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TO THE SENATE COMMITTEE ON LABOR, CULTURE AND THE ARTS
ON
SENATE CONCURRENT RESOLUTION NO. 211

March 19, 2021
3:15 P.M.
Conference Room 225

URGING THE EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF HAWAII TO ESTABLISH AND OFFER TO ITS QUALIFIED GOVERNMENTAL PENSION PLAN PARTICIPANTS, A QUALIFIED ROTH CONTRIBUTION PROGRAM

Chair Taniguchi, Vice Chair Ihara, and Members of the Committee,

S.C.R 211 urges the Employees' Retirement System (ERS) to establish and offer to its qualified governmental pension plan participants, a qualified Roth contribution program by July 1, 2022.

The ERS is a tax-qualified, defined benefit plan, and shares the general intent of ensuring that its members have adequate and guaranteed retirement incomes to live their retirement years in health and security. However, upon a brief review of the resolution by ERS's tax counsel, the ERS must respectfully oppose S.C.R. 211 and offers the following tax-qualification concerns:

The ERS cannot offer a "qualified Roth contribution program" as described in section 402A of the Internal Revenue Code (the "Code"). "Designated Roth contributions" are treated as "elective deferrals".* As a defined benefit pension plan, the ERS is not permitted to offer a "cash or deferred arrangement".** If the ERS offered a cash or deferred arrangement, it would lose its tax-qualified status under section 401(a) of the Code.

Please note that the employee contributions to the ERS are not "elective". They are mandatory contributions that are treated as "employer contributions" for federal tax purposes. *See* Code § 414(h)(2); *see also* Rev. Rul. 2006-43 (setting forth the requirements for “picked up” employee contributions under a governmental pension plan).

As a qualified governmental plan, and to maintain its tax-qualified status, the ERS must meet the requirements of section 401(a) of the IRC. The ERS would not meet the requirements of section 401(a) of the IRC if it allowed a “cash or deferred” arrangement for its members. We respectfully request that this Committee defer this resolution.

Thank you for this opportunity to provide testimony.

Notes:

* Code § 402A(a)(1). For Code section 401(a) trusts, an “elective deferral” is an “employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k) [of the Code]).” Code §§ 402(g)(3)(A), 402A(e)(2)(A) (defining “elective deferral” by reference to Code section 402(g)(3)(A)); *see also* Treas. Reg. § 1.402A-1 (Q&A-1) (“A designated Roth account is a separate account under a qualified cash or deferred arrangement under a section 401(a) plan.”).

** Treas. Reg. § 1.401(k)-1(a)(1) (“A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase plan, or rural cooperative plan does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement.”)

My name is Brandon Lee and I am testifying in <u>strong support</u> of SCR 211 / SR 174, which urges the Employees Retirement System to offer Roth programs.

Retirement is one of the largest financial burdens that an individual will need to save for. According to Investopedia, your retirement income needs to be about 80% of your final pre-retirement salary.[1] This means for someone making $100,000 annually at the end of their career, they will need $80,000 per year in retirement income. One easy-to-use formula is to divide your desired annual retirement income by 4%, which is known as the 4% rule. Therefore, to generate $80,000, you would need a nest egg of $2 million ($80,000 / 0.04), something very few employees have. There is lot of discussion about the cost of housing, food, health care, and other immediate expenses, but I would argue for many retirement savings on a numbers basis might be just as large but draws far less attention. There is also less safety net programs for retirees who run out of money in retirement, a growing problem as employers have switched to defined contribution retirement plans over the past few decades.

In addition, retirees without retirement savings will need to have their needs taken care somehow and ultimately that responsibility is likely to fall on government, further stressing the expenditure side of the State budget. Therefore, any program that can incentivize government workers to save for their own retirement is a very beneficial thing for both the worker and long term state budgets.

<u>Traditional vs. Roth Retirement Plans</u>

There are traditional and Roth retirement plans. Currently, State of Hawaii retirement plans such as deferred compensation, 457, 403b plans, etc. only allow for traditional retirement plans, instead of Roth versions. Opening up Roth options provide choice based upon the employee's financial circumstances, thereby creating economic efficiency within the marketplace.

Traditional plans deduct payments pre-tax thereby reducing taxable income and one's tax federal and state tax burden for that current year. However, the traditional plans will also count all future distribution (principal plus any gains over the years) as taxable income at the time of withdrawal. Meanwhile, Roth plans count contributions as taxable in the current year, but do not count tax any qualified distributions as taxable. Especially for contributors such as younger workers whose distributions won't occur decades into the future, the gains are often worth more than the contributions due to compounding growth. Therefore, for many government workers, it would be more beneficial to have the option of contributing to Roth vehicles as opposed to traditional vehicles.

Attached are visual examples that highlight different people with different life scenarios:

[1] How much do I need to Retire?, https://www.investopedia.com/retirement/how-much-you-should-have-saved-age/

Jeff (Age 45):

Wants current tax break

Jeff considers himself in his "peak" earning years. He knows he won't be making this money forever, but wants to enjoy it while he can.

- Doesn't think he can afford to lose another tax deduction at this point
- Doesn't really like change anyway
- Expects to be in a lower tax bracket when he retires

Linda (Age 25):

Wants long-term tax-free growth potential

Linda just got out of grad school and is embarking on her new career. She feels good about the fact she's already starting to build up her savings.

- Isn't worried about the tax deduction now
- Confident her salary will increase over the years to come
- Expects to be in a higher tax bracket when she retires

Comparing Jeff's options:

	Traditional Pre-tax 457(b)	**Roth** After-tax 457(b)
Gross income:	$75,000	$75,000
Annual salary available to save:	$10,000	$10,000
Less taxes at 25%[1]:	-$0	-$2,500
Net yearly contribution (totals over 20 years:	$10,000 $200,000	$7,500 $150,000)
Value at retirement (assumes **20** years of contributions at 6%)	$378,572	$283,929
Less taxes at 15%[2]:	-$56,786	-$0
After-tax value:	$321,786	$283,929

Considering

Traditional 457(b)

Comparing Linda's options:

	Traditional Pre-tax 457(b)	**Roth** After-tax 457(b)
Gross income:	$35,000	$35,000
Annual salary available to save:	$3,000	$3,000
Less taxes at 15%[1]:	-$0	-$450
Net yearly contribution (totals over 40 years:	$3,000 $120,000	$2,550 $102,000)
Value at retirement (assumes **40** years of contributions at 6%)	$477,811	$406,140
Less taxes at 33%[2]:	-$157,678	-$0
After-tax value:	$320,134	$406,140

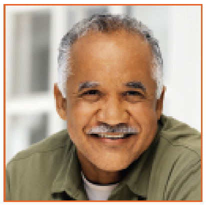
Considering

Roth 457(b)

[1] Based on current federal tax rates as of 2016.

[2] Assumed rates designed to illustrate impact of lower and higher tax rates in retirement.

Note: These are hypothetical illustrations for demonstration purposes only. They are not guaranteed and not intended to (1) serve as financial advice or as a primary basis for investment decisions and (2) imply the performance of any specific security. Contributions are subject to Internal Revenue Code limits. Systematic investing does not ensure a profit nor guarantee against loss. Investors should consider their ability to invest consistently in up as well as down markets. This example does not represent any specific product, nor does it reflect sales charges or other expenses that may be required for some investments. After tax value of traditional 457(b) assumes a one time lump sum distribution. Your actual results may vary.



Brian (Age 50):

Wants to maximize contributions and tax-free income

Brian is established in his career and makes a great salary. He thinks he'll be able to live on less when he retires, yet is eager to maximize his retirement income.

- Unable to contribute to a Roth IRA (his income exceeds the Roth IRA limits)
- Likes the idea of tax-free retirement income, previously unavailable for the highly compensated

Wanda (Age 55):

Wants tax flexibility now and in retirement

Wanda likes the idea of tax-free retirement income, but also likes her current tax deduction. And she doesn't have a clue where taxes are headed in the future!

- Is getting close to retiring, but not that close
- Wants the flexibility to optimize her tax strategy year-to-year as she withdraws retirement income

Comparing Brian's options:

	Traditional Pre-tax 457(b)	**Roth** After-tax 457(b)
Gross income:	$120,000	$120,000
Annual salary available to save:	$18,000	$26,866
Less taxes at 33%[1]:	-$0	-$8,866
Net yearly contribution (totals over 15 years:	$18,000 $270,000	$18,000 $270,000)
Value at retirement (assumes **15** years of contributions at 6%)	$431,173	$431,173
Less taxes at 33%[2]:	-$142,287	-$0
After-tax value:	$288,886	$431,173

Considering

Roth 457(b)

Comparing Wanda's options:

	Traditional Pre-tax 457(b)	**Roth** After-tax 457(b)
Gross income:	$60,000	$60,000
Annual salary available to save:	$6,000	$6,000
Less taxes at 25%[1]:	-$0	-$1,500
Net yearly contribution (totals over 10 years:	$6,000 $60,000	$4,500 $45,000)
Value at retirement (assumes **10** years of contributions at 6%)	$81,389	$61,041
Less taxes at 25%[2]:	-$20,347	-$0
After-tax value:	$61,041	$61,041

Considering

Combination of Traditional 457(b) and Roth 457(b)

[1] Based on current federal tax rates as of 2016.

[2] Assumed rates designed to illustrate impact of lower and higher tax rates in retirement.

This illustration assumes a weekly pay period, with contributions made at the beginning of each pay period.

This illustration is hypothetical, not guaranteed and does not depict the performance of any particular security and is not intended to predict or project future investment results. The illustration does not reflect any charges, expenses, or fees that may be associated with your Plan. Systematic investing does not ensure a profit nor guarantee against loss. Investors should consider their ability to invest consistently in up as well as down markets. This example does not represent any specific product, nor does it reflect sales charges or other expenses that may be required for some investments. After tax value of traditional 457(b) assumes a one time lump sum distribution. Your actual results may vary.

As one can see from the analysis above, retirement planning can be complicated for a lot of people and yet it is fundamental for one's economic future. Yet, one heavily under discussed benefit of Roth retirement plans is they provide greater fiscal certainty for the employee. In the traditional plans, the amount of money you actually receive in retirement is heavily based on what the tax rate is in your retirement years, which can be decades into the future. This uncertainty leads to making retirement planning even more challenging for knowledgeable retirement planners and rookies alike. With the

Roth option, you know exactly how much money you have for retirement at all times, further leading to better economic planning and decision making in the lead up to and during one's retirement years.

Roth Programs are not new

Roth programs are not a new concept. First, established in 1998, Individual Retirement Accounts (IRA) were allowed to have a Roth option. Currently, in 2021 anyone with modified adjusted gross income can put up to $6,000 into a traditional or Roth IRA with diminishing limits up to $139,000. Therefore, American citizens have experience with Roth options. This resolution asks the ERS to allow for that similar Roth option for its retirement contribution programs like its pension plan, Island Savings plan, 403b plan, and deferred compensation. Roth for all provides consistent options across all retirement choices that employees can select from. Currently, I use a Roth IRA for my personally created IRA retirement fund and then am forced to use a traditional plan for my workplace retirement account, further complicating my retirement planning and leading to greater long-term fiscal uncertainty.

As mentioned in the resolution's text, at least 13 other states and numerous municipalities offer Roth options for their government workplace retirement plans.

Public and Private Sector

The State of Hawaii requires a qualified workforce. However, public sector pay has not kept up with more financially lucrative private sector pay, leading to top talent moving out of the public sector. This resolution would strengthen retirement programs - one of the few advantages the public sector has over its private sector counterparts. Yet, because the public sector is a such a large employer who also has the goal of ensuring economic prosperity for all of its citizens, by establishing Roth options in government, private sector companies will also slowly over time need to re-evaluate to see if Roth options are necessary to retain competitive advantage for employees. Either way, this is a net benefit for the State and its mission.

I urge this committee to pass this resolution for the betterment of the people of Hawaii.

SCR-211
Submitted on: 3/18/2021 4:03:21 PM
Testimony for LCA on 3/19/2021 3:15:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
cheryl B.	Individual	Comments	No

Comments:

Comments

It seems to be a good idea to allow folks to have a more diversified ERS. This being said, perhaps the ERS could provide information on the Roth and other options and not actually provide the service? Helping the people to know more and have more options is a benefit either way.