreciation of the likely impact of the proposal on retirement savings. EBRI has previously performed detailed analysis on the administrative issues involved in individual Social Security accounts,[2] and a similar analysis would be applicable to this type of proposal as well. Directly related to the potential administrative complexity, a comprehensive analysis of the likely impact of this proposal also requires the modeling of the likely employer response to the new rules, once they are clarified. In prior research, EBRI has performed extensive modeling of likely employer responses to other proposals to modify the current federal tax treatment of 401(k) contributions,[3] as well as an analysis of the need to consider the unique set of incentives for employers in a voluntary retirement system.[4]

Additional information on this analysis, and a broader set of considerations will be available in a future EBRI publication, and will be among the topics presented next month at EBRI’s 72nd Policy Forum, “Decisions, Decisions: Choices That Affect Retirement Income Adequacy.”

Additional information about the Policy Forum, including the agenda and registration information can be found at www.ebri.org

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Endnotes

[1] EBRI plans to conduct additional research in the near future to expand this time series and include annuity purchase prices for females age 65 to provide for unisex actuarial equivalents.

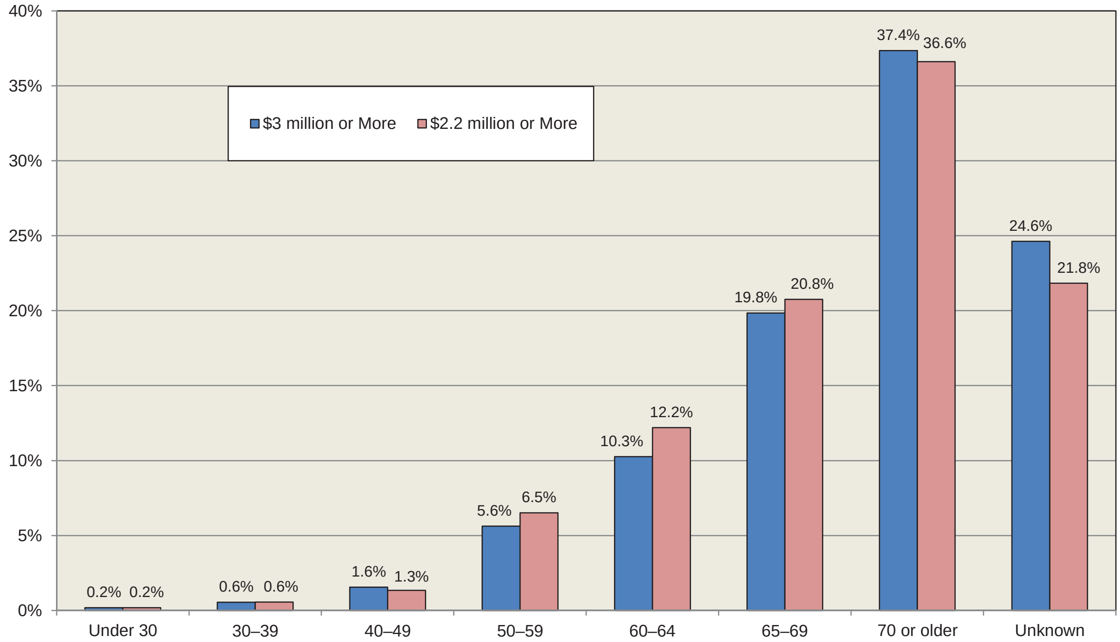
[2] www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=153

[3] ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4934 and ebri.org/pdf/publications/testimony/T-172.pdf

[4] ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=5157

Figure 1

Age Distribution of the Individuals With an IRA Balance of Greater Than $3 Million and $2.2 Million, 2011

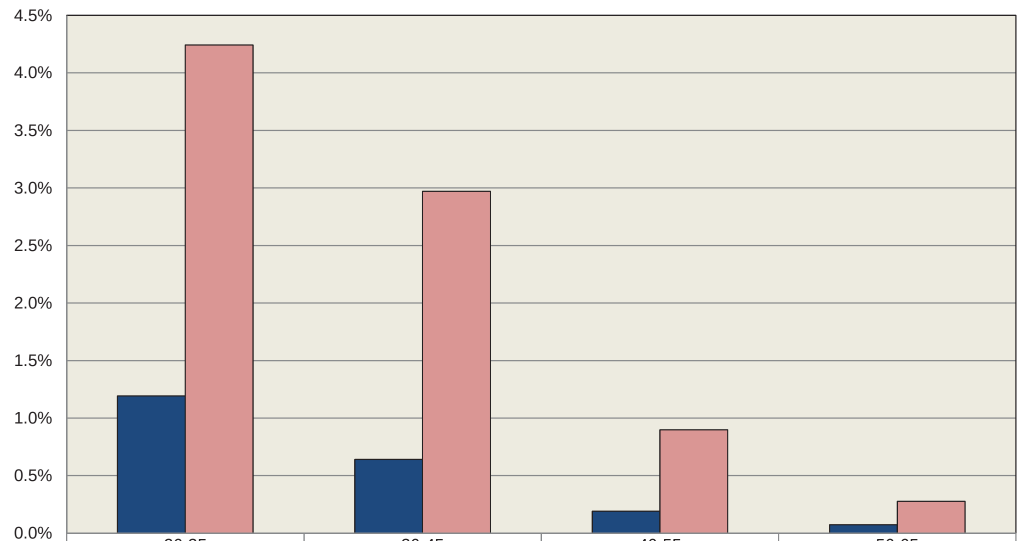


Source: Employee Benefit Research Institute IRA Database.

Figure 2

Impact of Age on Percentage of 401(k) Participants Reaching New Limit (Adjusted for Inflation), by Age 65

(baseline assumptions with age adjustments on asset allocation)



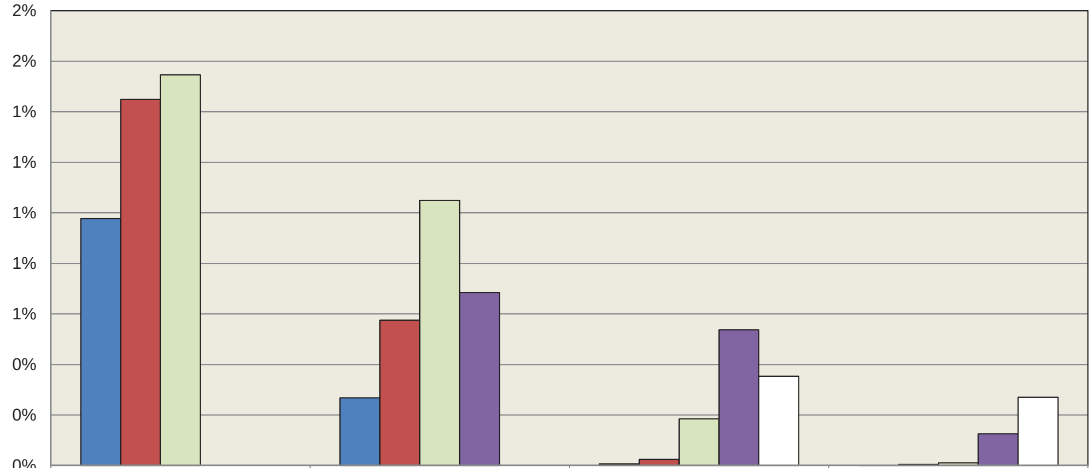
	26-35	36-45	46-55	56-65
Limit of 3 million	1.2%	0.6%	0.2%	0.1%
Limit of 2.2 million	4.2%	3.0%	0.9%	0.3%

Source: Employee Benefit Research Institute Retirement Security Projection Model,® version 1718.

Figure 3

Impact of Age and Tenure on Percentage of 401(k) Participants Reaching $3 million Limit (adjusted for inflation) by Age 65

(baseline assumptions with age adjustments on asset allocation)



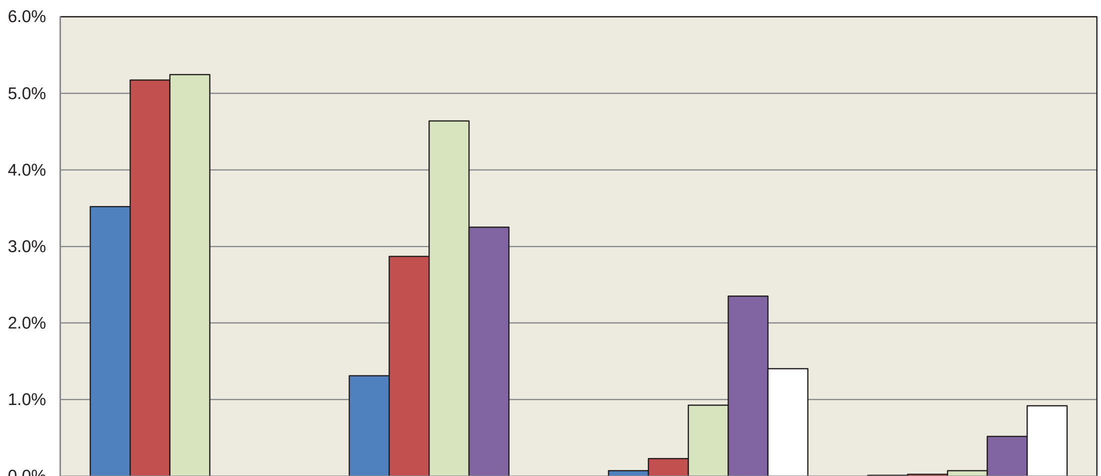
	26-35	36-45	46-55	56-65
1-4	1.0%	0.3%	0.0%	0.0%
5-9	1.4%	0.6%	0.0%	0.0%
10-19	1.5%	1.1%	0.2%	0.0%
20-29		0.7%	0.5%	0.1%
30+			0.4%	0.3%

Source: Employee Benefit Research Institute Retirement Security Projection Model,® version 1718.

Figure 4

Impact of Age and Tenure on Percentage of 401(k) Participants Reaching $2.2 million Limit (Adjusted for Inflation), by age 65

(baseline assumptions with age adjustments on asset allocation)



	26-35	36-45	46-55	56-65
1-4	3.5%	1.3%	0.1%	0.0%
5-9	5.2%	2.9%	0.2%	0.0%
10-19	5.2%	4.6%	0.9%	0.1%
20-29		3.3%	2.4%	0.5%
30+			1.4%	0.9%

Source: Employee Benefit Research Institute Retirement Security Projection Model,® version 1718.