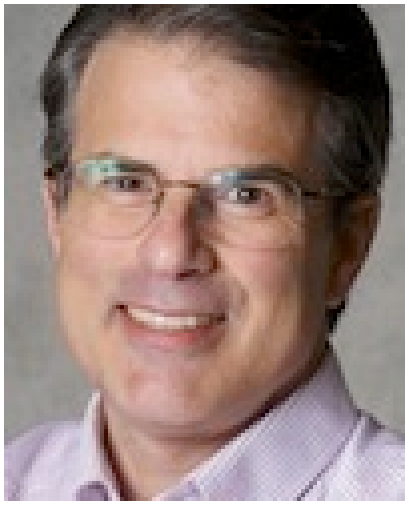
Is It Time to End Tax Deferral?

By Kerry Pechter *Thu, Jul 30, 2015*

This strikes me as the issue at the heart of the controversy over the Department of Labor's conflict-of-interests proposal—the issue we duck and dodge, while pretending that it's all about "advice."



Blame it on tax deferral.

Like a park ranger who blocks the road to a million acres of resource-rich wilderness and warns loggers and the miners that they shall not pass, the Labor Department's Phyllis Borzi is standing in front of the $7.2 trillion in America's IRAs and telling commission-driven brokers and agents: Back off!

The chief of the Employee Benefit Security Administration is doing it because of tax deferral. The government has hundreds of billions of dollars worth of tax expenditures invested in IRAs. Tax deferral is supposed to help Americans' retirement accounts grow faster and fatter. The DOL doesn't want to see its investment consumed by unnecessary commissions and fees.

(You may believe that most of those commissions and fees aren't useless at all, and that they pay for products and services that *enhance* investors' and retirees' financial security. The DOL doesn't appear to share that belief.)

Notice that the government has no beef with the treatment of taxable accounts. The trillions of dollars in those accounts are up for grabs. But retirement accounts are different. The DOL evidently thinks that as long as the money in rollover IRAs remains tax-deferred, it should be as closely regulated as the money in ERISA-regulated plans (whence almost all of it came).

Ergo, DOL proposal haters, be careful what you wish for. An argument against the spirit of the proposal is an argument for ending tax deferral for retirement savings. If you want to keep tax deferral, it might make sense to accommodate some of the DOL's concerns.

A nest of ambiguities

We tend not to see the situation in those terms because the role of tax deferral has been fogged over with ambiguities.

Tax deferral means different things to different people. Not everybody agrees that tax deferral is a subsidy. Not everybody believes that tax deferral should achieve a public policy goal. Not everyone believes that tax deferral is a "tax expenditure," or even that such a phenomenon as tax expenditures exist.

The nature of the rollover IRA is also ambiguous. Is it a personal pension fund—a kind of trust accounts—or is it like any other retail brokerage or mutual fund account, aside from the nuisances of penalties for early withdrawal and required minimum contributions at age 70½? Answer: It's both.

The purpose of the 401(k) itself is ambiguous. Created by the private sector, it was first seen as a tax management device, then as a supplemental savings plan, then as a replacement for defined benefit pensions, and now as a de facto incubator for retail rollover IRA accounts. The government didn't create the phenomenon and never had a clear goal for it, so why should it care to regulate it more closely?

Because of tax deferral.

There's a good reason why we don't recognize the tax deferral on savings as a direct federal subsidy. In the UK, they encourage savings differently. The government directly credits the participant's retirement account with an amount equal to the tax reduction. Here, we get a tax refund, which we don't necessarily have to save. There's no government-funded sleeve in our retirement accounts. So when the DOL says it wants to regulate our IRAs, we can accurately say, "But it's our money."

A modest proposal

It would seem, then, that everyone is right—and wrong. The DOL has a legitimate claim that rollover IRA money should be regulated like an ERISA plan, and the financial services industry has an equally legitimate claim that rollover IRA money should be treated the same (except for the penalty before 59½ and the RMDs at 70½) more like other retail money. Hence the battle. (The hearings on the conflict-of-interest proposal start August 10 in Washington.)

All I am saying here is that, the more strongly and successfully the industry presses its case, the easier it will be for enemies of the $100 billion annual tax expenditure for retirement

savings to say: Go ahead, brokers, have your way with rollover IRAs, and even 401(k)s for that matter. But you have to give up tax deferral. A subsidy without rules is a recipe for moral hazard. You can't have it both ways.

This strikes me as the issue at the heart of the current controversy—the issue we duck and dodge, while pretending that it's all about "advice." Perhaps it's time to reconsider tax deferral, and replace it with tax-free withdrawals from retirement accounts. Think how much simpler life might be.

© 2015 RIJ Publishing LLC. All rights reserved.