Employee Benefits Corner

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Tax Reform—What Does That Mean for Qualified Plans?

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Over the years, there has been continued pressure on preserving the tax-favored provisions available for qualified plans. With qualified plans typically viewed as the second largest tax expenditure, it is prudent to keep a watchful eye on legislative proposals. This year is particularly interesting as the Chairmen of the two tax-writing committees of Congress—the Finance Committee and the Ways & Means Committee—are both stepping down as leaders of their Committees at the end of the 113th Congress, so Chairman Baucus and Camp may well push hard for tax reform now.

To that end, the Joint Committee on Taxation recently issued a 558 report to the House Committee on Ways & Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups. Notably, this report includes a dedicated section on pensions and retirement, with several pages of comments regarding various ways to expand or improve the effectiveness of the current tax expenditures for pension plans, and to largely support the existing tax expenditures for retirement savings. These comments include provisions related to individual savings and plan designs (including automatic enrollment and limits on retirement savings), distributions and rollovers, Roth arrangements, ESOPs, pension funding, governmental and church plans, nondiscrimination rules, plan administration, and life insurance and annuity contracts. However, as this report does not contain any recommendations, it is too soon to tell the scope of the reform.

The Obama Administration also recently released its 2014 budget package, which includes a number of changes that impact qualified plans. Many of these changes would restrict current retirement benefits, and a few would create new programs or exemptions.

Although many of these budget proposals track the Administration's proposals for fiscal years 2010–2013, they are worth revisiting in their current form.

Accordingly, a brief summary of the Administration's key budget proposals for qualified plans (and related provisions) is set forth below. And as the Administration's 2014 budget proposals are another important step in the lengthy and uncertain process of tax and budget negotiations with Congress, everyone is encouraged to stay tuned!

New Overall Limit Cap on Retirement Benefits

The Administration's budget includes a complex new proposal to place an overall cap on the amount of tax-favored retirement accumulations that any individual can enjoy.

Under the proposal, which is technically described as limiting total contributions or accruals to the amount necessary to provide a maximum annuity (with 100-percent spousal continuation) of $205,000 at age 62, the taxpayer's overall accumulation would be calculated at the end of each calendar year—and would apply to contributions and accruals (but not earnings) in the following year. The limit (roughly $3.4 million in today's dollars) would be indexed and would be actuarially adjusted similar to the Code Sec. 415(b) dollar limit. It appears that all of an individual's tax-favored benefits—whether in defined benefit or defined contribution plans, including IRAs—would have to be taken into account.

If the taxpayer received contributions or accruals exceeding the maximum permitted accumulation, the excess generally would be treated like an excess 401(k) deferral, *i.e.*:

- the excess would be currently includible in income;
- the excess could be withdrawn penalty-free within a grace period; but
- if not so withdrawn, would be subject to tax again when distributed in a later year.

Various reporting requirements would be imposed on employers and financial institutions to enable individuals to track the limitations and presumably notify their employers if the limit applies to them.

This new proposal follows the footsteps of past efforts to cap the growth of tax-favored benefits including the longstanding combined plan limitation under Code Sec. 415(e) (included in ERISA and repealed in 2001), and the 15-percent excise tax on "excess accumulations"—a creation of the Tax Reform Act of 1986 that thankfully was repealed before it ever took effect. The Administration claims this one would raise over $9 billion over the 10-year budget period.

Limits on Retirement Tax Expenditures/"Fair Share" Tax

The Obama Administration's Fiscal Year 2014 budget includes last year's proposal to reduce to 28 percent the tax value of itemized deductions for taxpayers in the 33-, 35- and 39.6-percent tax brackets, as well as the tax value of certain other specified deductions and exclusions, including pre-tax employee contributions to defined contribution retirement plans and IRAs, and employer-provided health insurance paid for by employers or by employees with pre-tax dollars. An affected individual would get "basis" for amounts taxed under retirement plans. It is likely that similar proposals to reduce the value of retirement plan and other tax expenditures will resurface in future budget and tax reform negotiations.

The President's budget also contains a proposal to implement the so-called "Buffett Rule," under which taxpayers in the $1 to $2 million AGI range ($500,000 to $1 million for married filing separately) would pay a minimum effective income tax rate of at least 30 percent. This new minimum tax—called the Fair Share Tax—is generally equal to 30 percent of AGI less a credit for charitable contributions. This proposal would be effective for tax years beginning after 2014.

Repeal of ESOP Dividend Deduction

Another new proposal, tucked away in the section of the budget entitled "Loophole Closers," would repeal the deduction for dividends paid on employer stock held in an ESOP[1] sponsored by a regular "C" corporation (unless its annual receipts were $5 million or less). This provision—a rare exception to the rule that companies cannot deduct dividends to shareholders—originally allowed the deduction only for dividends paid out to participants, but, since 2002, also applies to reinvested dividends. The deduction has been popular among public companies that structure the company stock fund in their 401(k) plans as an "ESOP"—although protection from fiduciary claims also makes this structure very desirable. Repeal of the dividend deduction would not require companies to change plan operations regarding such dividends—though the tone of the explanation of the change reflects intent to discourage company stock investments by participants generally.

Given that this proposal (which would be effective upon enactment) would raise over $6 billion, we would not be surprised to see it again soon.

Automatic IRAs

The Administration's budget again includes a costly proposal to require employers that have been in business for at least two years and have more than 10 employees to offer automatic Individual Retirement Accounts (IRAs) on a payroll-deduction basis, unless the employer sponsors a qualified retirement plan, SEP or SIMPLE plan for employees. Specifically, if an employee does not make an election, he will be deemed to elect to contribute three percent of compensation (up to IRA limit) to a Roth IRA.

Small employers with 100 or less employees that offer an automatic IRA arrangement could claim a nonrefundable employer tax credit of up to $500 in the first year and $250 in the second year of the arrangement (with an additional nonrefundable tax credit of $25 per enrolled employee up to $250 for six years). For small employers that implement a qualified retirement plan, SEP or SIMPLE plan, the current law "start-up costs" tax credit would be doubled to a maximum of $1,000 per year for three years (extended for four years for any employer that adopts a new qualified plan, SEP or SIMPLE plan during the three-year period when it first offers or is first required to offer an automatic IRA arrangement). These proposals would first apply after 2014.

Five-Year Payout Required for Non-Spouse Beneficiaries

The Administration's budget adds a new provision that would limit post-death payments to non-spouse beneficiaries from an IRA or qualified retirement plan to payments over no more than five years (for minor children, the five years would run from the age of majority). An exception for disabled beneficiaries and beneficiaries within 10 years of the age of the deceased owner/participant would permit lifetime payments as otherwise permissible under current law. There is also an exception for binding annuity contracts in effect on the date of enactment.

This proposal—which briefly surfaced last year in Senate Finance Committee deliberations—would be effective for distributions with respect to owners/participants who die after 2013, and for participants/IRA owners who die before January 1, 2014, where the beneficiary dies after December 31, 2013. If enacted, this change will have a dramatic impact on estate planning and the use of stretch IRAs, and would appear to limit the advantages of non-spouse rollovers to IRAs (which were primarily allowed to provide for lifetime payments that may not have been available under a qualified plan).

Non-Spouse Beneficiary 60-Day Rollovers

The Administration's budget again contains a proposal to permit non-spouse beneficiaries to roll over amounts inherited from a qualified plan or IRA in a 60-day rollover, in addition to by means of a direct rollover from a qualified plan or a direct trustee-to-trustee transfer from an IRA. The 60-day rollover treatment would only be available if the non-spouse beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA so it can be titled accordingly. The amount rolled over would continue to be treated as an inherited IRA, subject to the same distribution rules. The proposal would be effective beginning January 1, 2014.

Minimum Required Distribution Relief for Certain Participants

As with last year's budget, the Administration's budget would exempt an individual from the minimum required distribution (MRD) rules if the aggregate value of the individual's IRA and tax-qualified plan balances does not exceed $75,000 (excluding accrued benefits under a defined benefit plan that have commenced payment in any life annuity form) as of any measurement date. The initial measurement date would be January 1 of the year in which the individual attains age 70 1/2, or, if earlier, the year in which the individual dies. If, after the original measurement date, contributions, rollovers or other transfers are made to the individual's IRAs or plans, a subsequent determination (on January 1 of the following year) as to whether the value of the balances of the individual's IRA and tax-qualified plans is still under $75,000 must be made. Under the proposal, the MRD requirements would phase in ratably for individuals with aggregate balances between $75,000 and $85,000. The proposal—which would raise nearly $5 billion—would be effective for individuals who attain age 70 1/2 on or after December 31, 2013, or who die after that date before reaching age 70 1/2.

Form 5500 Annual Report

The budget would provide the Department of Treasury authority to require electronic Form 5500 filings (similar to DOL authority), and to permit additional Internal Revenue Code requirements on the form (such as data on coverage for nondiscrimination testing). This would also permit the IRS to require electronic filing of a separate form that reports information to IRS and the SSA concerning plan participants who terminate employment with a right to future benefits under the plan (Form 8955-SSA). This proposal would be effective for plan years beginning after December 31, 2013.

PBGC Premiums

Following on the heels of last year's major premium increases, the Administration now proposes to give the Pension Benefit Guaranty Corporation (PBGC) Board authority to increase premium payments on participants in ERISA-covered defined benefit plans. The proposal would allow the PBGC to impose risk factors in setting premium levels for companies with underfunded plans starting in 2015. The budget would require one year of study and public comment before implementation and gradual phasing in of any increases. This proposal is estimated to raise $25 billion over 10 years.

Worker Classification Reforms

As with recent budget proposals, the Administration's budget again contains a package of significant worker classification proposals, including proposals to:

- repeal the section 530 relief from employment tax liability where the company has a "reasonable basis" for treating the worker as an independent contractor and certain other requirements are met, which would allow the IRS to require prospective reclassification of workers who are currently misclassified;
- repeal the 1978 Revenue Act restrictions on new IRS guidance on the proper classification of workers under common law standards, which could potentially result in stricter IRS guidelines classifying more workers as employees;
- limit reduced retroactive penalties for misclassification under current law[2] to employers who voluntarily reclassify their workers before being audited by the IRS or another agency, provided the employer has filed all required information returns (Forms 1099) (with retroactive penalties for small employers waived in certain circumstances);
- require companies to notify workers of their status as independent contractors when they begin performing services, and explain the tax, workers' compensation and wage and hour implications of the classification; and
- allow independent contractors receiving at least $600 per year in payments to require the company to withhold federal tax at a flat percentage rate selected by the contractor.

COLI Interest Deduction Limitation

As it did in its past budget and deficit reduction proposals, the Administration proposes to expand current law[3] limitations on the interest deduction of companies that purchase and hold corporate-owned life insurance (COLI) to, very generally, exempt only policies on 20-percent owners. Under these rules, a company's interest deduction is limited based on the ratio of the basis of the COLI to the adjusted basis of all its assets. The proposal generally would be effective on a prospective basis, *i.e.,* with respect to contracts issued after December 31, 2013.

Endnotes

1 Code Sec. 404(k).
2 Code Sec. 3509.
3 Code Sec. 264(f).