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Tax Reform Proposal Advanced by Republican Ways and Means Chairman Includes Major Changes to Retirement and Other Employee Benefit Programs

Over the last several years, proponents of tax reform have generally advocated lower individual and corporate tax rates and simplification of the Code without offering up what changes that they would make to pay for tax reform. On February 26, the Chairman of the Ways and Means Committee of the House of Representatives, Rep. Dave Camp (R-Mich.), released a discussion draft of the Tax Reform Act of 2014 that more completely spells out the tradeoffs for tax reform. Chairman Camp's draft legislation reduces and simplifies the current income tax rate structure with this new proposal. In order to fund the proposed changes and keep the progressivity of the tax code (so tax reform will not be seen as a means of reducing taxes on high income taxpayers), Chairman Camp has proposed a number of changes in tax provisions, including modifying or eliminating provisions relating to employee benefit plans.

Chairman Camp's proposal is important even if, as predicted, tax reform legislation is not enacted in 2014. Individual provisions in the proposal that raise revenue may be used to fund other legislation outside of the context of an overall legislative initiative to lower tax rates and simplify the Code. Consequently, it is important to follow the provisions in this tax reform discussion draft even if tax reform is not enacted since there may be other opportunities for some of these provisions to be enacted as revenue raisers.

Restructuring and Simplification of the Tax Rates

A key provision of Chairman Camp's proposal is that the tax rate would change from the current seven rates to three rates as follows:

Current Law	Tax Reform Act of 2014	
	Rate	Income
10%	10%	Up to \$71,200 (joint filers)
15%		\$36,100 (single filers)
25%	25%	\$71,200 to \$450,000 (joint filers)
28%		\$36,100 to \$400,000 (single filers)
33%		
35%		
39.6	25% (production income) 35% (other income)	Over \$450,000 (joint filers) \$400,000 (single filers)

Taxation of Retirement and Health Benefits for High Income Taxpayers. For taxpayers in the highest bracket, additional calculations are required to determine tax liability. Various tax benefits (such as employer-provided health care and employer pre-tax contributions to defined contribution retirement plans) only apply at the 25% rate and not at the 35% rate. This has been described by some as a 10% additional tax on these tax preferences. For example if a married taxpayer has \$600,000 in annual taxable income and \$15,000 in nontaxable employer-provided health benefits, the married couple will effectively have a 10% tax imposed on the \$15,000 of employer-provided health coverage. This would be a significant change in the taxation of employer benefits; albeit one that only impacts the top earners.

It is interesting to note that President Obama advanced similar concepts in his latest budget proposal under which the tax benefits of various provisions, such as employer-provided retirement savings plans and employer-sponsored health plans, would be limited for high-income taxpayers, so Chairman Camp may be limited in any criticism of the President's proposal. It is likely that Congressional Democrats may try to use concepts like this in funding other legislation.

Changes to Employer-Provided Qualified Plans

DC Plan Roth Contributions. Chairman Camp's proposal would generally require all defined contribution plans to permit after-tax Roth contributions – this includes 401(k), 403(b), and 457(b) plans. However, any employee contributions that are made in excess of one-half of the applicable IRS limits could no longer be made on a pre-tax basis, but must be made as after-tax Roth contributions. There is an exception to these rules for small plans (employers with 100 or fewer employees).

Uniform Contribution Limits for All Defined Contribution Plans. The proposal would extend the same 401(k) limits on contributions to 403(b) and governmental 457(b) plans and eliminate the special catch-up type contributions available under 403(b) and 457(b) plans. The proposal would also eliminate the ability of taxpayers to use multiple plans to increase the available limits.

Contribution and Benefit Limits Frozen Until 2024. Annual indexing for the various Code contribution and benefits limits – such as, the 415 contribution and benefit limits, catch-up contribution limits, and elective deferral limits – would be eliminated. The 2014 limits would remain in place through 2024; thereafter indexing would resume for the next several years. This change raises billions in tax revenue, thereby helping to pay for other provisions in Chairman Camp's tax reform proposal.

SEPs and SIMPLE 401(k) Plans Eliminated. In an attempt to reduce the complexity of choices surrounding the establishment of new retirement plans, the proposal would eliminate an employer's ability to establish a new SEP or SIMPLE 401(k) plan. Existing SEPs and SIMPLE 401(k) plans would be grandfathered. Notably, the bill does not eliminate SIMPLE IRAs.

Changes to the Plan Distribution Rules. Camp's proposal adopts a number of proposals that retirement plan proponents have advocated over the years.

- **In –Service Distributions at Age 59 ½ for Pension Plans.** This provision replaces the optional provision allowing distributions from pension plans at age 62 to allow distributions on or after age 59-1/2 while still employed. This provision would also apply to governmental 457(b) plans. It is intended to encourage phased retirement and provide uniformity among various types of retirement plans.

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- **Hardship Distributions.** The IRS hardship withdrawal safe harbor that requires employers to suspend employee deferrals for 6-months following a hardship distribution would be eliminated under the proposal. The goal is to encourage continued savings for retirement after a hardship withdrawal.
- **Extended Rollover Period for Certain Plan Loans.** The proposal extends the long-standing 60-day rollover period for an outstanding loan until the tax filing deadline (plus extensions) for the year (i) the employee terminates employment, or (ii) the plan terminates. This would allow participants to avoid taxation for a loan offset if rolled to an IRA or another tax-qualified plan by the extended date.
- **10% Early Withdrawal Tax Extended to Government 457 Plans.** The additional 10% early withdrawal tax (which is triggered when payments are made before age 59-1/2 – unless an exception applies) would be extended to governmental 457(b) plans that have historically been exempt from such tax. This change is intended to promote uniformity between the different types of plans.

Streamlined Minimum Required Distributions (MRD) Death Rules – IRAs and Qualified Plans. Under current law, distributions from an IRA or qualified plan payable upon the death of the account holder can be paid over the life of a young beneficiary with the benefits distributed and taxed over the life of the beneficiary rather than upon the account holder's death. Chairman Camp's proposal, which has been advanced in other legislation, would require that all payments would need to be paid out of the plan or IRA within 5 years following death of the account holder. However, for payments that commence within a year of death, to be paid to a spouse, child, disabled or chronically ill beneficiary, or a beneficiary that is not more than 10 years younger than the participant, the payments can be made over the beneficiary's life expectancy (or a period not extended beyond such life expectancy). In addition, the 5 year rule applies upon death of such beneficiary or upon the child turning age 21. (Note that a surviving spouse can still delay commencement of the MRD payments until the participant would have reached age 70-1/2.) Notably, existing annuity contracts will generally be grandfathered from this new rule. While this proposal change may ease plan administration, it eliminates an important estate planning opportunity.

Taxation of Distributions of Employer Stock. Under current law, if a participant receives a lump sum distribution of all of the participant's employer stock held in the plan, the participant can elect to exclude from taxation the value of the stock received that was attributable to the appreciation in the value of the stock while held in the plan (net unrealized appreciation or NUA). When the stock is later sold, the NUA is realized as part of the capital gain in the stock. Chairman Camp's proposal would eliminate the use of NUA in these distributions.

Changes to IRAs

IRA Contributions. Camp's proposal provides that no new contributions, including non-deductible contributions, may be made to traditional IRAs. However, traditional IRAs could still receive rollover contributions from other tax-qualified plans or IRAs.

The proposal expands Roth IRA eligibility by removing the income-based contribution phase-out. Thus the maximum Roth IRA contribution for a tax year would be the lesser of (i) \$5,500 (plus a \$1,000 catch-up contribution, if applicable) or (ii) taxable compensation (with special provisions for taxpayers who have less taxable compensation than their spouses and members of the armed forces). In accordance with the other inflation adjustment freezes described above, the \$5,500 limit would remain frozen until 2024.

SIMPLE IRAs Can Accept Roth Deferrals. The proposal adds an ability to offer Roth deferrals to a SIMPLE IRA, which had historically been limited to pre-tax deferrals.

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Expanded Early Distribution Taxes. The current exception from the additional 10% tax for early distributions for first-time homebuyers would be eliminated.

Other Benefit Provisions

Over-the-Counter Drugs. The Affordable Care Act did not permit reimbursements for over-the-counter drugs (other than prescribed drugs and insulin) from employer-provided health plans, such as flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs) and health savings accounts (HSAs). Camp's proposal reverses this provision of the ACA and allows FSAs, HRAs and HSAs to reimburse purchases of all over-the-counter drugs.

Tax-free Fringe Benefits Limited. Under current law, the provision of air transportation to an employee and certain members of an employee's family is not considered taxable income, as those services were provided at no additional cost to the employer. The proposal would limit the tax-free benefit so that the parents of an employee could not receive air transportation on a tax-free basis. Transportation fringe benefits relating to parking would be limited to \$250 per month and transit passes would be limited to \$130 per month. The qualified bicycle transportation fringe benefit provision in current law would be eliminated.

Outlook for Tax Reform Act of 2014 and Implications

Chairman Camp's proposal is important even if, as predicted, tax reform legislation is not enacted this year. Many of the changes described above will raise substantial amounts of revenue over the 10-year Congressional budget window. Thus, these provisions (some of which will appeal to Congressional Democrats) could be picked up as revenue raisers for other legislation. Consequently, these provisions, or similar ones, are likely to continue to resurface in various legislative proposals.

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