Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

Client Alert

Current Issues Relevant to Our Clients

March 17, 2014

Pensions and Retirement Provisions in Camp Proposal and Administration's 2015 Budget

Both House Ways and Means Committee Chairman Dave Camp and President Obama have recently released proposed changes to certain pension and retirement plans in the Internal Revenue Code.

On February 26, 2014, Representative Camp released draft legislation referred to as the Tax Reform Act of 2014 ("Camp Proposal") that proposes to amend the Internal Revenue Code, including certain pension and retirement provisions. On March 4, 2014, President Obama released his Budget Proposals for 2015 ("Obama Proposal"). The following is a summary of the proposed changes related to pension and retirement plans. We have also prepared summaries of other provisions relevant to other topical areas – please check our website for those. Although neither the Tax Reform Act of 2014 nor the Obama Proposal has been formally introduced as a bill, the prospects for passage are uncertain at this point, given the nature of the proposed reforms. We will monitor their progress and provide updates as warranted.

Reduced Tax Deduction on Retirement Plan Contributions

The Camp Proposal would subject individuals in the new 35% bracket to a 10% surtax at the time contributions are made to the plan and the full ordinary income tax rate when the funds are distributed from a retirement plan.

The Obama Proposal would limit the value of certain deductions, including employee contributions to defined contribution employer retirement plans and individual retirement accounts (*"IRAs"*). This limitation would reduce the value to 28% of the deductions that would otherwise reduce taxable income in the 33%, 35% and 39.6% tax brackets.

IRAs

Under current law, individuals generally may contribute $5,500 in 2014 ($6,500 if they are at least age 50) on a tax-deductible basis to traditional IRAs. Such amounts are phased out at certain income levels for taxpayers that are covered by an employer-sponsored retirement plan. Regardless of participation in an employer-sponsored retirement plan, but subject to certain income levels, taxpayers may contribute the aforementioned amount to Roth IRAs (no deduction for taxpayers, but all distributions from Roth IRAs are excluded from taxable income). In each case, the $5,500/$6,500 amount is adjusted for inflation.

Under the Camp Proposal, contributions to traditional IRAs would be prohibited, the income eligibility limits for contributing to Roth IRAs would be eliminated and inflation adjustments to Roth IRA contribution limits would be suspended until 2024.

The Obama Proposal would make changes related to IRAs as well. The Obama Proposal would require employers in business for at least two years that have more than ten employees to offer an automatic IRA option to employees (unless the employer sponsored a qualified retirement plan, SEP or SIMPLE IRA). Such automatic IRA would allow employees to have automatic payroll deductions made to an employee's IRA.

Recharacterization of IRAs

Under current law, a taxpayer may recharacterize a contribution to a traditional IRA as a contribution to a Roth IRA and vice versa. In addition, a taxpayer may recharacterize a conversion of a traditional IRA to a Roth IRA. Under the Camp Proposal, the rule allowing such recharacterizations would be repealed.

10% Excise Tax Exemption for First-Time Homebuyers

Under current law, a 10% excise tax is imposed on distributions from qualified retirement plans and IRAs. There are several exceptions to this excise tax, including distributions of up to $10,000 to pay for first-time homebuyer expenses. Under the Camp Proposal, the first-time homebuyer exception would be repealed.

Termination of New SEPs and SIMPLE 401(k)s

Under the Camp Proposal employers would no longer be able to establish new SEP IRAs or SIMPLE 401(k) plans. SIMPLE IRAs would continue to be available. Contributions could continue to be made to existing SEP IRAs and SIMPLE 401(k) plans.

Roth 401(k) Contributions

Under current law, 401(k) plans may offer either a traditional account or both a traditional account and a Roth account. If a plan offers both types of accounts, the employee may contribute to one or both accounts. Under the proposed legislation, plans would be required to offer Roth accounts. Employees would generally be able to contribute up to one-half the maximum annual deferral amount ($8,750 in 2014) into a traditional account. Any contributions in excess of these amounts would have to be made to a Roth account.

Required Distribution Rules

Under current law, owners of traditional IRAs and employees in tax-qualified employer-sponsored plans are subject to complex minimum distribution rules which generally require the IRA owner or employee in a qualified plan to take minimum required distributions beginning at age 70-1/2. The minimum distribution rules apply not only to distributions during the lifetime of the employee or IRA owner but also to distributions after death. While Roth accounts in an employer-sponsored plan are subject to the minimum distribution rules during the life of the Roth account holder, Roth IRAs are not subject to the distribution rules during the life of the Roth IRA holder. The minimum distributions rules do apply, however, to both Roth IRAs and Roth accounts in employer-sponsored plans after the death of the holder/employee.

The Camp Proposal would make certain changes that would somewhat simplify the complicated rules. For example, upon an IRA owner's/employee's death, distributions would be required to be made within five years, regardless of whether the IRA owner/employee dies before or after required minimum distributions have begun. The Camp Proposal also makes certain changes with respect to 5% owners of a business.

The Obama Proposal would exempt an individual from the required distribution requirements if the aggregate value of the individual's IRAs and tax-qualified plans does not exceed $100,000 (indexed for inflation). Certain defined benefit plans that already are in pay status in the form of an annuity would be excluded in determining the aggregate value.

In addition, the Obama Proposal would treat Roth accounts in employer-sponsored plans and Roth IRAs in the same manner as all other tax-qualified plans and, accordingly, require distributions to begin at age 70-1/2, without regard to whether the funds are held in Roth accounts in an employer-sponsored plan or Roth IRAs.

Finally, under the Obama Proposal, non-spouse beneficiaries of retirement plans and IRAs would be required to take distributions over no more than five years.

In-Service Distributions and Hardship Distributions

Under the Camp Proposal, all defined benefit plans as well as governmental plans could permit in-service distributions at age 59-1/2, the same as is currently permitted for defined contribution plans.

With respect to hardship distributions from 401(k) plans, under the Camp Proposal, the IRS would be required to change its guidance to allow employees who take a hardship distribution from a 401(k) plan to continue making contributions to the plan. Currently, contributions are required to be suspended for six months.

Rollover of Plan Offsets

Under the Camp Proposal, employees whose plan terminates or who separate from service while they have outstanding plan loans would have until their tax return due date to contribute the outstanding loan balance to an IRA in order to avoid the loan being taxed as a distribution. The current rule only gives employees 60 days to pay such loans back.

Coordination of Contribution Limits for 403(b) and Government 457(b) Plans

State and local governments often maintain a 403(b) plan and a 457(b) plan. Various contribution limitations apply to each of these plans. Under the Camp Proposal, all defined contribution plans (including 403(b) plans and 457(b) plans) would be subject to annual contribution limits that are currently applicable to 401(k) plans in 2014 ($17,500 *plus* $5,500 if an employee is at least age 50) and would not have additional limits for different classes of employees. Thus, all employees would be treated the same, regardless of whether they work for public or private employers.

10% Early Distribution Penalty

Unlike current law, the Camp Proposal would subject early distributions from 457(b) plans sponsored by state and local governments to the 10% penalty tax that applies to 457(b) plan distributions from non-state or local government plans.

Inflation Adjustments for Various Employer-Sponsored Plan Limits

Under current law, various contribution limits under employer-sponsored plans are indexed for inflation. Under the Camp Proposal, inflation adjustments to (i) the maximum benefit under defined benefit plans, (ii) the maximum contribution by an employer and an employee to a defined contribution plan, (iii) the maximum elective deferrals with respect to SEPs, SIMPLE IRAs and defined contribution plans (such as 401(k), 403(b) and 457(b) plans) and (iv) the maximum age 50 catch-up contribution would all be suspended until 2024.

Limitation of Benefits and Contributions to Tax-Favored Plans

Under current law, the maximum annual benefit under a qualified retirement plan is $210,000 (as indexed) per year. For defined contribution plans, in 2014 the annual contribution limit is $52,000 (as indexed) and the elective deferral limit is $17,500. Each of these defined contribution plan limits is increased by $5,500 (as indexed) for taxpayers who are age 50 or over. The annual limit in 2014 for IRA contributions is $5,500 (as indexed) with an additional $1,000 (as indexed) for taxpayers who are 50 or over.

Under the Obama Proposal, the taxpayer who has accumulated amounts in tax-favored retirement plans in excess of the amount necessary to provide the maximum annuity for qualified defined benefit retirement plans under current law ($210,000 per year) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements.

Rollover of Inherited Plan Account and IRA

Generally, assets can be moved from an employer retirement plan or from an IRA into an IRA or into an employer retirement plan without adverse tax consequences. This movement can generally be accomplished through a direct rollover of a distribution, a 60-day rollover or a direct trustee-to-trustee transfer that is not a distribution. Not all of these methods are available with respect to assets of a plan or IRA account that is inherited by a non-spouse beneficiary.

The Obama Proposal would expand the options that are available for the surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited plan or IRA assets to a non-spousal inherited IRA by allowing 60-day rollovers of such assets.

For More Information

For more information, please contact Gary Polega (312.845.2994).