NATIONAL CENTER FOR POLICY ANALYSIS

Limiting Retirement Account Growth Would Punish Saving

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President Obama's proposed 2014 budget includes a limit on the growth of tax-advantaged retirement accounts. Though Congress is unlikely to adopt his budget proposal, the idea of limiting retirement account accumulations could garner support among policymakers who favor wealth taxes.

Dallas Headquarters:
12770 Coit Road, Suite 800
Dallas, TX 75251
972.386.6272

www.ncpa.org

Washington Office:
601 Pennsylvania Avenue NW,
Suite 900, South Building
Washington, DC 20004
202.220.3082

However, limiting tax-advantaged accumulations violates a promise people relied on when they made deposits to these accounts.

What Are Tax-Advantaged Retirement Accounts? There are several tax-advantaged retirement savings options that allow an individual to contribute to an account that is invested in stocks and/or bonds. Contributions to traditional Individual Retirement Accounts (IRAs) and employer-sponsored 401(k) plans are made with pretax dollars and are taxed when the money is withdrawn at retirement. Contributions to Roth IRAs and Roth 401(k)s are made with after-tax dollars but accumulations can be withdrawn tax-free beginning at age 59 and one-half years.

Additionally, self-employed individuals or small business owners can establish simplified employee pension (SEP) plans for themselves and their employees. Individuals can participate in these plans in addition to making contributions to a 401(k) or IRA. SEP plans function much like 401(k)s except larger annual contributions are allowed, and the employer rather than the employee makes the contributions.

Contribution limits for each type of account vary. In 2013:

- The maximum annual contribution for a traditional IRA or a Roth IRA is $5,500 (savers age 50 and over can contribute an additional $1,000 annually).
- The maximum annual contribution for an employer-sponsored traditional 401(k) or Roth 401(k) is $17,500 (those age 50 and over may contribute an additional $5,500 annually).
- The maximum annual contribution for a SEP plan is the lesser of 25 percent of the employee's gross salary or $51,000.

The administration's proposal would cap the account balance, including reinvested dividends and interest, but would also affect contributions. The president's proposed 2014 budget notes that, "Under current rules, some wealthy individuals are able to accumulate many millions of dollars in these accounts, more than is needed to fund reasonable levels of retirement savings."

The budget claims that the proposed limit would be an amount "sufficient to fund an annuity [of] not more than $205,000 a year in retirement (beginning at age 62), or about $3 million for someone retiring in 2013." The 2013 limit could be subject to annual changes as interest rates rise and fall. Accordingly, if a retirement account accumulates more than the limit, the saver would have one year to report the excess as income and pay taxes due. But an accumulation limit would create a host of problems.

Problem: An Arbitrary Accumulation Limit Does Not Account for Geographical Differences in the Cost of Living. An arbitrarily set "reasonable" amount of tax-advantaged retirement income does not account for cost-of-

living differences. For instance, if a person retires in 2013, an annuity of $205,000 a year would buy $231,000 worth of goods and services in Temple, Texas, but only $133,000 worth in San Jose, California, where the cost of living is nearly two-and-one-half times higher. Thus, the limit would disadvantage residents of high-cost, high-tax areas.

Problem: An Accumulation Limit Favors One Financial Product over Another. When workers accumulate tax-advantaged savings, they have the option of choosing which financial product best fits their retirement needs. But a limit of $3,000,000 for an individual retiring this year would favor annuities over timed withdrawals. Consider:

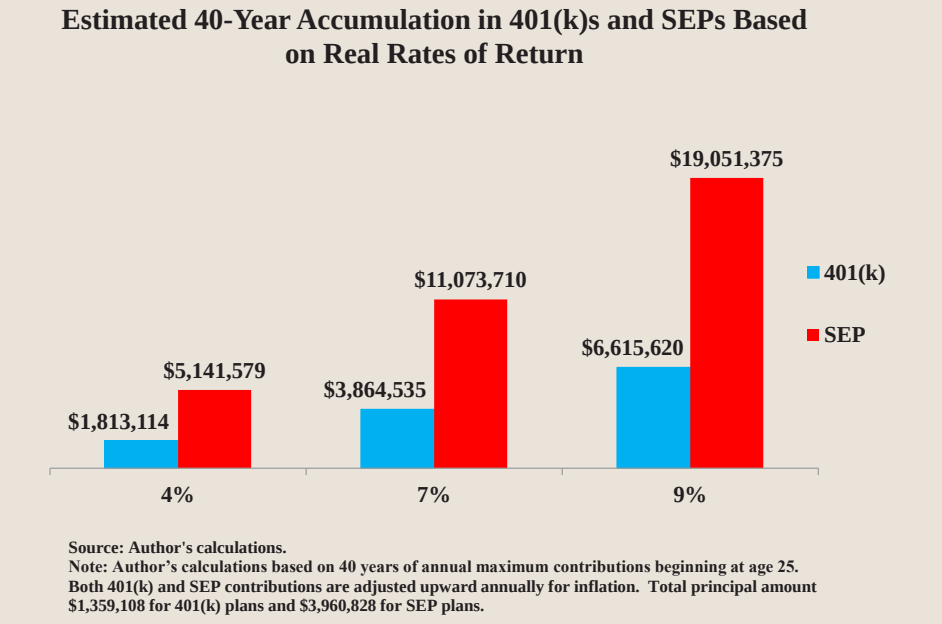
- Obama's budget assumes the 2013 limit of $3 million is sufficient to pay a lifetime annuity of about $205,000 a year.
- But an individual choosing programmed withdrawals of $205,000 a year would have to earn at least 6 percent a year on the remaining balance to ensure an annual income of $205,000 for 30 years of retirement.
- Thus, a retiree who does not choose an annuity must accumulate, roughly, an additional $3.6 million.

Problem: Accounts Could Easily Exceed What Is Needed to Fund a $205,000 Annuity after Adjusting for Inflation. Proponents argue that limiting retirement account accumulations would affect only a few savers. This is probably true, since the average soon-to-be retiree has not accumulated a savings account balance anywhere near what is necessary to fund a six-figure lifetime annuity.

But, in theory, a worker contributing the maximum allowed to a 401(k) plan (assuming the contribution limit was increased annually for inflation) for 40 years could easily have more than $3 million in a retirement account, depending on the rate of return [see the figure]. For example, assume 40 years of steady contributions to a 401(k) plan. With a 7 percent rate of return (before adjusting for inflation) compounded annually, the 401(k) account would have a balance of $6 million — the equivalent of $1.8 million in today's dollars — and fall within the "reasonable" limits defined by Obama's budget. However:

- With a 10 percent rate of return, the saver would have a balance of $12.9 million — the equivalent of $3.8 million in today's dollars, slightly higher than the "reasonable" limit defined by Obama's budget.
- With a 12 percent return, the saver would have a balance of $22.2 million — equal to $6.6 million today, far exceeding the limit.

Furthermore, the definition of "reasonable" could change every year, because the cost of a $205,000 lifetime annuity would vary annually based on current interest rates. Thus, what may not be considered excessive one year may be deemed excessive the next.



Problem: Simplified Employee Pensions (SEPs) Could Exceed Accumulation Limits. SEP plans have more generous contribution limits than 401(k)s or IRAs — up to $51,000 in 2013. However, if the current maximum contribution were adjusted annually for inflation, after 40 years [see the figure]:

- With a 7 percent rate of return over 40 years, a person would have $17.3 million — the equivalent of $5.1 million in today's dollars.
- With a 10 percent rate of return over 40 years, a person would have $37.2 million — or $11 million in today's dollars.
- With a 12 percent rate of return over 40 years, a person would have $64 million — or $19 million in today's dollars.

Solution: Level the Playing Field. An arbitrary accumulation limit attempts to level the outcome of tax-advantaged retirement accounts without leveling the playing field. Instead of taxing accumulations above a certain amount — essentially, punishing wise investment — policymakers should address the unequal contribution limits among the various plans.

Pamela Villarreal is a senior fellow with the National Center for Policy Analysis.