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# Tax reform draft released by Ways and Means may serve as model for future employee benefit tax law changes

The chairman of the Ways and Means Committee released a draft tax reform plan yesterday. The plan proposes significant changes to the tax rules for employee benefits, which raise revenue to pay for reductions to tax rates and other tax cuts. The plan is highly unlikely to become law this year. However, it's possible that the provisions that raise revenue will be used in the future to offset federal spending and deficits even in the absence of full tax reform.

## Overview

Representative Dave Camp (R-MI) released a draft tax reform plan yesterday — the Tax Reform Act of 2014. Rep. Camp is the chairman of the Committee on Ways and Means — the tax-writing committee in the US House of Representatives.

Tax reform is highly unlikely to be enacted this year. However, this reform plan is significant for several reasons. First, this draft is the first comprehensive tax reform plan issued by a tax-writing committee in this Congress. Senator Ron Wyden (D-OR) released a tax reform draft in the prior Congress, but this was before he became chairman of the Senate's tax-writing committee. (See our January 24, 2014 *Legislate* for more information on Senator Wyden's tax reform plan.) Second, this plan will likely serve as a basis for future tax reform plans — either because future plans incorporate and build upon its reforms or are purposely designed to distinguish themselves from its reforms. And third, the proposal contains many provisions that would raise revenue, and these provisions may be cherry-picked to offset future government spending or deficit reduction needs.

This tax reform plan would reduce and compress current tax rates, increase the standard deduction, expand the child tax credit, and permanently repeal the alternative minimum tax (AMT), and yet it would raise significant amounts of revenue to pay for these tax cuts. A goal of the reform plan is that it be revenue neutral — which means it would raise approximately the same amount of net revenue as under current law. The reform plan meets this goal, with an overall increase in revenue of only $3 billion over ten years.

Under the plan, the current seven statutory tax brackets for individuals (ranging from 10% to 39.6%) would be collapsed into three brackets: 10%, 25%, and 35%. These rate cuts collectively cost $544 billion over ten years. The reform plan's repeal of the AMT and increases in the standard deduction and child tax credit collectively cost over $2.5 trillion over ten years.

The tax rate that would apply to the 35% bracket is comprised of two rates: the 25% rate on taxable income that applies to lower bracket taxpayers; and an additional 10% rate that applies to an expanded definition of taxable income (referred to as modified adjusted gross income, or MAGI) in excess of the 35% bracket. The 35% bracket is for taxpayers with MAGI in excess of $450,000 for married taxpayers filing a joint return and $400,000 for single taxpayers. The purpose of this structure is to impose both a 35% rate and establish a limit on the value of certain tax benefits to the 25% rate. MAGI for this purpose includes, among other tax benefits, tax excludable contributions on behalf of the taxpayer to employer-sponsored defined contribution plans and health plans.

The reform plan would retain the Affordable Care Act's 3.8% tax on unearned income. In addition, the current law preferential rates for capital gains and dividends would be converted into deductions equal to 40% of the gains and dividends.

Accompanying the draft legislation are plain-English summaries prepared by Ways and Means staff, and a technical explanation, revenue table, and distribution table prepared by the staff of the Joint Committee on Taxation. The revenue tables indicate the amounts raised (and lost) by various provisions in the reform plan, and the distribution table indicates any change in aggregate tax liability for various income groups.

## Employee benefits provisions

Some key employee benefits provisions in the tax reform draft are listed below. Future issues of *Legislate* will provide a deeper look into these and other proposed changes.

### *Pensions and retirement*

Elective salary deferrals to 401(k), 403(b), and governmental 457(b) plans on a pre-tax basis would be limited in the case of plans sponsored by large employers (generally employers with more than 100 employees). Under present law, up to $17,500 generally may be deferred on a pre-tax basis. Under the reform proposal, only half of the contribution limit (so for 2014, this would be the first $8,750) could be deferred on a pre-tax basis; the remaining amounts would be required to be deferred as Roth contributions. The same rule would apply to catch-up contributions. The Roth contributions would be included in taxable income in the year of deferral, but generally would not be taxable in later years. Employers generally would be required to offer Roth accounts (or may choose to offer Roth accounts entirely with no pre-tax account at all), and employer contributions would still receive pre-tax treatment. This proposal would raise $144 billion over ten years.

The proposal would also freeze the contribution limits for tax-qualified retirement plans (such as the 415 limits and the limit on elective salary contributions and catch-up contributions) at 2014 levels until 2024. This is estimated to raise $63.4 billion over ten years.

There are numerous other changes to the tax rules for retirement savings, including elimination of the income limits on contributions to Roth IRAs, elimination of future contributions to traditional IRAs, harmonization of tax limits and penalties across 401(k), 403(b), and governmental 457(b) plans, repeal of the exclusion for net unrealized appreciation of employer securities distributed from a retirement plan, changes to the required minimum distribution rules, and a prohibition on the establishment of new SEP and SIMPLE 401(k) plans.

### *Health care*

The reform plan would not significantly alter the Affordable Care Act (ACA). Generally it would not modify the tax exclusion for employer-provided health coverage, nor would it alter the deduction for health coverage currently available to the self-employed — although both would be a tax-preference item for purposes of the MAGI definition that applies to 35% bracket taxpayers. The reform plan would repeal the ACA's limit on reimbursements of expenses for over-the-counter medications from health FSAs, HRAs, and HSAs.

### *Fringe benefits*

For qualified transportation fringe benefits, the parking benefit would be set permanently at $250 per month, the transit benefit would be set permanently at $130, with no future adjustments for inflation for either benefit, and the bicycle commuting fringe benefit would be repealed in its entirety. Additionally, employers would no longer be able to deduct the costs of qualified transportation fringe benefits provided to employees. The reform plan would also repeal the tax exclusion for air transportation provided as an employee discount or no-additional-cost fringe benefit to the parent of an employee. These changes would raise $39 billion over ten years. The plan also repeals the tax exclusion for employer-provided education assistance provided under a nondiscriminatory plan (up to $5,250 per year). This provision raises $10.5 billion over ten years.

### *Executive compensation*

The reform plan would modify the current rules under section 162(m) that limit the tax deduction for covered employees of a publicly traded corporation to no more than $1 million per year. Under the proposal, the definition of covered employee would be revised to include the CEO, CFO, and the three other highest paid officers (under current law the CEO and the three highest paid officers are covered employees), aligning it with SEC disclosure rules. The proposal would also repeal existing carve-outs from the deduction limitation for commissions and performance-based compensation, such as stock options. In addition, the reform plan would impose a 25% excise tax on compensation in excess of $1 million paid by a tax-exempt organization to one of its top five highest paid employees.

Further, the reform plan would repeal sections 409A and 457A, which provide rules governing nonqualified deferred compensation. Instead, the plan would limit the ability to defer compensation through non-qualified deferred compensation plans by taxing all individuals when the compensation is no longer subject to a substantial risk of forfeiture — thereby eliminating the ability to defer compensation on the basis that the taxpayer does not have constructive receipt of the compensation.

Collectively, these executive compensation provisions raise $25 billion over ten years.

## In closing

The tax reform draft released yesterday has little chance of becoming law. However, the draft does contain many provisions that raise revenue — including modifications to employee benefits. It is possible that some of these provisions will be picked up in the future to offset federal spending and reduce deficits.

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