American Benefits Council

Benefits Briefing Webinar:
Tax Reform & Implications for Benefit Plans

March 27, 2014
Chairman Camp’s Tax Reform Proposal

• February 26th Discussion Draft
  ▪ Comprehensive
  ▪ Statutory language and revenue estimates
• Not Happening This Year
• Still Important
  ▪ Starting point for future tax reform bills
  ▪ Menu for future revenue raising options
  ▪ Piecemeal tax reform still a possibility
• Next Steps
Camp’s Objectives and Ground Rules

• Basic Objective:
  ▪ Lower marginal tax rates/fewer tax breaks

• Ground Rules:
  ▪ Revenue neutrality
  ▪ Distributional neutrality

• Result:
  ▪ Winners: those with fewer tax breaks today
  ▪ Losers: those with more tax breaks (unless those breaks can be protected from cuts)
Proposed Individual Tax Rate Changes

- **Current Law**: Seven tax brackets from 10% to 39.6%
  - Applied to Taxable Income (i.e., income after exclusions, exemptions, and deductions)
  - Capital gains and dividends taxed at special rates up to 20%
- **Proposed Changes**: Three tax brackets: 10%, 25%, and 35%
  - 10% and 25% brackets applied to Taxable Income
  - Cuts in most itemized deductions and many exclusions
  - Special capital gains rates replaced with 40% above-the-line deduction (effective top tax rate of 21%)
  - A “35% Bracket” applies to a newly defined “Modified Adjusted Gross Income” (MAGI) of high income taxpayers
Modified Adjusted Gross Income (MAGI) Surtax

• The “35% Bracket” is actually a 10% surtax on MAGI above $400,000 (individual)/$450,000 (joint)
• MAGI includes all taxable income, plus
  ▪ Itemized deductions (but not charitable deductions)
  ▪ Pre-tax DC plan contributions (employer and employee)
  ▪ Excluded employer-provided health coverage
  ▪ Tax-exempt bond interest and HSA contributions
  ▪ Untaxed Social Security benefits and more
  ▪ Does not include Qualified Domestic Manufacturing Income
• Implications:
  ▪ MAGI surtax reduces the immediate value of the retirement, health and other exclusions to 25% for affected taxpayers (similar to Obama 28% proposal)
MAGI-Based Phase-Outs

• Camp draft also phases out certain items (e.g. 10% rate bracket) based on MAGI above $250,000 (individual) or $300,000 (joint)

• Phase-outs are routine, but basing them on MAGI is unprecedented and indirectly taxes excluded benefits
  ▪ Example: An individual with a $250,000 salary, employer-provided health coverage valued at $10,000, and a $10,000 employer profit-sharing plan contribution, would pay an additional 5% income tax on the $20,000 of employer-provided benefits because they are included in MAGI
Benefit Plans Provisions

• Health, Education & Transportation Exclusions
• Focus on Promoting Roth-Type Saving
• Contribution Limits
• Special Rules for 403(b) and 457(b) Plans
• Non-Qualified Deferred Compensation (“NQDC”)
• Stretch RMD Rules
• Other Proposals
Misc. Benefit Changes in Camp Draft

- Repeal Employer-Provided Education Assistance Program exclusion (+$10.5 billion)
- Freeze Transportation Fringe exclusion (without indexing) at $250 per month for parking and $130 per month for transit (+ $39 billion)
- Repeal Small Employer Health Credit (+ $12.2 billion)
- Repeal Employee Achievement Award exclusion (+ $3.4 billion)
- Repeal Medical Device Tax (- $29.5 billion)
- Allow over-the-counter drugs in FSAs (- $3.3 billion)
Funnel Retirement Contributions to Roths

- MAGI surtax (like Obama 28% proposal) increases relative value of Roth vs. pre-tax contributions
- Camp draft limits pre-tax CODAs (+ $143.7 billion)
  - Qualified DC plans of employers with 100 or more employees would be required to offer Roth option
  - For participants in those large employer plans, only $\frac{1}{2}$ of the elective deferral limit could be made on a traditional pre-tax basis (with any additional going to Roth account)
- Camp draft prohibits future traditional IRA contributions (except rollovers) and eliminates income limits for Roth IRAs (+ $16.7 billion)
- Reasons: revenue and distribution tables
Retirement Plan Contribution Limits

- **Current Law:**
  - Annual inflation adjustments are made to numerous limits on employment-based retirement plans
  - Similar inflation adjustments are made for IRAs

- **Proposed Changes:**
  - Suspend retirement plan inflation adjustments through 2023 (+ $63.4 billion)
  - Suspend inflation adjustments on IRA contribution limits through 2023 (revenue gain included in other estimate)
  - Adjustment thereafter for retirement plans using CPI-U and for IRAs using Chained CPI-U.
Non-Qualified Deferred Compensation (“NQDC”)

• Current Law:
  ▪ For “unfunded” deferred compensation, the employee is taxed (and the employer can deduct) when the compensation is received
  ▪ Special rules apply to tax-exempt & governmental employers: except for 457(b) and 415(m) plans, employee is taxed on deferred compensation when there is no longer a “substantial risk of forfeiture” (i.e. vested).
  ▪ Code Section 409A has additional restrictions

• Proposed Changes:
  ▪ Apply the tax-exempt / governmental employer rule to any arrangement providing for deferral of compensation, but without deferral for earnings after vesting
  ▪ 409A rules would be repealed as unnecessary
  ▪ Some grandfathering, but would expire in 2022 and then tax all deferrals (+ $9.2 billion)
Plans Affected by NQDC Proposal

- Defined Benefit and Defined Contribution SERPs
- Executive Contracts and Incentive Plans
- Equity Compensation
- Stock Options
- Severance / Separation Pay Plans
- Reimbursement Arrangements
- Independent Contractor Compensation
- 457(b) Plans of Tax-Exempts
- Any plan affected by 409A, and more.
Stretch RMDs

• **Current Law:**
  - Required minimum distribution rules apply to qualified plans, IRAs, etc.
  - Beneficiaries can “stretch” post-death payments over their life or life expectancy as long as payments start within a year of death

• **Proposed Changes:**
  - “Stretch” payments would be available only for certain “eligible” beneficiaries, such as surviving spouses (+ $3.5 billion )
  - Rules governing 5% owners also would be modified
  - Same as a recent Senate bill and Obama budget proposal
Rules for 403(b) and 457(b) Plans

• **Current Law:**
  - Special rules apply to 403(b) plans and governmental 457(b) plans under which additional contributions may be made in certain situation
  - 457(b) contributions do not count towards other plan limits
  - 457(b) plans can allow for special catch-up in 3 years before retirement
  - 403(b) plans can allow for special catch-up for employees with 15 years of service
  - 403(b) plans can make employer contributions for 5 years after employee terminates

• **Proposed Changes:**
  - Repeal the special rules for 403(b) plans and governmental 457(b) plans, and require 457(b) contributions to count against other plan limits (+ $0.9 billion)
Other Proposals

• Eliminate § 162(m) performance-based compensation exception (+ $12.1 billion)
• Limit COLI disallowance exception to 20% owners (+ $7.3 billion)
• Eliminate net unrealized appreciation (NUA) for employer stock (+ $0.9 billion)
• Eliminate education and first time home exceptions to 10% penalty tax, and apply penalty tax to governmental 457(b) plans (+ 0.9 billion)
• Discontinue SEPs and SIMPLE 401(k) plans (+ $0.6 billion)
Distribution Reforms

- Eliminate six-month waiting period for contributions after hardship distribution
- Extend period to roll over plan loan offset
- In-service distributions for all plans allowed at age 59½
  - Affects DB plans, money purchase plans, and governmental 457(b) plans
President’s FY 2015 Budget

• 28% proposal
• Cap on total retirement accumulations
• Stretch RMD provision
• Roth IRA RMDs during life (new item)
• Prohibit Roth IRA contributions after age 70½ (new item)
• Exempt IRA balances below $100,000 from RMDs (up from $75,000)