The War Against the Mutual Fund 1 Percent

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Demonstrators with 'Occupy Wall Street' march in the streets near the New York Stock Exchange.

When you think of the one percent of mutual funds, the first thing that probably comes to mind is the small percentage of funds able to outperform the index. Now there's a war being waged against the one percent of mutual funds—no, not those few able to beat the S&P 500, but those few savers "rich" enough to get the attention of budget battle wonks in Washington as Congress and the White House haggle over ways to add tax revenue and reduce the federal deficit.

As the Morningstar Investment Conference kicks off this week on Wednesday, the fund industry remains up in arms over recent budget proposals from the Obama White House budget that would limit investors' ability to save for retirement in two ways:

• Prohibiting taxpayers from making contributions and accruals when the accumulated value of their retirement savings is more than the amount necessary to provide the maximum annuity allowed for tax-qualified defined-benefit plans—currently an annual benefit of $205,000, beginning at age 62. According to the Treasury Department's Green Book, the maximum permitted accumulation for a person 62 today is about $3.4 million.

• Another budget proposal would only allow contributions into a retirement plan to be reduced from taxable income up to the level of the 28 percent tax bracket.

Since the proposals were released in April, many in the fund industry have been campaigning tirelessly against them—no surprise for a business in which retirement savings make up the lion's share of the trillions of dollars invested.

Fund companies claim that while only a small segment of the saver population would be affected by these caps, enacting them would send the wrong message to Americans, who need incentives to save more.

They also argue that the budget proposals will create an accounting nightmare for plan administrators, though this may be the weakest talking point within the staunch fund industry opposition.

Edward Kleinbard, a law professor at the University of Southern California and a former chief of staff of Congress' Joint Committee on Taxation, said that when push comes to shove, record -keeping headaches don't typically sway congressional debate over tax reform. He gave as an example changes made to capital gains taxation requiring securities firms to provide investors with their cost-basis in trades.

"The securities industry said, 'We don't have the technology,' but [Congress'] answer was, 'Yes, you don't have the technology, but you will when we tell you that you must,' " Kleinbard said.

It's a good thing the fund industry has other arguments to make.

"The argument that the Investment Company Institute [ICI] and the industry is making is that many corporations have changed from defined-benefit to defined-contribution plans, and if you are going to modify Social Security, then you need to do more, not less, to help individual investors save for their retirement," said William Glavin, chairman, president and CEO of OppenheimerFunds. "It is big theme we will focus on from the company level and industry level."

Niels Holch, executive director of the Coalition of Mutual Fund Investors, an advocacy organization, said, "It is counterintuitive to what we should be encouraging: more and more saving by Americans."

It's a legitimate concern that people don't save enough without encouragement, according to Kleinbard.

"We need to give people a push," he said. However, the goal should be to incentivize people who otherwise would not save. There is a good argument to be made for turning off the tax subsidy for successful, high-income people.

Proponent of the proposals point to the Office of Management and Budget's estimates that the roughly $3 million account cap would raise $9.3 billion in revenue over 10 years, shaving off a nice slice off the country's deficit. They also note that the government will continue to provide tax incentives for the vast majority of Americans to save for retirement.

According to the Employee Benefit Research Institute's (EBRI), at the end of 2011, only 0.03% of the 20.6 million IRA accounts in EBRI's database had balances exceeding $3 million, and 0.0041% of 401(k) accounts held $3 million or more by the end of 2012. So the proposed cap would affect less than 1% of IRA and 401(k) account holders.

Glavin said the proposed 28 percent deduction limit unfairly targets those in the top tax brackets, and if that cap went through, the highest-income earners would do better to invest outside their 401(k) plans on an after-tax basis.

"If they invest for less than 15 years, it's better to pay the taxes upfront than to defer the taxes to later," Glavin said. He also worries that if those employees in the top tax bracket walk away from their 401(k) plans, smaller companies would have a hard time paying the portion of the plan's expenses that those high-income earners had contributed.

Paul Schott Stevens, president and CEO of ICI, said it may not make sense for people with the top marginal tax rate of 39.6 percent to invest in a 401(k) plan, because the 28 percent cap on tax deferral would subject them to an effective tax rate of 11.6 percent on their contributions.

"So if you are in the same tax bracket of 39.6 percent at the time that you withdraw the money, you would have to add that 11.6 percent to determine what your effective tax rate is, which would be 51.2 percent," he said.

Nevertheless, Stevens admits that the issue is more complicated, because you have to consider that the wealth being accumulated in the retirement account is tax-free, as well as the employer match. These tax advantages would be lost if highest earners walked away from their 401(k) plans.

"When we analyzed it, the conclusion we have come to is that you have to have a pretty long holding period inside the 401(k) (over 15 years) in order to surmount the tax detriment you would have from being taxed on the front end and the back end," Stevens said.

Another argument voiced from within the fund industry is that focusing on a small group of savers isn't a fair way to reform retirement subsidies, even if they are high-income savers. If Congress wants to make a change, it should consider limiting the contribution limits for all savers, but that's an idea that could expand the fight rather than bring consensus.

In any event, Kleinbard thinks the likelihood of these changes being made is slight. "In light of the composition of Congress, a proposal like this has very remote prospects for success other than in context of major tax reform," he said. "As a stand-alone, as a pay-for in tax legislation, it strikes me it has no chance."

The 2012 campaign shone a spotlight on outsize retirement plans, namely the Mitt Romney $100 million IRA. But, Kleinbard said, this "1 percent" saver tax attack won't resonate with nearly as many voters on either side of the political divide. In a sense, the battle over tax-deferred retirement subsidies isn't a battle between the 1 percent and the 99 percent, but the 1 percent and the middle class. It's those who don't make enough to save at all, who really need help from the government.

"All the talk about tax-favored retirement benefits is all middle class and up," Kleinbard said. "This is a fight between the have-lites and the haves."