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Effect of Biden Individual Tax Proposals on Retirement Savings Tax Incentives

We do not as yet have a formal proposal from the Biden Administration on individual taxes, but in his recent speech to Congress President Biden identified one change—a near-doubling of capital gains taxes for the highly paid/wealthy—that will have a significant (positive) effect on retirement savings tax incentives.

The Biden Administration is proposing to increase the top capital gains/dividend tax rate from 20% to 39.6%.

Bottom line: for those affected by it, the increase in the capital gains tax will nearly double the value of saving in a tax-qualified retirement plan vs. outside the plan.

Our focus in this article will be on non-Roth 401(k) contributions—because the numbers in that context are relatively intuitive/easy to understand. But the tax savings we illustrate will (generally) be the same for Roth 401(k) contributions, other defined contribution plan contributions and defined benefit plan benefits.

To underline this point: for highly paid individuals, the more compensation that can be provided in a qualified retirement plan of any type, the bigger the tax savings.

In what follows, we provide an analysis of the effect of President Biden's investment tax proposal, beginning with a discussion of the Internal Revenue Code's retirement savings tax incentive framework.

Framework: the retirement savings tax deal

Under the current system, (non-Roth) 401(k) contributions are excluded from taxable income; earnings accumulate tax free; and the amount, when distributed, is taxed at ordinary income tax rates.

This system provides two direct tax benefits:

Investment taxes

First, assuming the participant's income tax rate is the same at the time of contribution and distribution, the value of the 401(k) tax break is the value of the non-taxation of trust investment earnings. That is why, in our analysis, President Biden's proposed change in capital gains tax rates is so significant.

Currently, the top tax rate on capital gains and dividends is 20%. President Biden is proposing to increase that rate to 39.6%. There is also (currently and under the Biden proposal), for top earners/investors, a 3.8% Medicare tax on net investment income. Thus, for the highly paid/wealthy, the total tax rate on investment income is, under the current system, 23.8% and, under the Biden proposal, 43.4%.

Income taxes

Second, where the participant's tax rate is *higher* at the time of (a non-Roth) contribution than it is at the time of distribution, the value of the 401(k) tax break is also the difference between those two tax rates. The 401(k) participant is in effect shifting income from a higher tax rate year to a lower tax rate year.

This tax benefit is not so much a function of the size of the top rate as of the steepness/progressivity of the tax rates generally. Thus, being able to shift income from (in the year of contribution) a tax rate of 37% (the current top rate) to (in the year of distribution) the next lower rate of 35% is less valuable than being able to shift income from, say, a 39.6% rate to a 36% rate.

We do not have a proposed new rate schedule from the Biden Administration—and the final schedule is likely to be a function of a lot of negotiation in Congress. However, we do know that the Administration has pledged not to increase taxes for those earning less than $400,000, so we expect that the proposed schedule will begin to ramp up on the first dollar in excess of $400,000. We will analyze these tax effects when we have a better idea of that new rate schedule.

The effect of changes in the taxation of investment earnings

With this background, we calculated the value of saving inside a plan vs. outside a plan in 2021 under current investment earnings tax rules and under the Biden proposal on the basis of the following assumptions:

(1) We consider a one-time savings of the 2021 401(k) maximum (without catch-up) of $19,500. For the inside-the-plan saver, all $19,500 goes into the 401(k) plan. For the outside-the-plan saver, the individual pays income taxes and then invests the balance.

(2) Inside the plan, the contribution accumulates tax-free at a rate of 4% per year for 10 years. Outside the plan, savings earn 4% but are subject (yearly) to tax at the top capital gains rate + the 3.8% Medicare net investment income tax rate. (If, alternatively, we used a "buy and hold for 10 years" strategy for the outside-the-plan saver the difference in tax effect is marginally reduced.)

(3) On distribution (at the end of year 10), the amount distributed from the 401(k) plan is taxed at (the same) ordinary income tax rate that applied at the time of contribution.

The table below compares the tax benefit for a high earner from saving in a 401(k) plan under current rules and under President Biden's proposal. The "net tax benefit" from saving in 401(k) plan is the payout after 10 years minus the payout of an outside-the-plan saver.

TABLE 1 – 401(K) TAX SAVINGS CURRENT VS. BIDEN

	In-plan		Payout	Outside-plan	Payout	Net tax benefit
	Beginning	Ending	Net of tax	Beginning	Ending	
Current	$19,500	$28,865	$18,184	$12,285	$16,587	**$1,597**
Proposed	$19,500	$28,865	$17,434	$11,778	$14,733	**$2,701**

Thus, under these assumptions, the out-of-plan saver gets a payout after 10 years under the current system that is $1,597 *less* than she would have if she had saved inside the plan. Under the Biden proposal, that "payout gap" widens to $2,701—that is, the out-of-plan saver gets a payout after 10 years that is $2,701 *less* than she would have if she had saved inside the plan.

Note that we are comparing the *relative* value of saving in a plan vs. saving outside of it under the current system vs. the Biden proposal. The increased 401(k) tax benefit under the Biden proposal results from the higher investment taxes on outside-the-plan savings. In fact, the dollar amount of 401(k) savings goes down under the Biden proposal—because of President Biden's proposed higher income tax rate.

Outlook

We expect some version of the Biden tax proposals to be part of a Fall 2021 reconciliation package and to take effect in 2022. It is likely, at least within the Democratic conference, to be the subject of significant negotiation. We will continue to follow this issue.

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