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Obama Administration Budget Proposals Would Expand Impact on Tax-Favored Retirement Benefits

On February 2, the Obama Administration released its budget request for Fiscal Year 2016. The new package includes numerous proposals that would restrict current retirement tax benefits, and some that would create new programs or exemptions. Many of these budget proposals track the Administration's proposals for fiscal years 2010-2015, but the 2016 package also includes several new items of significance to sponsors of tax-qualified retirement plans, including proposals to

- repeal the longstanding favorable tax treatment of "net unrealized appreciation" on employer stock distributed in kind to participants,
- require employers to report employer contributions to defined contribution plans on an employee's Form W-2,
- require certain part-time employees to be given the opportunity to make pre-tax contributions under qualified plans, and
- facilitate the addition of lifetime income options in DC plans.

A brief summary of the Administration's key budget proposals in the retirement and related areas follows.

In addition, the budget package includes –

- the Administration's proposal to allow PBGC to set risk-based premium rates for defined benefit plans,
- a recommendation that EBSA's budget increase by 15% from 2015, including $6.5 million to assist states with increasingly popular retirement savings initiatives (*e.g.* California and Illinois), as well as authority to grant a temporary waiver from ERISA's preemption of state laws that "relate to" benefit plans, and
- a recommended 18% increase in the IRS budget to implement key strategic priorities, such as the ACA, FATCA and IRS document matching.

The tax-writing committees have already held some hearings on the proposals with many more to come.

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Proposals Primarily Affecting Taxation of Plan Participants

<u>Overall Cap on Retirement Accumulations</u> – The Administration's budget includes a complex 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% spousal continuation) of $210,000 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 based on todays' interest rates) would be indexed and actuarially adjusted similar to the Code section 415(b) dollar limit for defined benefit plans. However, all of an individual's tax-favored benefits – whether in defined benefit or defined contribution plans, including section 401(k), 403(b) and governmental 457(b) plans and 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, it 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 proposal follows in the footsteps of past efforts to cap the growth of tax-favored benefits, including the longstanding combined plan limitation under Code section 415(e) (included in ERISA and repealed in 2001), and the 15% excise tax on "excess accumulations" – a creature of the Tax Reform Act of 1986 that thankfully was repealed before it even took effect. The Administration claims this proposal would raise over $26 billion over the 10-year budget period starting with 2016.

<u>Limits on Retirement Tax Expenditures/"Fair Share" Tax</u> – The Obama Administration's Fiscal Year 2016 budget includes a prior 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.

The President's budget also contains a prior proposal to implement the so-called "Buffett Rule," under which affected taxpayers would pay a minimum effective income tax rate of at least 30 percent. (The proposal would phase in from $1 to $2 million for joint filers ($500,000 to $1 million for married filing separately).) This new minimum tax – called the Fair Share Tax – is generally equal to 30% of AGI less a credit for charitable contributions. This proposal is projected to raise over $35 billion over the 10-year budget period, and would be effective for tax years beginning after December 31, 2015.

5-Year Payout Required for Non-Spouse Beneficiaries – The Administration's budget once again proposes to 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 and chronically ill beneficiaries, and for beneficiaries within ten 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 would raise $5 billion in new revenues – would be effective for distributions with respect to owners/participants who die after December 31, 2015, and for participants/IRA owners who die before January 1, 2015, where the beneficiary dies after December 31, 2015. 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).

Roth IRA "Harmonizers" – Under current law, Roth IRAs have several advantages over traditional IRAs. A significant advantage is that the pre-death (*i.e.*, age 70½) minimum required distributions rules don't apply. A second advantage is there is no prohibition on a person making contributions after age 70½. The Administration package would remove both of these advantages for Roth IRAs. The revenue impact of these changes is relatively small since only the investment earnings are tax-favored (Roth contributions are, of course, after-tax).

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 for distributions made after December 31, 2015.

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-favored retirement accumulations does not exceed $100,000 as of any measurement date (indexed for inflation), excluding accrued benefits under a defined benefit plan that have commenced payment in any life annuity form. The initial measurement date would be January 1 of the year in which the individual attains age 70½, 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 $100,000 must be made. Under the proposal, the MRD requirements would phase in ratably for individuals with aggregate retirement benefits between $100,000 and $110,000.

Penalty-Free Withdrawals for Long-Term Unemployed – The Fiscal Year 2016 budget includes a new proposal to expand an exception to the 10-percent additional tax on early withdrawals from tax-qualified retirement plans and IRAs. Current law includes an exception for individuals who take a distribution from an IRA during the taxable year in which they become unemployed or the following year, provided that the individual has received unemployment compensation for 12 consecutive weeks and the aggregate amount of all such distributions does not exceed the health insurance premiums paid during the taxable year.

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The Administration's proposed expanded exception would apply to distributions from 401(k) plans and other tax-qualified defined contribution plans in addition to IRAs. Distributions would not be limited to the amount of health insurance premiums paid, but could not exceed half of the fair market value of the individual's aggregated IRAs or vested defined contribution plan accounts, whichever is applicable, determined as of the end of the year preceding the first distribution for IRA amounts (date of first distribution for vested defined contribution plan accounts). To be eligible for the expanded exception, individuals generally must have been unemployed and receiving unemployment compensation for more than 26 weeks.

Annuity Portability – The Administration now proposes permitting plans to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the investment is no longer authorized to be held under the plan – whether or not a distribution would otherwise be permitted (*e.g.*, due to a severance from employment). The distribution would not be subject the additional 10-percent tax on early withdrawals. This would address an often expressed concern with including lifetime income products in employer-sponsored plans. The proposal would be effective for plan years beginning after December 31, 2015.

Limit Roth Conversions to Pre-Tax Dollars – Another Administration proposal that is new in the FY2016 budget would permit amounts held in a traditional IRA to be converted to a Roth IRA only to the extent that they would be includable in income if they were distributed and not rolled over (*i.e.*, after-tax amounts cannot be converted). Under the proposal, which would be effective for distributions occurring after December 31, 2015, a similar restriction would apply to amounts held in eligible retirement plans.

Repeal of Exclusion of Net Unrealized Appreciation in Employer Securities – Under current law, the amount of net unrealized appreciation in employer stock that is distributed from a tax-qualified retirement plan in a lump sum (or purchased with after-tax employee contributions) generally can be excluded from gross income in the year of the distribution. The employer is currently taxed only on the trust's "cost basis" for the stock. The Administration views this as providing an undesirable incentive for plan participants to invest in their employer's stock. Accordingly, the budget proposes eliminating this exclusion for participants who have not yet attained age 50 as of December 31, 2015; participants who have already turned 50 by that date would be unaffected. If enacted, this proposal would raise about $2.5 billion over 10 years.

Proposals Primarily Affecting Employers and Plan Administrators

Automatic IRAs/Start-Up Tax Credits – 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 3% of compensation (up to the IRA limit) to a Roth IRA (or traditional IRA).

Small employers with 100 or fewer employees that offer an automatic IRA arrangement could claim a non-refundable employer tax credit for the employer's expenses associated with the arrangement of up to $1,000 per year for three years (with an additional non-refundable 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 tripled to a maximum of $1,500 per year for three years (extended to four years for any employer that adopts a new qualified retirement 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 December 31, 2016.

Form 5500 Annual Report – The budget would provide the IRS the authority to require electronic filing of information that is relevant only to employee benefit plan tax requirements, so that it can be electronically filed with the Form 5500 (which current law requires to be filed electronically with the DOL). This would permit the IRS to require electronic filing of Form 8955-SSA, a separate form that reports information to IRS and the Social Security Administration ("SSA") concerning plan participants who terminate employment with a right to future benefits under the plan. This proposal would be effective for plan years beginning after the date of enactment.

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 (Code section 3509) to employers who voluntarily reclassify their workers before being audited by the IRS or another agency and who have 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.

Inclusion of Long-Term, Part-Time Workers in 401(k) Plans – Another new proposal included in this year's budget is to require section 401(k) plans to allow long-term part-time workers to participate. Section 401(k) plans would be required to permit an employee to make salary reduction contributions if the employee has worked at least 500 hours per year with the employer for at least three consecutive years. Plans would not be required make such workers eligible for employer contributions, including employer matching contributions; if they are eligible, however, then the plan must credit a year of service for purposes of vesting in employer contributions for any year in which the long-term, part-time employee worked at least 500 hours.

The proposal would become effective in plan years beginning after December 31, 2015. Employers would receive nondiscrimination testing relief, including permission to exclude workers newly covered by the proposed change from top-heavy vesting and minimum benefit requirements.

Form W-2 Reporting of DC Plan Contributions – The Administration has also proposed requiring employers to report the amount of any contributions to an employee's account under a defined contribution plan on the employee's Form W-2. While this proposal would not affect revenue, it is intended to facilitate compliance with section 415 annual contribution limits, and to provide workers with a better understanding of their overall retirement savings and compensation. The requirement would apply to W-2s due for calendar years beginning after December 31, 2015.

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Proposals Reducing Tax Benefits to Employers

Repeal of ESOP Dividend Deduction – Another carryover proposal would repeal the corporate tax deduction for dividends paid on employer stock held in an ESOP (Code section 404(k)) sponsored by a publicly traded corporation. 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." 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 an intent to discourage company stock investments by participants generally.

Given that this proposal (which would be effective upon enactment) is projected to raise well over $8 billion, we would not be surprised to see it again soon.

"COLI" Interest Deduction Limitation – As it did in its past budget and deficit reduction proposals, the Administration proposes to expand the current law (Code section 264(f)) limitations on the interest deduction for companies that purchase and hold corporate-owned life insurance ("COLI") to, very generally, exempt only policies on 20% 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, 2015.

Observations

The Administration's 2016 budget proposals are notable in that they continue in the direction of primarily adverse changes to tax-favored retirement plans. Whether they get off the ground is anybody's guess, and so is the likelihood of many of the above proposals becoming law. Nevertheless, a number of the revenue-raising proposals may attract bipartisan support, and the more radical ones – such as the proposed overall pension limitation – have triggered important dialogues that may make their way into any broader tax reform debate.