Re: Comments Concerning Internal Revenue Code Issues Relating to Private Sector Pensions and Social Security Reform

Dear Mr. Iwry:

This is the first of a series of discussion papers on Internal Revenue Code issues relating to private sector pension programs which may arise under various social security alternatives, prepared by members of the Committee on Employee Benefits.

These comments are presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

Sincerely,

Stefan F. Tucker
Chair, Section of Taxation

cc: The Honorable Alexis M. Herman, Secretary of Labor, Department of Labor
The Honorable Leslie Kramerich, Deputy Assistant Secretary for Policy, Department of Labor
The Honorable Donald C. Lubick, Assistant Secretary Tax Policy, Department of Treasury
The Honorable Stuart L. Brown, Chief Counsel, Internal Revenue Service
Mark Prater, Chief Tax Counsel, Senate Finance Committee
Russell Sullivan, Minority Tax Counsel, Senate Finance Committee
James D. Clark, Chief Tax Counsel, Ways and Means Committee - Majority
John L. Buckley, Chief Democratic Tax Counsel, Ways and Means Committee
Lindy L. Paull, Chief of Staff, Joint Committee on Taxation

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INTERNAL REVENUE CODE ISSUES RELATING TO PRIVATE SECTOR PENSIONS AND SOCIAL SECURITY REFORM

This written submission is presented on behalf of the Section of Taxation. Except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

Executive Summary

This is the first of a series of discussion papers on Internal Revenue Code issues relating to private sector pension programs which may arise under various social security alternatives. The paper does not advocate any of the social security alternatives discussed herein. Rather, it identifies the existing federal tax statutes that may have to be amended depending upon the proposal that is implemented. This paper was prepared by a Task Force consisting of individual members of the Committee on Employee Benefits of the Section of Taxation. Other issues the Task Force intends to address include issues under the Internal Revenue Code which may result from the use of individual accounts as an alternative and/or supplement to social security benefits, which accounts have been the subject of a number of legislative proposals. Hopefully, these observations will be useful to Congress, the Administration, and the public in considering the impact of any changes that are to be undertaken in the Social Security system on the Federal tax system and its support of private sector pension plans as the changes in the system are debated and ultimately enacted.

Potential changes to the Internal Revenue Code for social security reform are analyzed in this paper as falling into three broad categories. The first category of changes to the Internal Revenue Code are those that arise from changing the benefits provided under the system. The second involves steps to "privatize" part or all of the system through requiring private sector investments or allowing participants to maintain individual accounts. The third category includes various proposals to change the way in which revenues are raised to fund the system.

Date: June 15, 1999

Implications Of Benefits-Oriented Changes in Social Security on the Internal Revenue Code

Raise Retirement Age

Description of Possible Change in Social Security System

Several of the proposals to reform Social Security propose changing the normal retirement age and, in some cases, the early retirement age. These changes will alter when individuals will be able to retire with full benefits from the Social Security system or commence distribution of any benefits.
For example, the Committee for Economic Development ("CED") proposes raising the retirement age two months per year starting in 2000 until the normal retirement age reaches age 70 in the year 2030, with any change thereafter based on average life expectancy of American workers. The Individual Account ("IA") proposal and the Personal Savings Account ("PSA") proposal from the Social Security Advisory Council each would increase the retirement age, slated to increase from age 65 to 67 by 2011, proportionally with overall life expectancy after that point. The proposal from the CATO Institute, while generally advocating individual savings accounts, would limit distributions from the individual accounts until the individual reached early retirement age, which would be 65 for men and 60 for women.

Legislative proposals from Senator Moynihan, Representative Porter, and Representative Smith propose raising normal retirement age above age 67 and indexing it thereafter based on life expectancy. Similarly, Rep. Smith would increase early retirement to age 65 and indexed thereafter.

The American Academy of Actuaries estimates that raising the normal retirement age gradually to age 70 for beneficiaries reaching that age in 2037 and later would solve about half of the long-range problems of Social Security.

Major Economic and Social Changes that May Result

Potentially the greatest change to employer-sponsored plans that could be caused by changing the eligibility age for unreduced or early Social Security benefits could be the anticipated change in retirement patterns of workers. The change in retirement patterns could take several different forms, but primarily the expected change would be to have workers remain in the work force for longer tenures, either at the same position or at a different job, with potentially reduced hours or responsibilities. This anticipated delay in exiting the work force could affect employee benefit plans in several ways.

Workers remaining in the work force for longer tenures, but at different positions will increase job transition costs for employers. Additionally, having older workers remain in the work force, regardless of their position, hours, or responsibilities, will increase the disability and other health-related expenses for active employees. (It will also, on the other hand, reduce expenses for retiree medical plans, since the individuals will not be eligible for coverage under those plans as active employees.)

For example, it can reasonably be anticipated that if Social Security retirement age is increased, the age for commencing Medicare benefits may also increase. Since most employer-sponsored retiree medical plans provide benefits that are integrated with Medicare benefits, delaying Medicare benefits would extend the time that a retired employee is primarily covered under the employer-sponsored retiree medical plan. A longer period of primary coverage under such plans will affect the cost of providing such plans to employees.

Because many employers have changed or limited the scope of their liability under retiree medical plans in recent years, the full impact of shifting the retiree medical liability from Medicare to employer-sponsored plans is unclear. Employers that have recently changed the scope of coverage may take the view that such change will automatically limit that liability (such as plans that have been amended to contain a lifetime maximum on benefits). Other employers
may adopt similar changes. Accordingly, the end result will be a shift of liability either to employers that do not change the terms of coverage under their retiree medical plans or to employees who are covered under plans with appropriate limits on coverage or whom an employer does not cover.

Another pattern that can be anticipated is an increased shift away from "traditional retirement" to "phased retirement." Traditional retirement is when a worker totally leaves the work force and commences distribution of his or her entire retirement benefit. A phased retirement is when a worker remains employed but at a reduced work schedule and earns reduced wages, but simultaneously receives a portion of his or her pension benefit. The combination of reduced wages and distribution of a portion of the pension benefit results in the individual continuing to receive a similar or slightly reduced amount of income from the combined sources.

Areas of Possible Amendments to Existing Statutes

Code Section 401(l)
The permitted disparity rules of section 401(l) and many defined benefit plans refer to Social Security retirement age. For example, the permitted disparity rules require a reduction in the permitted disparity factor if benefits commence prior to Social Security retirement age, regardless of the plan’s normal retirement age. Currently, the reduction factors are set forth in tables based on the Social Security retirement ages of 65, 66, and 67, depending on the employee’s date of birth. Changing Social Security retirement age to a variable age that fluctuates with the longevity of workers will require changing the permitted disparity rules to reflect this change in the reduction of the disparity factor.

Code Section 411(a)(8)
Section 411(a)(8) of the Internal Revenue Code of 1986 (the "Code") defines normal retirement age, which is used for a variety of purposes by qualified plans, such as determining compliance with vesting requirements or the accrual rules. Additionally, the plan’s definition of normal retirement age is used for determining when benefit payments commence under section 401(a)(14). The Small Business Job Protection Act ("SBJPA") changed the Code to treat Social Security retirement age as a uniform normal retirement age for purposes of the permitted disparity and other nondiscrimination regulations, but not for other purposes under the Code.

Further delaying Social Security retirement age (coupled with other potential changes to the Social Security system) could so significantly change retirement patterns that plan designs should reflect different retirement ages for different participants. In order to permit such plan designs, Social Security retirement age should be considered as a definition of normal retirement age under section 411(a)(8) for benefit accrual and vesting purposes and section 401(a)(14) commencement date purposes.

Code Section 411(d)(6)
If normal retirement age for benefit accrual purposes is changed to reflect the definition of Social Security retirement age, pension plan documents will have to be changed to reflect this. IRS officials have informally indicated their belief that the definition of normal retirement age that is attached to a benefit accrual is protected against plan amendment by section 411(d)(6).
Therefore, legislative relief from section 411(d)(6) will be necessary to permit plans to change the definition of retirement age, or all pension plans will have to be administered to reflect one retirement age for benefits accrued before the change and another retirement age for benefits accrued after the change. This would be an administrative burden of monumental proportions for plan sponsors and administrators.

Code Section 401(a)(4)

For plans that satisfy the nondiscrimination rules using the general nondiscrimination test, accrual rates of highly compensated employees are compared to accrual rates of nonhighly compensated employees, with accrual rates determined at normal retirement age. There are several changes to the general nondiscrimination test that would be desirable if Social Security retirement age is delayed. Similar to the permitted disparity rules discussed above, the imputed disparity rules will have to reflect the delayed age in determining the imputed disparity factor for early retirement. Additionally, it would be preferable to determine accrual rates at Social Security retirement age, rather than at normal retirement age, in order to reflect the change in plan design and retirement patterns prompted by the delay in receiving Social Security benefits.

Code Section 401(a)(9)

Another Code section that should be reconsidered is section 401(a)(9), which governs minimum distribution requirements from qualified plans. As a result of the enactment of the SBJPA, minimum distributions may be required at the later of attaining age 70 ½ or retirement. Though none of the Social Security reform proposals would delay Social Security retirement age to age 70 ½, most reform proposals would increase the age based on longevity data. With the potential for Social Security retirement age to increase to a point relatively close to the minimum distribution commencement age, the point for commencing minimum distributions should be reconsidered. It seems incongruous to have the earliest age for commencing unreduced Social Security benefits be nearly the same as the latest age for commencing distribution of benefits from qualified employer-sponsored retirement plans.

In-Service Distributions

Finally, if phased retirement becomes an increasing trend, as can reasonably be expected, the distribution rules for qualified pension plans should be revised. Currently, distributions from pension plans to active employees are permitted only after the employee has attained normal retirement age under the plan. The prohibition on distributions to active employees applies regardless of whether the employee is working in a full or part-time situation. Thus, the current distribution rules would prohibit a phased retirement distribution to an employee who has not attained normal retirement age.

A change to the in-service distribution rules can be accomplished without a legislative change. The prohibition on distributions to active employees is based on several Revenue Rulings interpreting Treas. Reg. 1.401-1(b)(1)(i), which defines pension plans as providing for "the payment of definitely determinable benefits to...employees over a period of years, usually for life, after retirement." The rulings that interpret the regulation have limited the application of the phrase "after retirement" to distributions commencing after normal retirement age. But there is no reason the IRS could not interpret the phrase to include distributions to active employees who have attained early retirement age and could commence distribution of benefits under the plan if they separated from service.
Decrease Benefits Formula

Description of Possible Change in Social Security System

There have been several proposals to change the Social Security benefit formula to reduce the level of benefits in relation to beneficiaries’ career-average earnings. The Social Security benefit formula calculates a monthly benefit amount (the Primary Insurance Amount or PIA) that is a percentage of the beneficiary’s average indexed monthly earnings subject to Social Security taxes (AIME). The formula is progressive, providing a lower "replacement" of average earnings at higher levels of earnings. The formula breaks AIME into three ranges. The benefit is based on 90 percent of monthly earnings below $505 (1999), plus 32 percent of the monthly earnings between $505 and $3,043 (1999), plus 15 percent of earnings above $3,043 (1999). Social Security benefits replace 90 percent of earnings for the very lowest wage earners and 24 percent of earnings for workers at Social Security’s highest covered earnings. The benefits replace 42 percent of average earnings for a career worker earning average wages and retiring at age 65 today. Social Security uses a wage index to adjust both the AIME and the formulas "bend points" or dollar levels where the replacement percent changes, in order to maintain current replacement rates into the foreseeable future.

Proposals to change the Social Security benefit formula would either reduce benefits across-the-board, or make specific changes in the benefit formula to shift the distribution of benefits among different groups of workers. The proposals fall into three categories:

1. Reduce benefits by a uniform percentage across all levels of earnings (maintaining the current progressive "tilt" of the formula). The CED, for example, discusses an across-the-board reduction in benefits. This could be accomplished by reducing the percentage amounts in the formula (i.e., 90, 32, 15) to reduce all PIAs by a uniform percentage. The reduction would have to be phased in over several years to avoid a significant "notch" in benefits between retirees reaching age 65 in different years. An alternative approach that would achieve a similar result would be to switch from wage indexing to price indexing in the AIME. Over time, AIMEs would decline relative to current wage levels, gradually lowering relative benefit payments (while maintaining real benefits). The drop in benefit payments would be more rapid if the indexing of the formula "bend points" were shifted from wages to prices as well.

2. Reduce benefits by a different percentage at different levels of earnings (changing the "tilt" of the formula). An alternative included in the IA proposal from the Advisory Council on Social Security would make the benefit more progressive by lowering replacement rates only for middle and/or upper earnings beneficiaries. Under this approach, the lowest replacement rate (90% of the first $505) would remain unchanged. The 32 and 15 percent rates would be gradually lowered to 22.4 and 10.5 percent, respectively, over 30 years. Alternatively, a similar result could be accomplished gradually by switching from wage to price indexing of the "bend points." Assuming slower price than wage growth, this would result in a higher percentage of the wage-indexed AIME sliding above the bend points and being subject to lower replacement rates. Benefit levels would be sustained for lower-income workers, while being reduced for middle- and upper-income beneficiaries.
3. Extending the number of years of covered employment for full benefits. The Social Security Advisory Council also included in the Maintenance of Benefit ("MB") and IA options a recommendation to extend the number of years of earnings included in the computation of Social Security benefits. Similarly, the Moynihan and Smith legislative proposals included an increase in the number of benefit computation years. Currently, Social Security benefits are calculated based on the average of the highest 35 years of covered earnings. Beneficiaries who continue to have earnings can substitute later years of high earnings for earlier years of low earnings. The Advisory Council recommends extending the number of years of earnings to 38 – in keeping with the scheduled increase in the age of eligibility. The increase in years generally would not affect workers with a 38 year work career, but it would lower benefits by up to about 7% for those that work 35 or fewer years. The CED proposes extending the number of years to 40. The American Academy of Actuaries estimates that this type of change can produce almost any desired amount of savings.

Major Economic and Social Changes that May Result

Reducing Social Security benefits in relation to lifetime earnings would reduce the role that Social Security plays in providing retirement income. This would most likely lead to a decline in retirement income relative to workers’ wages, and a freeze in the standard of living of the elderly and disabled. Future elderly might be able to buy the same market basket of goods and services as today’s elderly, but would not share in the rising standard of living of future workers.

The net reduction in retirement income would depend on the extent to which workers increased private pension accumulations and savings to offset the Social Security reductions. Without a reduction in Social Security taxes there would be no additional income to stimulate savings and pensions. Any increase in savings would come as the result of an increased propensity to save or decreased consumption. Barring any other change in retirement savings incentives, an increased propensity to save is likely only as a result of greater anxiety among workers about their retirement income adequacy.

An across-the-board reduction in Social Security benefits would have a significant effect on the retirement incomes of the workers with the lowest earnings -- those least likely to make up the difference with pensions and savings -- contributing to an increase in poverty rates among the elderly. Some of the government’s savings in the Social Security Trust Funds would be offset by an increase in federal budget spending in the general budget on Supplemental Security Income ("SSI") and Medicaid.

A cut in benefits focused on the middle and upper earnings groups would increase the amount of income redistribution in the Social Security program, reducing the earnings-relationship of the benefits. The return on contributions, which is already near zero for some younger contributors, would decline significantly at upper earnings levels – running into negative returns for some groups. This could be expected to fuel a renewed interest among middle- and upper-income workers in "cashing-out" of Social Security or in reforming Social Security to provide individual accounts and investment opportunities.

A cut in Social Security benefits would also increase the pressure for increases in employer provided retirement benefits. In defined benefit plans, the reduction in Social Security benefits
would cause an automatic increase in pension benefits paid from defined benefit pension plans that use an "offset" type of Social Security integration. Pension plans with other forms of integration (excess or offset) or with no integration would not be directly affected. Plan sponsors would be likely to increase the pace at which they are already moving away from offset integration. It is also likely that plan sponsors would be pressured by workers to adjust pension benefits to make up for the Social Security reduction.

Areas of Possible Amendments to Existing Statutes

Any effort to increase pension benefits under qualified plans to make up for the Social Security benefit reductions would require a number of legislative changes. In general, the cutback in Social Security would directly shift costs for retirement benefits to employers sponsoring defined benefit plans integrated with Social Security. Employees with other types of retirement income would have costs shifted directly to them. Their losses would have to be made up either through voluntary increases by their employers in employer contributions or through an increase they would make themselves in elective deferrals or individual savings. In any of these instances, employees would most likely forgo wages to finance increased pension benefits.

Increases in tax qualified retirement savings would not generally be possible without a substantial restructuring of the retirement income and savings incentives and limits in the Code. This would require a complete rethinking of retirement income policy in relation to the role that Social Security would be playing. There are several other, more specific areas where statutory changes would be needed to respond to reductions in Social Security benefits.

Code Section 401(l)

Increasing benefits for middle- and upper-income workers without adjusting lower-income workers’ benefits would conflict with the permitted disparity rules of section 401(l). Both the excess and offset integration rules (for defined contribution and defined benefit plans) would need to be adjusted to permit a greater disparity in accrued benefits. The integration rules would have to be adjusted only to accommodate plan sponsors that wanted to avoid increasing pension payments to lower-income workers by increasing the amount of disparity in pension benefits above the current maximum disparity. Plan sponsors would be able to maintain or reduce their benefit adjustments in response to Social Security benefits without a change in statute. In addition, if the number of years of Social Security coverage were extended, the definition of "covered compensation" for integration purposes would have to be adjusted as well.

Code Sections 415, 401(a)(17), 401(k), 403(b), et al.

If Social Security benefits were reduced, private pensions could not be increased significantly without an increase in section 415 contribution and benefit limits, 401(a)(17) maximum benefit amounts, 401(k), 403(b), SIMPLE, IRA, and other pension and retirement savings limits. The entire area of tax-deferred retirement savings would have to be reviewed to develop an appropriate set of limits that permitted an increased level of private savings.

Pension and savings limits would be a particular problem if Social Security benefits were reduced only at the higher levels for middle and higher earnings workers. Without an increase in contribution and benefit limits, corporations would be driven to providing retirement benefits for
middle-income workers through nonqualified deferred compensation plans. These arrangements would greatly increase the risk of benefit loss or forfeiture for middle-level workers.

Using nonqualified deferred compensation arrangements to provide additional benefits to middle-income workers also has significant cost implications for employers beyond the costs associated with simply providing additional benefits. Nonqualified deferred compensation plans for middle-income workers are likely to be subject to ERISA, triggering funding and vesting requirements for such plans that will have deleterious tax consequences on both the employer and employee. In short, if employer-sponsored retirement benefits must increase to a level not currently permitted by qualified plan limitations, employers must shift benefits from a tax advantaged savings vehicle to a tax disadvantaged savings vehicle.

Code Sections 401(k), 401(m), and 416

In addition, if Social Security benefits were reduced only for middle- and upper-income workers, the section 401(k) and 401(m) non-discrimination tests, and top heavy rules (section 416) would have to be reviewed to determine whether they provided sufficient room for employers to raise benefits for this group.

Decrease COLA or Adjust CPI

Description of Possible Change in Social Security System

Several Social Security reform proposals would change the cost-of-living adjustment ("COLA") for benefits. The National Taxpayers’ Union Foundation supports a one-year freeze of the COLA, followed by a COLA based on the Consumer Price Index (CPI) minus 0.5 percent.

As a separate proposal, Congress and several other organizations are considering whether the CPI is an accurate representation of inflation and its effect on the purchasing power of American consumers. The Senate Finance Committee-created Advisory Commission to Study the Consumer Price Index (occasionally referred to as the Boskin Commission, in recognition of its chair, economist Michael Boskin) has recommended several changes in the methodology of determining the CPI to reflect what it terms various "biases" in the current system. The report of the Advisory Commission has stirred substantial debate and alternate proposals on how to adjust the CPI. As a practical matter, any modification to the CPI would be equivalent to a phased-in, across-the-board reduction of benefits with an increasingly negative impact on the return for Social Security contributions for younger and future Social Security beneficiaries.

The American Academy of Actuaries estimates that reducing each future COLA by one percentage point would eliminate about two-thirds of the long-range deficit.

Major Economic and Social Changes that May Result

Reducing the COLA for Social Security benefits would reduce the purchasing power and income replacement power of recipients and would affect long-lived retirees most. Over time, the reduced value of Social Security benefits will place additional pressure on employer-sponsored retirement plans to provide sufficient retirement income, especially in the form of annuity income streams, to ensure that a retiree’s retirement income lasts as long as needed. Specifically,
it can be anticipated that a reduction in the COLA for Social Security benefits will result in increased pressure on employer-sponsored retirement plans to provide a COLA feature in order to compensate for the loss of purchasing power from Social Security benefits.

Any pressure to reexamine whether a plan is providing sufficient retirement income, and especially any pressure to add or increase a COLA feature to a qualified retirement plan, will fall exclusively on defined benefit plans. Defined contribution plans cannot provide a COLA feature as such and are less likely to be examined with regard to the income replacement ratios the plan provides, since that is so dependent on the investment experience of each individual employee.

Like a change in Social Security retirement age, a change in the COLA for Social Security benefits is likely to result in a similar change in the adjustment for Medicare benefits. Because employer-sponsored retiree medical plans are coordinated with Medicare, any reduction in the benefits provided to retirees from Medicare results in a corresponding increase in the benefits that are provided from employer-sponsored plans.

While these potential issues that result from changing the COLA for Social Security benefits are significant, it can be fairly said that changing the COLA affects the Social Security benefit, but changing the CPI changes everything. It is almost impossible to understate the significance of potential economic and other changes affecting retirees and employer-sponsored plans that will result from any change in the method of determining the CPI. Any adjustment in how the CPI is determined will have implications on every aspect of the economy and all government entitlement programs.

Because of its potentially far-reaching affect, a complete discussion of the effect a change in the determination of the CPI would have on employer-sponsored benefit plans is beyond the scope of this paper. At its most fundamental level, a change in the CPI determination methodology could require a reexamination of every pension plan in the country in order to determine whether the plan is providing sufficient or excess retirement income replacement ratios and whether the plan is still serving the employer’s retirement policy.

Areas of Possible Amendments to Existing Statutes

The Task Force was unable to identify any change to the Code or the Employee Retirement Income Security Act of 1974 ("ERISA") that would be required because of a change in the Social Security COLA. Accordingly, all potential changes mentioned below are with respect to a change in the CPI.

Code Sections 415 and 401(a)(17)

There is a direct relationship between a change in the CPI and several of the various limits applicable to qualified retirement plans. The limits on contributions and benefits for qualified plans under section 415 and the compensation limit under section 401(a)(17), among others, are indexed based on increases in the third quarter CPI over a base period CPI. However, while a change in the method of calculating CPI would directly affect the adjustments to the various qualified plan limits, it does not appear that a change in the provisions of the Code would be required. Section 415(d), which is the primary Code section for increasing the various qualified plan limits, incorporates the limits by reference so that the CPI, however its adjustments are determined, is used for adjusting the qualified plan limits.
Similarly, a change in how the CPI is calculated will have a direct affect on the funding of defined benefit plans, but a change to the funding provisions of the Code and ERISA does not appear to be required. Funding of defined benefit plans will be affected because a change in the CPI will have a indirect effect on interest rates and interest assumptions used in funding calculations.

Means Testing
Description of Possible Change in Social Security System

One category of proposals, including the legislative proposal of Rep. Smith, would introduce a "means test" for eligibility for Social Security benefits. Such a test might relate to income or net worth or both and would cause a reduction or elimination of the applicant’s Social Security benefit commensurate with the level of income or net worth.

Major Economic and Social Changes that May Result

Introduction of such a limitation might lead to a number of consequences. For example, a means test might discourage employers from sponsoring pension or profit-sharing programs or discourage employees from saving for retirement under a section 401(k) tax-deferred savings program. Sponsoring or involvement in the private pension system would be discouraged, because a direct consequence of receiving a pension or having an account balance might be the reduction or elimination of Social Security benefits.

Other significant consequences of imposing a means test include an effect on the timing of various elements of a worker’s retirement income. Retirees might seek to accelerate or delay receipt of lump-sum distributions or other benefits from qualified plans in order to manipulate the receipt of Social Security benefits. For example, someone might receive a lump-sum distribution of his or her qualified plan benefit prior to becoming eligible for Social Security benefits and then be considered eligible for full Social Security benefits under an income-based means test. Alternatively, the individual could take the lump sum distribution of his or her qualified plan benefit prior to becoming eligible for Social Security benefit and then dispose of it in some fashion in order to be considered eligible for full Social Security benefits under a net-worth-based means test.

A means test could also be viewed as a significant "marriage penalty" for married retirees. Distributions from a spouse’s pension could reduce or eliminate an individual’s Social Security benefit, when no such reduction could be incurred if the couple were not married. In addition to issues of equity involved in such a situation, the economic relationship between a Social Security means test and pension benefits could significantly change spouses’ patterns in consenting to qualified joint and survivor annuity distributions or other types of pension distributions.

An annual income-based means test could also significantly affect benefit elections by participants. Provision of a lump sum distribution or an annuity distribution would have different impacts. If an annuity were of a comparatively small amount, an employee would be encouraged not to elect a lump-sum because having the lump sum might cause loss of Social Security benefits in the year of distribution. If the annuity benefit were high enough to potentially trigger
the means test, then the employee would be advised to take the benefit in a lump sum so that the means test would apply for one year and full Social Security benefits would be payable in future years.

A means test would also change the underlying philosophy behind the integration of pension plan benefits with Social Security benefits. Currently, employers are allowed to provide greater benefits to higher-income workers because Social Security provides greater benefits, as a percentage of pay, to lower-income workers. The premise of integration is that taking both the employer-sponsored pension benefit and the employer-paid Social Security benefit into account, the total employer-provided retirement benefit is nondiscriminatory. If a means test takes into account distributions from employer-sponsored retirement plans, a greater pension distribution would result in a smaller Social Security benefit.

Areas of Possible Amendments to Existing Statutes

Code Sections 401(l) and 401(a)(4)

There are at least two statutory provisions affecting employer-sponsored retirement plans that would require amendment if a means test is applied to Social Security benefits. The provisions and regulations dealing with integration of social security benefits, such as section 401(l) and regulations under section 401(a)(4), would have to be reexamined in light of the change in the relationship between private pension benefits and Social Security benefits. Arguably, the philosophical underpinnings of integration of pension benefits and Social Security benefit would be so altered that integration should no longer be allowed. This would be a change in pension regulation that would not only dramatically affect a significant percentage of private pension plans, but would also require substantial lead time to implement without unduly increasing employers’ costs.

Even if integration continues to exist after a means test is added to the Social Security benefit program, many of the technical rules and requirements affecting the amount of integration would have to be reconsidered. For example, the amount of permitted disparity in a qualified retirement plan currently has to be reduced if the participant commences distribution of benefits prior to attaining Social Security normal retirement age. That reduction should be reconsidered in light of the effect that such early commencement of benefit will have on the application of the means test to the participant’s Social Security benefit.

Code Section 401(a)(9)

Additionally, the minimum distribution rules under section 401(a)(9) should be reconsidered. Currently, the minimum distribution rules require participants to commence distribution of pension benefits no later than the April 1 following the later of the year in which the participant attains age 70 ½ or the year in which the participant retires. As currently drafted, the minimum distribution rule is intended to prevent participants from delaying distribution of retirement benefit so long that the primary purpose of the benefit becomes a generational wealth transfer mechanism. This follows from the requirement that the primary purpose of a qualified retirement plan is to provide retirement benefits, not death benefits.

However, if a means test is added to the Social Security program, the date for required commencement of retirement distributions might have to be accelerated in order to avoid
allowing participants to time distributions in order to maximize Social Security benefits. For example, minimum distributions could be required to begin the year after the participant attains Social Security normal retirement age.

Tax Benefits
Description of Possible Change in Social Security System

Social security benefits are currently taxable to a limited extent for taxpayers with higher levels of income. The current rule is that 85 percent of such benefits are taxable for recipients with income above $44,000 in the case of joint filers and $34,000 for single filers. This does not apply to recipients with income below $32,000 in the case of a joint return and $25,000 in the case of a single return.

Social Security reform proposals could consider either moving the 85 percent level to a higher percentage, such as 100 percent, or to dropping the dollar thresholds to lower levels, thus making 85 percent of all Social Security benefits subject to taxation.

The American Academy of Actuaries estimates that if the entire portion of any benefit taxation increase is allocated exclusively to Social Security (instead of Medicare), the total could meet nearly one-fourth of Social Security’s long-range deficit.

Major Economic and Social Changes that May Result

If a higher percentage of Social Security benefits were included in taxable income, either by increasing the taxable percentage of benefits or by decreasing the dollar threshold, the disposable income of retirees would be directly reduced. Additionally, such an increase in taxation would be highly regressive, affecting retirees with retirement income below the current dollar thresholds. Countering the regressive nature of the increase, however, would be the standard deduction and personal exemptions, which would protect low-income taxpayers from the income tax.

At its most fundamental economic level, increasing the amount of Social Security benefits included in taxable income is an imposition of an income-based means test. The application of the income tax serves as the reduction in Social Security benefits, with a maximum reduction in benefit equal to the highest marginal income tax rate in effect. Accordingly, all comments previously made concerning the impact of an income-based means test to Social Security benefits on private retirement plans also apply, albeit to a lesser extent, to an increase in the tax levy applied to Social Security benefits. The following comments deal with tax policy issues related to such a potential increase.

Inasmuch as Social Security benefits represent a recovery of contributions made to the system, taxing benefits represents a double taxation of a portion of the Social Security benefits. Contributions to the system ("FICA wages") are generally subject to income tax at the same time FICA taxes are withheld. The most significant category of FICA wages that are not subject to income taxation is elective deferrals to a cash or deferred arrangement under a section 401(k) plan. Most other major categories of FICA wages, such as current compensation, are taken into
Areas of Possible Amendments to Existing Statutes

To the degree that increasing the amount of Social Security benefits included in taxable income is an imposition of an income-based means test, the previous comments concerning the adoption of an income-based means test are similarly applicable. There do not appear to be any other aspects of tax law or of pension law that would require change as a direct result of such an increase in Social Security taxes.

Spousal Issues

Description of Possible Changes in the Social Security System

The Social Security Advisory Council recently recommended increasing the Social Security surviving spouse benefit to the higher of the decedent's benefit (that is, the present survivor's benefit) or 75 percent of the combined benefit that the survivor and decedent spouse were receiving when both were alive. In support of this change, the Council relied on statistical studies that suggest that it costs retired survivors about three-fourths as much to live as it takes retired couples. To partially pay for the cost of increasing the benefits for surviving spouses, the Council recommended cutting the spousal benefit from 50 percent to 33 percent of a worker's benefit (or to a flat dollar amount).

The MB proposal made no other significant recommendations with respect to spousal benefits. On the other hand, both the IA proposal and the PSA proposal recommended adding a second-tier of Individual Retirement Savings Accounts ("IRSAs") on top of the basic Social Security system; consequently, both considered the issue of spousal rights for IRSAs.

Under the IA plan, when a worker elected to retire (at any time after age 62), the accumulated funds in individual accounts would be converted to single or joint minimum guarantee indexed annuities. (The minimum guarantee provision would assure that something would be payable even if the individual died immediately; for example, the IA plan suggests that an amount equal to at least one year's worth of annuity might be paid to the estate of a worker who died soon after retirement.) As for married workers, the IA plan would follow the usual rules for defined benefit plans; that is, a married worker would have a choice (with consent of the spouse) on whether to take a single-life or a joint and survivor annuity.

Also, if a worker died before reaching retirement age, the accumulated funds would inure to the surviving spouse and would be payable (in the form of an annuity) when the surviving spouse became eligible for widower's benefits at age 60. If the worker died without leaving a surviving spouse, the accumulated funds would go to the worker's estate. Finally, it appears that rules similar to those for Qualified Domestic Relations Orders ("QDROs") would allow courts to split individual accounts at divorce or separation.

Under the PSA plan, workers would be permitted to purchase annuities at retirement with some or all of the funds accumulated in their PSAs, but they would not be required to do so. As for
married couples, each worker's PSA would be separate from any accounts the spouse might be accumulating. Spouses would be allowed to inherit each other's accounts, and, PSAs presumably could be split at divorce or separation under the usual QDRO rules. Beyond that, it would appear that a spouse would have no inherent rights in a worker's account, not even the right to information about the balance.

Under the CED's Personal Retirement Account ("PRA") plan, at retirement, the funds accumulated in individual accounts could be withdrawn only gradually, presumably through forced annuitization of account balances. No early withdrawals or borrowing before retirement would be permitted. PRAs would also be subject to the usual ERISA rules governing private pension plans, section 401(k) plans, and IRAs, revised as needed. That presumably means that PRAs would be subject to the usual defined contribution plan rules (e.g., QDROs).

Major Economic and Social Changes that May Result

Social Security currently provides generous spouse and surviving spouse benefits and these benefits are over and above the benefits that are earned by individual workers. Moreover, because of Social Security's progressive benefit formula, workers with high lifetime earnings subsidize the benefits of other workers and their families. The net effect of these provisions is that the Social Security system is pretty generous for women in general, and for married nonworking women in particular. Women are the principal recipients of spousal benefits, women tend to live longer than men, and women tend to have lower lifetime earnings than men. Of particular importance is the fact that for millions of elderly widows, these subsidized Social Security benefits are the only thing standing between them and poverty.

On the other hand, with IRSAs, there would be no redistribution at all. Payroll contributions and the earnings on those contributions would remain in individual accounts, and no money would ever be taken from a worker's account to provide benefits for other workers or their families. Of course, it might make sense to compel individual workers to share their retirement accounts with their own spouses, divorced spouses, surviving spouses, and other survivors, but there would be no redistribution to other workers or their spouses; nor would there be any loss of benefits to the worker and his or her family.

Marriage per se does not affect the Social Security tax liabilities of the individual workers who marry, but it can greatly affect their benefits. Consequently, there are significant marriage penalties and bonuses, and couples with equal total earnings can receive dramatically different amounts of benefits, depending upon how much is earned by each spouse.

On the other hand, with IRSAs there would be no marriage penalties at all. Marriage simply would have no impact on the balance in an individual worker's account. Again, it might make sense to compel individual workers to share their retirement accounts with their own spouses, divorced spouses, and surviving spouses. But there would be no redistribution to other workers or their spouses; nor would there be any loss of benefits to the worker and his or her family.

While IRSAs look a lot like bank accounts, Social Security looks more like a joint and survivor annuity program. At retirement, a worker covered by Social Security is not allowed to withdraw the balance of some bank account, real or hypothetical. Instead, at retirement, Social Security provides monthly benefits over the course of the worker's life. Moreover, if a worker is married,
the Social Security benefit looks like a joint and two-thirds survivor annuity, and Social Security benefits are indexed for inflation. The "two-thirds" survivor component reflects the fact that the survivor benefit (100 percent of the worker's PIA) is two-thirds of the married couple's benefit during life (150 percent of the worker's PIA for a worker plus spouse). In short, Social Security provides a forced, indexed, joint and two-thirds survivor annuity to married couples.

On the other hand, it is not at all clear that IRSAs would be required to pay out benefits in a way that mimics Social Security. In the simplest case, there might be no limitations on withdrawals (or borrowing) from IRSAs. Alternatively, IRSAs could fall under the usual ERISA rules governing pensions.

Currently, the political environment seems inhospitable to a total privatization of Social Security. Rather, it seems more likely that Social Security benefits could be reduced and reformed, and a second tier of IRSAs might be added on top. These IRSAs might incorporate significant spousal protections. In particular, significant limits might be placed on distributions out of the basic amount needed to protect individuals and couples from poverty. Beyond that basic amount, however, more relaxed distribution rules might apply.

Both pieces of a reformed two-tiered Social Security system might be designed to ensure that all individuals and couples have adequate incomes throughout their retirement years. For example, a system might be designed that ensured that all elderly citizens have retirement incomes at least equal to the poverty level. (In 1998, the poverty level for a single individual was $8,050 and the poverty level for a couple is $10,850. The poverty income guidelines used here are those applicable to all States (except Alaska and Hawaii) and the District of Columbia. Like current Social Security benefits, these numbers are adjusted for inflation each year.) To meet that target, individuals and couples would need to have the equivalent of an indexed joint and survivor annuity that is targeted at 100 percent of the poverty level.

A first-tier Social Security benefit could provide a sizable portion of this minimum benefit, but the balance would need to come from the second-tier IRSA accounts. Consequently, significant limits might be placed on IRSA distributions. Specifically, basic balances might be available under just three options:

1. A 100 percent payout to purchase an indexed joint and 75 percent survivor annuity that, when coupled with the first-tier Social Security benefit, results in sufficient annual income to meet the 100 percent of poverty standard.

2. Withdrawals as desired with the constraint that the amount remaining in the account after withdrawal must always be at least 110 percent of the amount (or some other level considered sufficient to provide enough financial security) necessary to purchase an annuity guaranteeing the 100 percent of poverty standard.

3. A combination of 1 and 2.

For those individuals and couples who retired with IRSA balances in excess of the amount needed to meet the minimum targeted benefit level, restrictions on withdrawals might still be imposed. Restrictions on such large IRSA balances might include compelled annuitization of excess balances for all but the most extraordinarily large accounts, and compelling the same joint and 75 percent survivor approach applicable to basic balances might be considered. Loans from IRSAs might also be limited unless the account had an extraordinarily large balance.
Alternatively, IRSAs might be subjected to the usual QJSA/QPSA and QDRO regimes. At the very least, spouses might be guaranteed information about their spouse’s IRSAs and might be required to give consent to any significant withdrawals.

Areas of Possible Amendments to Existing Statutes

The Task Force was unable to identify any change to the Code or ERISA that would be required because of changes in Social Security spousal benefits.

Implications Of Privatization Options on Tax Qualified Plans

This section discusses the privatization options with an emphasis on how they will affect employee benefits. Privatization is the most controversial part of Social Security reform. However, our focus is not whether privatization is a good idea, but rather, what are its effects on employee benefits. Proponents of privatization are now referring to it as "using private sector investments," which explains the concept more accurately. However, for ease of reference, the term "privatization" will continue to be used in this comment.

How can Social Security use private-sector investments? There are three ways they can be invested:

- The Social Security Administration (as fiduciaries for beneficiaries) could invest the trust funds directly in the private sector.
- Individuals could do it through individual accounts.
- Employers of plan sponsors and fiduciaries could do it through private pension plans.

Change Investments

Description of Possible Change in Social Security System

If Social Security invests the funds in the private sector, more benefits can be afforded with the same contribution. The MB proposal uses this method.

Major Economic and Social Changes that May Result

Under the MB scenario, stock prices will go up, giving great appreciation to investors who were already invested. However, future yields would probably decrease, especially in the future, when the baby boom generation starts retiring, and investments have to be liquidated to provide for their retirement income. Employer-sponsored pension plans can likely expect lower yields on equities in the future, so employer pension contributions to defined benefit plans will have to increase. Defined contribution plan benefits will have lower yields and thus have smaller benefits. Unless U.S. outlays are reduced, the U.S. Treasury will still be required to borrow money from sources other than Social Security. The Treasury will have to increase its interest rates to attract more money, which will increase the deficit and eventually taxes. Higher interest rates can lower annuity prices and FAS 87 liabilities for pension disclosures and expensing.
Thus, Social Security would become a better deal to its beneficiaries, but government would become more expensive to the taxpayers. That may be considered fair in historical context, since currently the government uses Social Security as a cheap source of funds.

Another concern is that Social Security could eventually own a significant percentage of private industry, with the amount of public ownership of private business variant on the amount of Social Security benefit privatized and estimated rates of return (e.g., 5% of the stock and bond market if 40% of Social Security assets are privatized). Concern has been expressed that concentrating a significant portion of private industry ownership in the federal government could result not only in substantial social investing but also compromise the regulatory function. If a company contested a governmental agency’s interpretation of a legal requirement, compliance could be obtained through the boardroom rather than the traditional venue of the courtroom.

Currently, two government agencies manage investments in the private sector, the Pension Benefit Guaranty Corporation ("PBGC") and the Federal Thrift Savings Plan Board. The PBGC does not vote its shares, but its investment managers do. The same is true for the large sum of section 401(k) type funds that the Federal Thrift Savings Plan Board (the plan fiduciary for the Federal Thrift Savings Plan) holds for federal employees. In addition, the Federal Thrift Savings Plan funds are only invested in indexes. Only participants make allocation decisions. Congress could mandate that Social Security not use its ownership to influence private business, but a future Congress could relax these rules. This would have a potential for strongly affecting individual companies.

Areas of Possible Amendments to Existing Statutes

The Task Force was unable to identify any change to the Code or ERISA that would be required because of investment in the private sector by Social Security.

Individual Accounts

Description of Possible Change in Social Security System

The other two options of the Social Security Advisory Council suggested privatization of the system using individual accounts. Under individual accounts, individuals would directly invest some of their FICA contributions. This could be done through payroll deduction and employers might become involved in the investment education of employees.

Major Economic and Social Changes that May Result

Many of the potential economic and social changes from privatizing Social Security will also apply if the contribution for an individual account is taken from the existing payroll tax revenues. In addition, Social Security’s guaranteed benefits would have to be further reduced. On the other hand, if the contribution used to fund individual accounts is from new federal revenue sources, such as an increase in the payroll tax, then interest rates may go down, not up, and Social Security’s guaranteed benefits may not increase as much. Similarly, annuity prices and FAS 87 expenses would go up.
If individual accounts are adopted by Social Security and are successful in providing meaningful retirement benefits to taxpayers, it is unclear whether that would stimulate private-sector plan sponsorship towards defined contribution plans or defined benefit plans. If the stock market continues its long bull market, employees may like the individual account idea so much that they may convince employers to drop defined benefit plans in favor of defined contribution plans. This can be viewed as an imprudent concentration of the risk of loss in individual workers.

Alternatively, the concentration of such a signification portion of individuals’ retirement income in individual accounts could prompt a demand for a greater portion of their benefit in defined benefit plans. Employees may want employers to keep or start defined benefit plans so that they won’t have to bear the investment risk on both their individual accounts and their employer plans.

Individual accounts take the risk away from the group and put it on the individual. The greater the portion of the total FICA tax allocated to and invested in individual accounts, the more risk on the individual. Thus, employees may want their employers to help them share these risks. There are a variety of different types of risks inherent in individual accounts, each of which has a variety of different ways to manage or reduce the risk:

- **Investment risk** – the individual has the risk of any investment losses. This risk can be mitigated by employer-provided investment education. Additionally, investment in certain types of vehicles, such as options or futures could be restricted, or a certain amount of diversification could be required. Investment in indexes might be encouraged.
- **Longevity risk** – individuals may outlive their retirement savings. This risk can be managed by requiring individuals to purchase annuities or restrict the amount of distribution allowed in any year.
- **Inflation risk** – the rising cost of living could outpace any increase in the individual’s retirement savings. To manage this risk, inflation-adjusted annuities could be required. Insurers could use inflation-indexed bonds to create indexed annuities.
- **Disability risk** – an individual could become disabled early in his or her work career before sufficient earnings have been made to fund the individual account. Long-term disability ("LTD") plans with Social Security offsets would become more expensive. It is unclear whether any offsets would be allowed against IA distributions. An increased demand for LTD plans can be expected.
- **Death risk** – an individual could die without an individual account sufficient to cover potential family needs. If Social Security survivor benefits are limited by reform, more employees will want employers to provide additional life insurance to replace the lost survivor benefits.
- **Leakage risk** – workers may desire to obtain all or a portion of their individual account benefit prior to retirement, for a variety of reasons. This risk to the individual’s retirement savings could be managed by permitting withdrawals before retirement only if a minimum annuity is purchased or only for certain specified events. Annuities also reduce leakage by using up the funds for retirement and not leaving leftover funds for the estate.
- **Divorce risk** – a nonworking spouse might not have sufficient retirement savings on his or her own after divorce. Laws or courts may force the division of individual accounts between the worker and spouse. Since two cannot live as cheaply as one, life insurance could be required.
• Early retirement risk – employees might not have built an individual account balance sufficient to fund an early retirement. Employees will push for greater retirement benefits with supplements. Employers may also wish to avoid an aging workforce by encouraging older workers to retire with early retirement window programs. However, increased use of retirement supplements or window programs can be expected to have significant cost implications for employers.

• Enforcement risk – do you put people into jail or fine them for not contributing to their own individual accounts? Additionally, enforcement of the anticipated myriad requirements for financial institutions that hold individual accounts can be expected to generate a significant drain on government resources. Would the government use employers for collection, reporting, and allocation to a government clearinghouse? Such a program could reduce costs for the employee, but increase them for employers and the government. In addition, the current Form W-2 tax reporting process will create a very long lag period before the account balance records are updated or communicated to employees. Alternatively, if employees demand quicker information on their account balances, it could force quarterly, monthly, or even weekly or biweekly pay period reporting by employers. Such reporting would likely be required even for temporary and part-time employees.

• Political Risk – certain segments of the population can be expected to desire that the application of individual accounts be optional rather than mandatory. Having any portion of Social Security be optional would have enormous implications for the future financial and political survival of the program.

One major concern for employers will be that individual account benefits will not be adequate if employees wish to retire early or if the stock market declines in value, potentially encouraging employees to work longer. Employers that wish to continue current retirement patterns may provide supplements to allow earlier retirement by employees. Such an increase in retirement subsidies could significantly increase plan sponsors’ costs and create hidden liabilities.

It is unclear what effect the creation of individual accounts will have on the national savings rate. While some commentors suggest that the existence of individual accounts will get employees who currently do not save in the "habit" of saving, many believe that savings in individual accounts will be largely offset by reductions in other savings, resulting in only minor overall savings increases.

Financial institutions may prefer employer-sponsored section 401(k) plans to individual accounts because there is less administration in dealing with one employer than with each employee. There would be about 150 million individual accounts (some very tiny), which is unlikely to be the market desired by such institutions. However, financial institutions are expected to like the fact that 50 million people who currently don’t save would be forced to have accounts in the future.

Areas of Possible Amendments to Existing Statutes

Code Section 401(k)

If employees have to contribute additional amounts to an individual account, nonhighly compensated employees may view this contribution as taking the place of tax-favored savings in employer-sponsored plans and reduce their section 401(k) plan elective deferrals. Any
widespread reduction in deferral rates for nonhighly compensated employees could have significant consequences for their personal retirement savings, especially if by lowering their elective deferral rate employees fail to receive an employer matching contribution. Additionally, under current law, lower deferral rates for nonhighly compensated employees would result in lower permitted deferral rates for highly compensated employees (unless the section 401(k) plan is a safe harbor plan), potentially endangering their retirement savings as well. If the safe harbor section 401(k) plans only have highly compensated employees contributing to them, Congress could restrict or eliminate the safe harbors.

Code Section 401(l)

Perhaps the most significant impact adoption of individual accounts would have on private pension plans would be a change in the integration rules of pension plans. Current integration or permitted disparity rules for defined benefit plans are based on estimated Social Security benefits provided to employees. If a significant percentage of Social Security benefits is converted to individual account-type benefits, the methodology for recognizing Social Security benefits would have to be completely reconsidered and revised.

It is conceivable that the individual-account portion of Social Security and the traditional, defined benefit portion would be considered together to determine the maximum amount of integration allowed in qualified retirement plans. If the employer sponsored a defined contribution plan, the maximum permitted disparity could still be based on total employer FICA taxes paid, but determination of the limit on integration for defined benefit plans would become substantially more complicated. IRS regulations concerning the conversion of defined contribution allocations to equivalent defined benefit accruals could be used to determine the equivalent Social Security benefit for integration purposes. However, not only would determining equivalent Social Security benefits for each plan participant be an administrative burden on plan sponsors, but verification of that calculation by the IRS is likely either to be inadequate or to require very intrusive examination techniques.

Additionally, the determination of the maximum permitted disparity when an employer sponsors more than one type of plan would become more complex. An employer sponsoring a defined contribution plan and a defined benefit plan, for example, could base the integration of the defined contribution plan on the portion of FICA taxes paid to the Social Security individual account. Integration of the defined benefit plan could be based on the portion of FICA taxes used to provide traditional Social Security retirement benefits. Plan sponsors might wish to be able to use a portion of the "defined contribution integration limit" in integrating the defined benefit plan, and vice versa.

Finally, it is unclear what portion of a Social Security individual account benefit should be considered under the qualified retirement plan integration rules. It is conceivable that a worker’s Social Security benefit could be substantially less than anticipated because of investment losses, and the worker’s pension plan benefit would reflect integration with Social Security benefits the worker is not receiving. However, it would be equally unfair to prohibit the employer from considering any portion of the payroll taxes used to provide Social Security individual accounts in determining the maximum permitted disparity limit. In short, while the economic rationale for integration of Social Security benefit with qualified retirement benefits would still exist, the regulation, compliance, and enforcement of a new integration methodology would be more cumbersome than the existing regime.
Privatization Using Employer-Sponsored Pension Plans

Description of Possible Change in Social Security System

As an alternative, the individual account idea could be slightly modified to allow the mandatory individual accounts to be waived for employees in a pension plan (or only those accruing vested benefits). Then, employees might encourage employers to establish and maintain pension plans. The government could establish minimum requirements for pension plans to qualify as a replacement for an individual account, similar to the rules for governmental retirement systems. They might include requirements such as rapid vesting, a minimal accrual or contribution level, coverage of all employees, and a prohibition or restriction on the payment of benefits in a lump sum distribution. Additionally, indexing benefits could be required, either during the period of the participant’s employment, from date of termination to retirement, or during the period of retirement.

The use of employer-provided pension benefits as a method of providing a minimum level of retirement benefit in lieu of Social Security benefits has certain advantages:

- The group or employer carries the risks, not the individual.
- It is broad-based and more efficient.
- Employer-sponsored plans historically have higher returns than participant-directed accounts because they can take on more risk, usually have greater investment expertise and have a longer investment horizon.
- Employers and employees with pension plans already exist and could be implemented faster or more efficiently than 150 million new Social Security individual accounts.
- Enforcement can be concentrated on the plan or plan sponsor and fiduciary, rather than on many individuals.

Major Economic and Social Changes that May Result

The current coverage of private sector retirement plans is very pervasive, especially for defined benefit plans, among larger employers. Any further expansion of the qualified retirement plan system among larger employers is likely to have minimal effect on the operation of the American economy. An increase in the sponsorship of qualified retirement plans by smaller employers, however, is likely to increase the operating costs of such businesses, potentially endangering the continued viability of some businesses (and thus would probably not be mandated, but voluntary). Such a threat to smaller businesses is likely to be similar to any increase in the tax burden of such employers.

Areas of Possible Amendments to Existing Statutes

Code Section 401(a) et seq. and ERISA Title III

Existing laws governing qualified retirement plans would have to be substantially revised to essentially establish two different sets of requirements – those affecting plans intended to provide minimum Social Security benefits and those affecting plans not intended to provide
minimum Social Security benefits. The various provisions that would have to be revised will depend, of course, on the specific requirements that are eventually determined to be necessary for "replacement" plan status.

In addition to the specific requirements for replacement plan status, Congress will have to consider whether any different tax treatment is desirable for distributions from replacement plans than for distributions from nonreplacement plans. If different treatment is required for distributions from replacement plans, plan administrative costs will increase, since it will become necessary to track separately funds earned while the plan was a replacement plan and funds earned while the plan was not a replacement plan. Other coordination of benefit issues, such as whether a replacement plan and a non-replacement plan sponsored by the same employer can be aggregated for nondiscrimination testing, will have to be considered.

Implications Of Taxation Changes

Increase FICA Tax

Description of Possible Change in Social Security System

Several proposals would increase the FICA tax rate on payroll amounts. The MB proposal from the Social Security Advisory Council recommends increasing the contribution rate by 0.3 percent, with that amount shared equally by an increase in the tax rate paid by both employee and employer. The IA proposal would fund the contributions to the individual accounts through a 1.6 percent payroll tax paid by exclusively by employee contributions. The PSA proposal would fund the transition costs of shifting to the new benefit design by a temporary increase in the payroll tax of 1.52 percent over a 72-year period. It is unclear whether the proposal from the CATO Institute would increase the FICA tax rate or not.

The American Academy of Actuaries note that changes to the tax rate could solve as much of the long-range problem as policy makers choose.

Major Economic and Social Changes that May Result

Currently, Social Security benefits provide a disproportionate return for many taxpayers, with some employees receiving significantly greater benefit value for their contributions than other employees receive for their contributions. The principal reasons for these differences result from the benefit formula skewing the delivery of benefits primarily to lower wage workers. As a result, higher wage workers receive a substantially lower "return" on their "investment" in the Social Security system than lower wage workers.

Increasing the FICA tax rate without a corresponding change in the benefit formula would worsen the value of the benefits provided to higher-wage workers. Decreasing the relative value of the benefits provided to such workers could erode the support for the Social Security system that exists among those individuals.

Alternatively, the application of the FICA tax can be viewed as regressive since it applies to the first dollar of wages for both lower- and higher-wage workers. Increasing the FICA tax rate would just exacerbate the regressive nature of the tax.
Finally, there are political and economic considerations that accompany any tax increase to be considered.

Areas of Possible Amendments to Existing Statutes

Code Section 3111

The only statutory change necessary to effect an increase in the FICA tax rate would be an amendment to section 3111, which sets that rate.

The amount of the Earned Income Tax Credit might be increased in order to help low-income taxpayers pay their increased FICA tax.

Additionally, the rate of tax allocated to the OASI portion of the FICA tax rate is used as part of the limit on the permitted disparity allowed in defined contribution plans under section 401(l). The permitted disparity rules allow for an increase in the rate of employer contributions to qualified defined contribution plans for compensation over a specified level. For example, a qualified defined contribution plan can provide allocations to employees equal to 5 percent of compensation up to a specified level and 10 percent of compensation over that amount. Increasing the rate of tax for the OASI portion of the tax could increase the amount of permitted disparity allowed in employer contributions in such plans. The current provisions of section 401(l) and the regulations thereunder would allow an increase in the amount of permitted disparity if the rate of tax for the OASI portion of the tax were increased.

Increase in the Wage Base for FICA Taxation, or Increase in the Wage Base With a Corresponding Increase in the Benefit Base

Description of Possible Change in Social Security System

Several proposals would increase either the definition of wages used for determining the FICA tax imposed on employees, either by including additional items in the definition of wages or by eliminating the limit on wages imposed by the taxable wage base, or increasing the definition of taxable income. The CED proposal recommends treating all excess benefits as taxable income.

The PSA proposal and the IA proposal from the Social Security Advisory Council would change the tax treatment of the remaining defined benefit-type benefit, and have employee contributions made on an after-tax basis into the new savings account.

Alternative proposals could include employer-provided benefits, which are currently excluded from the definitions of both taxable income for income tax purposes and the definition of FICA wages. Proposals could include taxing either or both employer-provided health care benefits or employer-provided retirement benefits (elective deferrals to a section 401(k) plan are already included in FICA wages).

The American Academy of Actuaries estimates that removing the limit on wages imposed by the taxable wage base could solve about half the long-range problems of Social Security.

Major Economic and Social Changes that May Result
A change in the treatment of employer-provided benefits under the payroll tax program could significantly change the nature of those benefits and how both employers and employees perceive them.

If employer-provided benefits are subject to FICA tax, there will not be a corresponding increase in the amount of current compensation to coincide with the increase in taxes. Accordingly, it can be anticipated that taxpayers may view such a change in the tax system as an increase in rates or as a penalty for the provision of such benefits. A potential consequence of this would be increased pressure from employees to opt out of benefit programs because they are not receiving a current benefit but having to pay current taxes.

Areas of Possible Amendments to Existing Statutes

Code Section 3121

Any change to the definition of FICA wages would require an amendment to section 3121. Potential changes include the coverage of S Corporation dividends, employer-provided health benefits, or pension and deferred compensation benefits in FICA wages. No changes would be necessary to the Code sections governing income taxation of such benefits, such as sections 104, 105, and 402, in order to include these items in FICA wages.

Addition of Alternative Taxes

Description of Possible Change in Social Security System

Currently, none of the major reform proposals have recommended the addition of alternative taxes to assist the financing of Social Security reform, but the continuing debate on reform measures can be expected to examine the revenue-raising potential of such provisions. Alternative taxes that might be considered would be an increase or creation of a new consumption tax, in the form of either a national sales tax or a value added tax. Additionally, an increase in the so-called "sin" taxes, such as the existing taxes on the sale of alcohol or cigarettes, could be considered as part of a financing program.

Major Economic and Social Changes that May Result

Congress routinely considers the increase of existing taxes, including the "sin" taxes, and is well versed in the potential economic and social implications of such actions. Additionally, as part of recent income tax reform discussions, significant attention has been directed in recent years to the use of consumption taxes and the resulting impact on the American economy. A wealth of information and opinion already exists concerning the potential addition of a consumption tax or the replacement of the income tax system by a consumption tax program, including a substantial study by the American Bar Association Section of Taxation and the American Academy of Actuaries. With the existing wealth of resources available concerning such tax regimes, further examination of such issues will not be done in this paper.
Areas of Possible Amendments to Existing Statutes

Similar to a discussion of the potential economic and social changes that could result from the adoption of a consumption tax, significant resources on the potential changes to current statutes necessary to effectuate such a change already exist and do not need to be explored in this paper.

Expand Coverage of Social Security System

Description of Possible Change in Social Security System

Currently, the Social Security system includes most types of private sector employment, with substantial coverage of public sector employment as well. However, some types of public sector employment are excluded from the definition of covered employment. Nearly all major reform proposals, including the MB, the IA and the PSA proposals from the Social Security Advisory Council, and the Moynihan, Smith, and Porter legislative proposals recommend expanding coverage under the Social Security system to all new state and local government employees.

The American Academy of Actuaries estimates that if all of the noncovered groups could be covered, the effect would be to eliminate one-tenth of Social Security’s long-range deficit.

Major Economic and Social Changes that May Result

The current coverage of public sector employment is so pervasive, and the coverage of private sector employment is so inclusive that any further expansion of the definition of covered employment is likely to minimal effect on the operation of the American economy. A significant change in the Social Security coverage of public sector workers could, however, significantly disrupt existing state and local pension systems.

Areas of Possible Amendments to Existing Statutes: Code Section 3121(l)

Coverage of several types of government service are currently excluded from Social Security coverage if the government employee is covered by a "retirement system" providing a minimum level of benefits. Section 3121(l) would have to be amended to change the retirement system requirements and include all such employees in the Social Security system. Many government employers have altered their retirement systems in order to satisfy these provisions, and the mandatory coverage of all employees could result in the modification of such government retirement systems.

The inclusion of existing government employees in Social Security coverage could cause significant cost increases or plan design challenges for government employers. If employees currently covered under government retirement systems are included in Social Security, employer costs would increase unless offsetting benefit changes were made in the design of the retirement system. Changing government retirement plans, however, raises several constitutional and legal issues. In some states, the terms of the retirement plan for government employees cannot be changed after the employee commences employment or becomes vested in the plan benefit. This is essentially the same issue that resulted in the permanent exemption from the qualified plan nondiscrimination rules for government plans, enacted by the Taxpayer Relief Act.
of 1997. Since the underlying theory in many cases stems from the provisions of State Constitutions, it is unclear what relief could be provided by Congress.

Conclusion

Any reform of Social Security is bound to have a significant and lasting affect on employer-sponsored retirement plans. While legislators will consider a variety of potential reform measures for Social Security, they should also consider the impact such changes will have on other aspects of the economy in general and qualified retirement plans in specific. The Task Force has tried to view a wide range of reform ideas objectively and, without expressing an opinion on the desirability of any reform proposal, identify potential economic and social changes resulting from the proposal and other possible changes to existing tax laws affecting retirement savings that would be required.