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TOPIC: What the Future May Hold – Part II: Tax Reform Proposal Highlights (Retirement and Deferred Compensation Planning) - Tax Reform Act of 2014 vs. President's FY 2015 Budget

MARKET TREND: As the hunt for additional revenue continues, one focus seems to be on limiting approaches to deferring compensation to mitigate taxes, possibly making retirement planning more challenging in the future.

SYNOPSIS: The draft "Tax Reform Act of 2014" and the President's FY 2015 budget each contain several provisions that would affect tax-qualified retirement plans. In both cases, the provisions indicate an intent to enhance retirement savings (particularly by lower-income individuals), simplify the administration of qualified plans, restrict the maximum amounts that may accrue for the benefit largely of higher earning individuals and raise revenue for the federal government. Interestingly, however, the two reform proposals have only one specific provision in common, which may indicate that there may not be much consensus on this subject. In addition, the draft "Tax Reform Act of 2014" contains two other notable provisions relating to executive compensation. The passage of some or any of these proposals would lead to extreme changes to compensation planning across the board.

TAKE AWAYS: As noted in Part I of this *WRMarketplace* Report, the discussion draft and budget have not yet been introduced as legislation, and members of both parties have indicated that we are unlikely to see tax reform in 2014. However, these proposals are important because they may indicate potential law changes affecting qualified retirement plan implementation and operation and tax planning using qualified and nonqualified retirement arrangements. Given that several of the draft and budget provisions could affect AALU members who consult on retirement plan administration and/or tax planning relating to deferred compensation, heightened awareness is warranted, and continued monitoring and interaction with those who craft legislation will be crucial. AALU will remain vigilant in advocacy and monitoring these proposals.

PRIOR REPORTS: *14-10; 13-16; 12-22; 12-10; 12-9; 11-22; 11-17; 10-81; 09-46; 08-33***.**

MAJOR REFERENCES: *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (March 2014); Section-by-Section Summary of the Tax Reform Act of 2014; AALU WRNewswires WRN# 14.02.27 (Feb. 27, 2014) and WRN# 14.03.07 (Mar. 7, 2014).*

As noted in Part I of this WR Marketplace Report, the Chairman of the House Ways and Means Committee, Representative Dave Camp (R-MI), released a discussion draft of the "Tax Reform Act of 2014 (the "**Draft**"), and the President released his budget and revenue proposals for FY2015 (as described in the General Explanation of the Administration's FY2015 Revenue Proposals, the "**Budget**"). Both the Draft and the Budget contain provisions affecting retirement plans with similar policy considerations – *i.e.*¸ an intent to enhance retirement savings (particularly by lower-income individuals), simplify the administration of qualified plans, restrict the maximum amounts that may accrue for the benefit largely of higher earning individuals and, of course, raising revenue for the federal government. However, unlike in other areas, such as insurance and individual tax reform, the specific provisions of the Draft and the Budget regarding retirement and deferred compensation planning directly overlap in only one instance. Thus, the following summarizes the relevant provisions of the Draft and the Budget separately.

THE BUDGET

The retirement plan-related provisions of the Budget are almost identical to those contained in the President's budget and revenue proposals for FY2014 (the "**2014 Budget**"), with only a few minor "tweaks" -- no new provisions were added or removed. The following is a description of the most significant retirement plan-related Budget proposals.

Limitation on the Total Accrual of Tax-Favored Retirement Benefits. The Budget would limit the maximum amount an individual could accrue in the aggregate under all tax-favored retirement arrangements in which he or she participated. This limit applies to IRAs and to tax-qualified plans, 403(b) tax-sheltered annuities, funded 457(b) arrangements, regardless of the identity of the employer maintaining the arrangement. The Budget would limit the maximum accrual in any year to the actuarial value of a joint-and-100-percent survivor annuity beginning at age 62 in an amount equal to the maximum annual benefit that could be provided that year under a tax-qualified defined benefit plan under Internal Revenue Code ("**Code**") § 415(b). This annual amount is $210,000 for 2014, and the Budget estimates the maximum accrual to be approximately $3.2 million dollars.

The limit applies to contributions and accruals, not to investment earnings on plan and IRA account balances. Thus, earnings may allow total accounts to exceed this limit. In addition, if the participant's accounts suffer investment losses, such that the total aggregate value of all IRAs and plans subject to this rule drop below the maximum permissible amount, additional contributions or accruals can be made to bring the aggregate accrual to the limit.

- ✓ ***Comment:*** This limitation would affect high earners and individuals who have participated in tax-qualified retirement plans and IRAs for many years and who derived substantial investment earnings on the amounts deferred under those arrangements. For these individuals, this limitation can be expected to shift their attention to other capital accumulation vehicles, such as life insurance.

This cap would be very complicated to administer and would significantly increase burdens on plan participants, who would face new obligations (such as obtaining an actuarial valuation of their aggregate retirement savings). Individual participants would bear the onus for complying with this limitation and would be required to remove amounts contributed to tax-favored retirement arrangements if the cap is exceeded. Employers also would need to cooperate with those plan participants who need to remove amounts from employer-sponsored plans.

Elimination of "Stretch" Payments. Currently, the required minimum distribution ("**RMD**") rules applicable to qualified plans and IRAs allow plan/account distributions made after the death of the plan participant or IRA holder to be made over the life expectancy of the designated beneficiary, thereby "stretching" out the period of distribution and, therefore, the deferral of taxation on distributions. Under the Budget, distributions to non-spouse beneficiaries of qualified plan accounts or IRAs would be required to take distribution of the entire inherited account balance within five years. Exceptions to this rule apply in limited circumstances – to any beneficiary who, as of the date of the participant's death, is (1) disabled, (2) a chronically ill individual, (3) an individual not more than ten years younger than the participant or IRA holder, or (4) a minor child (but the exception applies only until the child reaches majority).

✓ ***Comment:*** This provision also has appeared in recent proposed legislation. Its enactment would eliminate stretch IRA planning and the appeal of Roth conversions (because why incur income tax now when the deferral benefits will be limited to only five years?), but it may increase the attractiveness of life insurance (*i.e.*, if the IRA funds will ultimately be taxed anyway, why not relocate the money into annuities, life insurance, or an irrevocable life insurance trust).

Simplification of RMD Rules. RMDs must be taken from qualified plans and IRAs (but not Roth IRAs) shortly after the plan participant has both terminated employment with the plan sponsor and attained age 70-1/2. In addition, RMDs must be made to 5% owners of the plan sponsor without regard to termination of employment, and complicated rules apply to distributions made after a participant's death. The Budget would eliminate RMDs to an individual if, as of a measurement date, the individual's aggregate value of IRA and tax-qualified plan accumulations (disregarding the value of any defined benefit plan benefits that have already begun to be paid in any life annuity form) does not exceed $100,000, and the RMD requirements would phase in ratably for individuals with aggregate benefits are between $100,000 and $110,000.

In addition, unlike the 2014 Budget, the Budget would make the RMD rules, subject to the exemption described above, applicable to amounts held in Roth IRAs. Relatedly, individuals could not make additional contributions to Roth IRAs after attaining age 70-1/2.

✓ ***Comment:*** This provision likely would have no effect for many taxpayers, because individuals who have actively and meaningfully participated in qualified plans and IRAs over the course of their working lives will have accumulated amounts in excess of the applicable threshold and, thus, will remain subject to the current RMD rules.

Automatic Enrollment in IRAs. The Budget would require employers who have been in business for at least two years and who have more than ten employees to offer an automatic IRA option, pursuant to which contributions would be made on a salary reduction basis, unless the employee opts out. Employers offering a qualified retirement plan, a SEP or a SIMPLE to its

employees would be exempt from this requirement, unless it excludes from participation in its existing arrangement employees other than those who are covered by a collective bargaining agreement, are under age 18, are nonresident aliens or have not completed the plan's eligibility waiting period. In such a case, it would have to offer the automatic IRA arrangements to those excluded employees.

Elimination of Deduction for Dividends on Stock of Publicly Traded Corporations Held in ESOPs. Generally, a corporation is not entitled to a deduction for dividends it pays on its stock. However, an exception to this rule applies to certain dividends paid on stock held under a tax-qualified employee stock ownership plan ("**ESOP**"). The Budget would deny this deduction for stock held by an ESOP that is maintained by a publicly traded corporation, whereas the 2014 Budget denied the deduction to C corporations with annual receipts of more than $5 million. Thus, the Budget's denial of the deduction turns on the publicly-traded status of the corporation, meaning larger private companies could still take advantage of it.

- ✓ ***Comment:*** ESOPs have been afforded a number of tax benefits, including the dividend deduction, to give employers an incentive to encourage employee investment in employer stock, because that ownership has been considered to enhance employee productivity and company performance. The Administration questions whether the degree of employee ownership of employer stock provided through an ESOP in a publicly traded company is sufficient to bring about these benefits and, therefore, whether the sponsors of these ESOPs deserve to receive the dividend deduction. This provision, however, should not affect those sponsors who have established ESOPs as a tax-efficient means of transferring ownership of all or a part of their business, because those transactions are rarely, if ever, effected by publicly traded companies.

THE DRAFT

TAX-FAVORED RETIREMENT PLANS

As noted above, the Draft contains provisions relating to tax-favored retirement arrangements that are intended to achieve most of the same policy objectives as those contained in the Budget, but the specific provisions largely differ from those in the Budget. The following is a description of the Draft's most significant retirement plan-related provisions.

Suspension of Inflation-Adjustment of Limits Applicable to Tax-Favored Retirement Plans. Current law imposes limits on various amounts applicable to the operation of tax-favored retirement vehicles. Specifically, the Code limits, among other things, (1) the amount of contributions and forfeitures that can be allocated to a participant's account under a defined contribution plan; (2) the amount payable during a year under a defined benefit plan; (3) the amount of the annual elective deferral that participants can make for a calendar year under a 401(k) plan (either traditional or Roth), including the amount of "catch-up" contributions for participants age 50 and older; (4) the amount that can be contributed for a year to a SIMPLE retirement account; and (5) the amount that can be contributed under a plan maintained by a tax-exempt or governmental employer. In addition, the Code generally provides that these amounts will be increased annually to reflect inflation. The Draft provides that these amounts will be held constant at 2014 levels and will not be adjusted for inflation until 2024, at which time adjustment would recommence off of the frozen level.

We note that the Ways and Means Committee's "Section-by-Section Summary" of the provisions of the Draft ("**Draft Summary**") states that "[w]hen interest rates are relatively low, as they have been for the last several years, these provisions would have little or no effect on the annual contribution limitations" and notes that certain limitations did not increase from 2013 to 2014. Nevertheless, the summary indicates that the Joint Committee on Taxation estimates that the ten-year suspension of the indexing of qualified plan limits would increase revenues by $63.4 billion over 2014-2023.

Interestingly, the revenue estimates of the Budget indicate that, over 2015-2024, the provision capping the aggregate accumulation under tax-favored retirement vehicles would increase revenues by only $28.4 billion. Thus, it seems that both of these provisions are intended to be significant revenue raisers, although the Draft's limit on retirement accumulations may raise more than the Budget proposal, most likely to the detriment of higher earning individuals.

Elimination of "Stretch" Payments. This provision is the one retirement-plan related provision that is identical in the Draft and the Budget. This provision would operate in the same manner as the Budget proposal, and would contain the same exceptions.

Limiting Elective Deferrals Other Than Designated Roth Contributions. Currently, individuals may make elective deferrals under a 401(k) plan either on a traditional basis or on a Roth basis. Amounts contributed on a traditional basis reduce a participant's current taxable income, and the contributions plus earnings are taxed when distributed. On the other hand, amounts contributed on a Roth basis are after-tax, and, if the amounts remain in the plan for the required period, neither the contributions nor the earnings are subject to income tax upon distribution. Presently, a plan is not required to offer participants the opportunity to make contributions on a Roth basis.

Intriguingly, the Draft would limit the amount of elective deferrals that can be made on a traditional basis during a calendar year to one-half the limit on elective deferrals in effect for that year. Any contributions in excess of that amount would be required to be made on a Roth basis. A participant can elect to make all of his or her elective deferrals on an after-tax basis. To accommodate this rule, plans would generally be required to offer Roth accounts.

This provision would not apply to employers with 100 or fewer employees. But if an employer maintaining a SIMPLE IRA chooses to offer Roth accounts under the SIMPLE IRA and limit contributions as described above, the contribution limit for the SIMPLE IRA would be increased to that applicable to 401(k) plans.

- ✓ ***Comment:*** The Draft Summary indicates that the proposal would offer "greater retirement security by effectively increasing the amounts [participants] have available at retirement" because these amounts would not be reduced by a tax-payment obligation. It is not clear that that statement is applicable to many participants. For example, older participants might benefit more from reducing current income tax and paying tax at the time of distribution, while younger participants might reasonably expect that the majority of their account at the time of retirement consists of earnings (rather than contributions) and, therefore, they would benefit from having their earnings distributed tax-free. On the other hand, younger individuals and lower-income earners may not feel that they can afford to contribute to a retirement plan unless the "cost" is offset by a reduction in their current income tax liabilities; as a result, this provision could potentially cause a meaningful reduction in retirement savings (note that the Joint Committee on Taxation scored this provision as one of the most significant revenue raisers, at $143.7 billion over 2014 – 2023.)

Expanding Roth IRA Availability & Discontinuing Traditional IRA Contributions. Income tax-wise, traditional and Roth IRAs are treated comparably to traditional and Roth contributions to a 401(k) plan. Currently, there are income limits on the amount a taxpayer can earn while still being able to contribute to a traditional or a Roth IRA. In addition, there are limits on amounts that can be contributed annually to either type of IRA. Under the Draft, the income limitations applicable to Roth IRAs would be eliminated and the limits on annual contributions to a Roth IRA would be indexed for inflation beginning in 2024. In addition, taxpayers would no longer be able to make deductible and non-deductible contributions to traditional IRAs.

- ✓ ***Comment:*** The consequences of forcing individuals to save with Roth IRAs are similar to those associated with forcing savings on a Roth basis under qualified retirement plans (see above).

Repeal of Rule Allowing Recharacterization of Roth IRA as Traditional IRA. Currently, an individual may recharacterize a traditional IRA (or contribution thereto) as a Roth IRA (or contribution to a Roth IRA) – and vice versa. Some taxpayers have tried to derive an exceptional result by using a Roth IRA to invest aggressively and earn significant returns that would never be subject to tax because of the rules applicable to Roth IRAs, but recharacterizing the IRA as a traditional IRA if the investment did not produce the desired yield. To curb this potential for abuse, the Draft would preclude taxpayers from recharacterizing the Roth IRA as a traditional IRA.

Harmonizing Certain Rules Applicable to Various Retirement Plans. Over time, a variety of retirement plans have developed under differing regimes. The Draft seeks to simplify administration of these plan types by making certain rules apply to all in the same manner:

First, defined contribution plans may be required to limit in-service distributions of certain amounts (such as 401(k) elective deferrals) until a participant is at least age 59½, while defined benefit plans cannot permit in-service distributions until a participant attains age 62. The Draft would allow all plans to make in-service distributions to participants who have attained age 59½.

Second, 401(k) plans, 403(b) tax-sheltered annuities and governmental 457(b) plans all allow participants to make salary reduction contributions and employers to make additional contributions, but the limits are not the same for each type of plans. The Draft would make all defined contribution plans subject to the same annual limits as are currently applicable to 401(k) plans.

NONQUALIFIED DEFERRED COMPENSATION

As indicated above (and as many advisors know well), tax-favored retirement vehicles are constrained in their ability to meet the income tax planning needs of many higher earners because of the limits imposed on the amounts that can be deferred for any year. Accordingly, many higher earners took advantage of nonqualified deferred compensation arrangements to meet their additional compensation deferral needs. So long as the nonqualified arrangement was structured in a manner that avoided the participant being in constructive receipt of the amounts deferred and was designed and operated in a manner that complies with the complex rules of Code § 409A, the individual could defer tax on the income (and any earnings thereon) until these amounts were paid to the individual or his or her beneficiary. ***Under a surprising provision of the Draft,***

however, nonqualified deferred compensation would largely cease to be a viable planning vehicle.

Specifically, the Draft provides that, for amounts attributable to services performed after 2014, an employee would be taxed on compensation as soon as there is no substantial risk of forfeiture with regard to the employee's rights to that compensation. Moreover, this provision would become applicable to currently existing deferred compensation arrangements until the last tax year beginning before 2023. Further, the Draft adopts the narrowest possible definition of "substantial risk of forfeiture" – *i.e.*, "the employee's rights to the deferred compensation are subject to the performance of substantial services by any individual." This is the definition currently applicable to compensation deferred under an "ineligible" deferred compensation plan of a tax-exempt or governmental employer under Code § 457(f). There are very few of these arrangements in place, however, because employees do not want their rights to compensation to remain subject to the requirement that they continue to work for the employer.

Such an arrangement may be somewhat acceptable if the deferred compensation is nonelective compensation provided by the employer and/or the deferral period is relatively short. On the other hand, it would be extremely rare for an individual who is currently entitled to compensation to elect to defer that compensation subject to the risk of loss if his or her employment is terminated before the date to which he or she deferred receipt.

EXECUTIVE COMPENSATION

Currently, Code § 162(m) denies a deduction for compensation paid to the CEO and the three highest paid officers of a public corporation (other than the CFO) (each, a "**covered employee**") to the extent the compensation paid to a covered employee exceeds $1 million for the year. Under complex rules in the Treasury regulations, commissions and compensation that are considered "performance-based compensation" are exempt from this deduction limitation. Also, the deduction limitation applies only to an individual who is a covered employee on the last day of the year.

The Draft would make three changes to these rules: (1) it would include the CFO in the definition of "covered employee," (2) it would provide that an individual who is at one time a covered employee remains one for so long as the corporation pays remuneration to the individual or his beneficiaries, and (3) ***the exception for performance-based compensation would be eliminated***.

✓ ***Comment:*** Compensation Committees of publicly traded companies have worked hard to devise compensation arrangements for covered employees that consist largely of performance-based compensation. This allows executives to receive a compensation package that is competitive and rewards the achievement of objectives that enhance shareholder value, while also allowing the employer to take a corresponding tax deduction for that compensation. The proposal would effectively limit a company's ability to deduct compensation in excess of $1 million paid to covered employees, which certainly does not enhance shareholder value.

TAKE-AWAYS

- Neither the Draft nor the Budget have been introduced as bills and, given the lack of consensus on many issues, both parties have indicated that we are unlikely to see tax reform in 2014.

- However, these proposals are important because they may indicate potential law changes affecting qualified retirement plan implementation and operation and tax planning using qualified and nonqualified retirement arrangements.

- Given that several of the Draft and Budget provisions could affect AALU members whose work involves consulting with respect to retirement plan administration and/or tax planning relating to deferred compensation, heightened awareness is warranted, and continued monitoring and interaction with those who craft legislation will be crucial. AALU will remain vigilant in its advocacy and monitoring of these proposals.

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