American Benefits Council

Benefits Briefing Webinar:
Tax Reform & Implications for Benefit Plans

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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 ½ 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)