Next on Congress' to-do list: budget

By **Hazel Bradford**
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After all the wrangling over raising the U.S. debt ceiling, another divisive fight looms in Washington — crafting and approving the federal budget for 2012.

And while the debate centers on spending cuts, revenue generation is also high on the list of legislators and budget negotiators — including retirement savings incentives and higher tax rates for partnership carried interest that would affect hedge funds, private equity funds and real estate investment funds, among others.

Congressional budget negotiators who would normally be working on appropriations by this time have been forced to sit on their hands until deficit reduction targets get resolved in the debt ceiling debate, sources say.

Widespread talk of capping retirement incentives has many on edge. “We're taking it very, very seriously,” Edward Ferrigno, vice president of Washington affairs for the Profit Sharing/401k Council of America, said in an interview. “We have our work cut out for us.”

This year's budget is a moving target, with no fewer than six major proposals for 2012, ranging from deficit reduction to full-scale government spending.

A proposal pitched by House Budget Committee Chairman Paul Ryan, R-Wis., would eliminate retirement savings incentives altogether, while others propose capping annual contributions to tax-deferred retirement accounts at $20,000 per year or 20% of income, whichever is lower. That “20/20” proposal is almost 60% below the current combined employer and employee contribution limit of $49,000.

Capping contributions

Meanwhile, the Joint Committee on Taxation, a congressional panel led by House Ways and Means Committee Chairman Dave Camp, R-Mich., dangles the prospect of $16 billion in new revenue over five years by limiting contributions to $14,850 for 401(k) plans, capping all of a participant's contributions to a single deferral limit, instead of having one limit for each 401(k), 403(b) and 457(b) plan, and eliminating catch-up contributions, among other measures analyzed by the Congressional Budget Office.

Retirement savings incentives are getting a lot of attention because they're one of the most expensive for the federal government to provide, right after mortgage deductions and health-care exemptions. The CBO estimates that keeping them will cost $600 billion over the next five years, led by 401(k) contributions, which will result in an estimated $67 billion in lost revenue in 2012. The Gang of Six — Democratic Sens. Kent Conrad of North Dakota, Richard Durbin of Illinois and Mark Warner of Virginia and Republican Sens. Mike Crapo of Idaho, Tom Coburn of Oklahoma and Saxby Chambliss of Georgia — proposes raising $1 trillion by reducing a variety of tax incentives, including for retirement savings.

Retirement experts warn that budget negotiators are missing the point by removing such savings incentives. “It is important to remember that unlike other government tax expenditures such as health-care or mortgage exemptions, tax preferences for retirement savings are actually deferrals — those savings are ultimately taxed at the time of distribution,” Robert A. Holcomb, executive director of legislative and regulatory affairs for J.P. Morgan Retirement Plan Services LLC, Overland Park, Kan., said in an interview. ”We think that it's very important that plans continue to be structured in a way that encourages people to save as much as they can.”

According to the American Society of Pension Professionals & Actuaries, because the various deficit-reduction proposals are required by federal budget accounting law to rely on current cash-flow analyses instead of present-value analysis, the proposals fail to estimate the value of the tax breaks over the accounts' lifetime, which shrink the government's cost by as much as 75%, especially as they grow in popularity.

That “bad budget” math could have a disastrous effect on workplace retirement savings, if tax incentives are reduced or removed, warned Brian H. Graff, executive director and CEO of the Arlington, Va.-based ASPPA.

Public pension plan participants are not immune, either, particularly in states re-evaluating their contributions and putting more pressure on employees to save more themselves. Without the tax incentive, “their ability to save will be cut, too,” said Mr. Graff.

Employer groups like the American Benefits Council are relying on budget negotiators on Capitol Hill to understand the value of workplace retirement savings. The council cites a study released in July by the Employee Benefit Research Institute, which found that the proposed “20/20” cap would not just affect highest-income workers, but lower-paid ones as well.

No sympathy for alts

There is less sympathy in Washington for general partners of alternative investment funds, including private equity, real estate and hedge funds. Several of the budget proposals have revived the recurring call to close the “carried interest” loophole that allows them to pay at the capital gains tax rate of 15%, rather than the income tax rate of up to 35% for their share of profits.

“Any time the government needs money, it comes up,” said one hedge fund lobbyist who is part of a coalition of all types of partnership-based investors fighting the idea. He asked not to be identified. “It's a tax on all partnerships.”

According to the Joint Committee on Taxation, the tax hike could bring in as much as $10 billion in revenue cumulatively over the next five years, and $21 billion from 2012 through 2021. But University of Pennsylvania law professor Michael S. Knoll, co-director of the school's Center for Tax Law and Policy, says the actual number is elusive, but probably lower, unless the tax treatment of “every other kind of investment partnership fund” is changed, and firms fail to simply restructure their affairs to avoid the new rates.

“It's not a big dollar issue, but a lot of people see it as a fairness issue. That's not really the right way to look at it,” Mr. Knoll said in an interview.

There's increasing opposition for these revenue proposals among interest groups representing employers, managed funds firms, real estate partnerships and others, who hope to discourage their appearance in making it less likely that they will appear in the 2012 federal budget, or even before the 2012 election cycle, their lobbyists say.

“It's something easy to talk about in the abstract, but there is not a lot of talk on Capitol Hill about getting into the weeds of tax reform,” said the PSCA's Mr. Ferrigno.

Still, said ABC President James Klein, “Eventually Congress is going to turn its attention to tax reform. It's most likely that (retirement savings) will be considered as an offset for lowering the overall tax rates when Congress gets around to it.”