AMERICAN BENEFITS COUNCIL

American Benefits Council response to April 5, 2005, request for comments by the President's Advisory Panel on Federal Tax Reform

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April 29, 2005

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The American Benefits Council is a trade association.

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COUNCIL

April 29, 2005

VIA COURIER

The President's Advisory Panel on Federal Tax Reform

1440 New York Avenue, NW, Suite 2100

Washington, DC 20220

Re: American Benefits Council Response to April 5, 2005, Request for Comments by the President's Advisory Panel on Federal Tax Reform

Dear Sir or Madam:

The American Benefits Council (the Council) appreciates the opportunity to respond to the April 5, 2005, request for public comment by the President's Advisory Panel on Federal Tax Reform (the Panel). The Council is a public policy organization representing principally large companies and other organizations that assist employers of all sizes in providing benefits to employees. Our members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

The Council urges the Panel to make recommendations for tax reform that build upon the current regulatory and legislative foundation of our voluntary employer-sponsored benefit system in providing millions of working Americans and their families with financial security. The existing federal tax code incentives for retirement and health plans contribute enormously to this system's success and any reforms

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should expand the flexibility required by employers to maintain and enhance their current retirement income, active and retiree health care, long-term care and stock accumulation offerings.

Employer-sponsored benefit plans are a major economic and social pillar of this country. In 2004, there were more than 130 million non-farm workers in the United States, according to the Department of Labor's Bureau of Labor Statistics. Of these, 59 percent had access to an employer-sponsored pension plan and 50 percent participated in a plan. The Federal Reserve's Flow of Funds reports that more than $4.4 trillion is currently invested in these retirement programs. In addition, employer stock option plans (ESOPs) were available to 8 percent of the work force in 2004. With regard to health care, 69 percent of workers had access and 53 percent participated in an employer-sponsored health plan. Long-term care plans sponsored by employers were available to 11 percent of workers in 2004. The Centers for Medicare and Medicaid reported that in 2003 (the latest available statistical year) U.S. health expenditures topped more than $1.7 trillion.

The Council considered these statistics and many others in our two-year review of the employer-sponsored benefits system that culminated in last year's publication of *Safe and Sound: A Ten-Tear Plan for Promoting Personal Financial Security*.[1] The Council's long-term strategic plan identifies the most prominent demographic and policy challenges threatening personal financial security and sets forth nine very specific, quantitative goals to be achieved by the year 2014 by all three of our nation's primary

[1] *Safe and Sound* is available at *http://*www.americanbenefitscouncil.org/documents/ltsp_paper_all.pdf

stakeholders – individuals, employers and government. Each goal is clearly framed in the references from which success will be measured and supported by a set of initial policy recommendations focused upon retirement, active and retiree health care, long-term care and stock ownership plans. This letter highlights what we believe to be the governmental contributions needed to achieve these goals and the specific tax policy recommendations plan sponsors support.

FUTURE RETIREMENT SYSTEMS

Employer-sponsored retirement systems need incentives that encourage employers and employees to contribute adequate amounts to retirement income and savings programs, and encourage employees to manage their assets to last throughout retirement. To increase plan participation, more employers must offer retirement plans. Variations in workplaces and competitive pressures inspire employers to offer retirement plans and dictate the type of plan sponsored in order to recruit/retain the best employees. Since sponsoring these plans is voluntary, a successful national retirement policy outcome depends on encouraging innovative and flexible plans. Expanding plan participation and increasing contribution levels remains the best way to increase retirement saving. Federal income tax return data reports that the proportion of filers who claim an individual retirement account (IRA) or Keogh deduction remains fairly modest and is steadily declining over time while the workplace plan participation rates remain healthy.

An additional challenge faces defined benefit plans. Funding rules, market declines, and artificially low interest rates used for pension calculations, including determining plan liabilities, forced some employers to freeze their defined benefit plans and deterred other employers from starting new pensions. The unpredictability of funding liability complicates the task of preserving these plans. Legal uncertainty surrounding hybrid plans, such as cash balance plans, also contributes to increased plan freezes and stalls the growth of these innovative plans designed to meet the needs of today's mobile workforce.

All retirement plan types, including defined benefit pension, hybrid plans, and defined contribution plans such as 401(k) plans, play an important role in boosting participation and savings rates. Rules that dictate predictable funding and recognize the ongoing nature of defined benefit plans, that clarify the legitimacy of hybrid plans, and that strengthen defined contribution plan participation are critical to improving savings. Additionally, tax policy should encourage current efforts to develop new types of plans that combine the best features of 401(k) plans (requiring an employee contribution) and defined benefit plans.

To increase employer-sponsored retirement plan participation rates, we specifically recommend the following:

- New policies should ensure employers have a range of plan designs available so they can select the retirement plan design that best suits their workforce needs. This would include enhancing all existing plan design types and encouraging new simplified plan designs that offer employer tax incentives, reduce administrative requirements, and provide for worker education on saving for retirement.

- Eliminate rules that restrict workers and employers from creating flexible working relationships and benefits arrangements such as phased retirement programs.

In addition, to raise retirement savings, we recommend the following:

- Provide an enhanced saver's tax credit for low-income individuals above and beyond current law, which provides a partial tax credit for employee contributions made to defined contribution plans and IRAs.
- Provide new tax credits to employers to finance contributions that represent for each employee a uniform percentage of wages and salaries and/or to finance supplemental contributions for low-income workers.
- Provide increased tax incentives to all individuals to encourage them to maximize retirement savings and to ensure that their savings last throughout retirement.

FUTURE HEALTH CARE SYSTEM FOR ACTIVE WORKERS

Health care spending has, on average, risen faster than the gross domestic product (GDP). A goal aligning total health care spending closer to GDP growth rates assures this already quite high portion of the economy does not sharply increase its relative share, although the United States may not be likely to prevent such spending from taking a larger share of GDP. For businesses, keeping health care spending closer to GDP growth rates can help assure that the cost of providing health care to employees can be relatively stable and sustainable.

When businesses drop health care coverage or when participants can no longer afford the offered coverage, these workers usually join the pool of uninsured. Both employment-based and public health insurance can expand coverage and reduce the number of uninsured. In each of these two sectors, periodic trends of reduced coverage have emerged since 1987, according to the Employee Benefit Research Institute (EBRI). By expanding coverage in both the employment and public sectors, the chances for reducing the pool of uninsured are increased. To reduce health care costs and increase the number of people with health care coverage, we recommend the following:

- Significantly expand the availability of different forms of health plans that support and reward individuals who become more actively engaged in making well-informed decisions about the appropriate use of quality health care services. Such plans currently include health savings accounts (HSAs) and health reimbursement arrangements (HRAs), which were recently authorized under the federal tax code and regulations. Future tax policy should recognize that additional forms of consumer-directed health plans are now rapidly evolving in the marketplace and the tax code should encourage the development of alternative plan designs leading to more affordable health coverage by making individuals more conscious of the costs and quality of health services they use.
- Make health coverage more affordable for lower-income individuals by providing tax incentives to help them purchase coverage through employer-sponsored plans or in the individual insurance marketplace.

FUTURE RETIREE HEALTH AND LONG-TERM CARE SYSTEMS

Workplace-sponsored retiree health and long-term care programs continue to face a two-pronged policy attack as both individuals and employers still lack tax-favored financing vehicles. Current accounting rules require corporations to list their mostly unfunded retiree health care programs on their balance sheets. This rule resulted in companies reducing their benefit liability exposure and prompted a steady decline in the portion of the working-age population with a future retiree health benefit. If companies could pre-fund these programs, they would be more likely to retain them, as full pre-funding would remove the liability from the balance sheet.

In addition, tax-favored instruments would encourage workers to save while they are still employed for future premiums of an employer-provided retiree health plan. Individuals also need to prepare in advance for additional coverage costs beyond Medicare as EBRI estimates that this federal program covers only about half the medical costs for retirees.

Providing funding mechanisms for employers and individuals would also boost long-term care savings rates. Encouraging employers to provide active workers with access to long-term care insurance enhances affordability when participants can pay lower premiums at a younger age. To make retiree health and long-term care accessible and affordable, we recommend the following:

- Create mechanisms to allow individuals and employers to advance fund anticipated retiree health and long-term care costs in a tax-favored manner and integrate these programs with more traditional retirement savings programs.
- Allow an income tax deduction for the qualified health care expenses of retirees without access to an employer-provided plan.
- Allow retirees to pay their share of health insurance premiums out of retirement plan distributions on a pre-tax basis.

- Encourage employers to provide employees with access to long-term care insurance coverage by permitting its offering as a cafeteria plan benefit or through a flexible spending arrangement. Allow an above-the-line income tax deduction for individuals for the purchase of long-term care insurance.

FUTURE STOCK PLANS

Currently an estimated 8 to 10 million employees hold stock through broad-based stock option plans (both incentive stock options and non-qualified stock options). Also, an estimated 12 million to 16 million participate in employee stock purchase plans, according to the National Center for Employee Ownership. These arrangements advance personal financial security through the accumulation of capital. To boost broad-based opportunities for employees to own stock, we recommend the following:

- Maintain accounting, disclosure, securities law, domestic and international tax law and administrative regimes that will encourage employers to make broad-based stock programs available to their employees.
- Recognize that changes in the accounting treatment for stock options may deter employers from providing broad-based stock arrangements, necessitating the institution of additional tax incentives to encourage employers to maintain these programs.
- Pursue income tax and payroll tax policies that support the adoption and maintenance of employer-sponsored stock option and stock purchase programs, and that minimize the tax burden on employees participating in these programs. Such policies should include the following: First, ensure that employees are not required

to pay tax on stock acquired through employer-sponsored stock programs prior to the time they receive cash in conjunction with the sale of the stock. Second, exempt incentive stock option transactions from the Alternative Minimum Tax (AMT). Third, clarify through legislation that the exercise of incentive stock options (ISOs) or options acquired through employee stock purchase plans will not trigger payroll tax obligations.

Fundamental tax reform presents an important opportunity to strengthen our nation's retirement and health systems. The above tax policy changes will expand and encourage the employment-based system with minimal or no revenue costs.

Radical changes in tax rules governing employer-sponsored benefits programs, however, could instigate the demise of this highly successful, voluntary system. A wholesale change to a national sales tax would eliminate all of the existing tax incentives for employers to maintain health and retirement plans. This would be catastrophic for American workers and their families. Similarly, eliminating all federal taxes on investment income would devastate the employer-sponsored retirement system by erasing the incentive of the federal tax deferral on investment income earned in workplace retirement plans. Given the enormously important role these plans play in this country's retirement security, the Council urges you to preserve current tax incentives and support strengthening the ability of employers to offer retirement plans.

Others suggest eliminating tax preferences for employer-provided health coverage as a means of raising revenue. The Council feels strongly that tax reform and the need to reduce the federal budget deficit should not drive employee benefits policy.

Any fundamental health tax reform must be considered not on a piecemeal basis but in the overall context of overhauling our nation's health delivery system. The Council firmly believes that new tax incentives will be one – but only one – necessary element for creation of a health care system characterized by positive individual lifestyle choices, expanded coverage, broad flexibility in plan design and high quality, cost effective health care services.

Fundamental tax reform presents an opportunity to strengthen and expand the voluntary employer-sponsored benefit system. The Council strongly encourages the Panel to include tax incentives such as those described in *Safe and Sound* in its tax reform proposal. It is equally important that the Panel remain cognizant of the risks that tax reform could entail for the voluntary employer-provided benefits system. Tax reform could be devastating for the retirement and health security of American workers and their families unless appropriate incentives for employment-based plans are maintained. We appreciate the opportunity to comment and look forward to providing any assistance to the Panel in meeting its important objectives.

Sincerely,

James A. Klein

James A. Klein

President