General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals

Department of the Treasury
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TAX CUTS FOR FAMILIES AND INDIVIDUALS

PROVIDE FOR AUTOMATIC ENROLLMENT IN INDIVIDUAL RETIREMENT ACCOUNTS OR ANNUITIES (IRAS), INCLUDING A SMALL EMPLOYER TAX CREDIT, AND DOUBLE THE TAX CREDIT FOR SMALL EMPLOYER PLAN START-UP COSTS

Current Law

A number of tax-preferred, employer-sponsored retirement savings programs exist under current law. These include section 401(k) cash or deferred arrangements, section 403(b) programs for public schools and charitable organizations, section 457 plans for governments and nonprofit organizations, and simplified employee pensions (SEPs) and SIMPLE plans for small employers.

Small employers (those with no more than 100 employees) that adopt a new qualified retirement, SEP or SIMPLE plan are entitled to a temporary business tax credit equal to 50 percent of the employer's plan "start-up costs," which are the expenses of establishing or administering the plan, including expenses of retirement-related employee education with respect to the plan. The credit is limited to a maximum of $500 per year for three years.

Individuals who do not have access to an employer-sponsored retirement savings arrangement may be eligible to make smaller tax-favored contributions to IRAs.

In 2013, IRA contributions are limited to $5,500 a year (plus $1,000 for those age 50 or older). Section 401(k) plans permit contributions (employee plus employer contributions) of up to $51,000 a year (of which $17,500 can be pre-tax employee contributions) plus $5,500 of additional pre-tax employee contributions for those age 50 or older.

Reasons for Change

For many years, until the economic downturn in 2008, the personal saving rate in the United States has been exceedingly low. Tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In addition, the proportion of U.S. workers participating in employer-sponsored plans has remained stagnant for decades at no more than about half the total work force, notwithstanding repeated private- and public-sector efforts to expand coverage. Among employees eligible to participate in an employer-sponsored retirement savings plan such as a 401(k) plan, participation rates typically have ranged from two-thirds to three-quarters of eligible employees, but making saving easier by making it automatic has been shown to be remarkably effective at boosting participation well above these levels.

Beginning in 1998, Treasury and the Internal Revenue Service (IRS) issued a series of rulings and other guidance defining, permitting, and encouraging automatic enrollment in 401(k) and other plans (i.e., enrolling employees by default unless they opt out). Automatic enrollment was further facilitated by the Pension Protection Act of 2006. In 401(k) plans, automatic enrollment has tended to increase participation rates to more than nine out of ten eligible employees. In contrast, for workers who lack access to a retirement plan at their workplace and are eligible to

engage in tax-favored retirement saving by taking the initiative and making the decisions required to establish and contribute to an IRA, the IRA participation rate tends to be less than one out of ten.

Numerous employers, especially those with smaller or lower-wage work forces, have been reluctant to adopt a retirement plan for their employees, in part out of concern about their ability to afford the cost of making employer contributions or the per-capita cost of complying with tax-qualification and ERISA (Employee Retirement Income Security Act) requirements. These employers could help their employees save -- without employer contributions or plan qualification or ERISA compliance -- simply by making their payroll systems available as a conduit for regularly transmitting employee contributions to an employee's IRA. Such "payroll deduction IRAs" could build on the success of workplace-based payroll-deduction saving by using the capacity to promote saving that is inherent in employer payroll systems, and the effort to help employees save would be especially effective if automatic enrollment were used. However, despite efforts more than a decade ago by the Department of the Treasury, the IRS, and the Department of Labor to approve and promote the option of payroll deduction IRAs, few employers have adopted them or even are aware that this option exists.

Accordingly, requiring employers that do not sponsor any retirement plan (and meet other criteria such as being above a certain size) to make their payroll systems available to employees and automatically enroll them in IRAs could achieve a major breakthrough in retirement savings coverage. In addition, requiring automatic IRAs may lead many employers to take the next step and adopt an employer plan, thereby permitting much greater tax-favored employee contributions than an IRA, plus the option of employer contributions. The potential for the use of automatic IRAs to lead to the adoption of 401(k)s, SIMPLEs, and other employer plans would be enhanced by raising the existing small employer tax credit for the start-up costs of adopting a new retirement plan to an amount significantly higher than both its current level and the level of the proposed new automatic IRA tax credit for employers.

In addition, the process of saving and choosing investments in automatic IRAs could be simplified for employees, and costs minimized, through a standard default investment as well as electronic information and fund transfers. Workplace retirement savings arrangements made accessible to most workers also could be used as a platform to provide and promote retirement distributions over the worker's lifetime.

Proposal

The 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, under which regular contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsored a qualified retirement plan, SEP, or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. Thus, for example, a qualified plan sponsor would not have to offer automatic IRAs to employees it excludes from qualified plan eligibility because they are covered by a collective bargaining agreement, are under age eighteen, are nonresident aliens, or have not completed the plan's eligibility waiting period. However, if the qualified plan excluded from eligibility a portion of the employer's work force or a class of employees such as

all employees of a subsidiary or division, the employer would be required to offer the automatic IRA option to those excluded employees.

The employer offering automatic IRAs would give employees a standard notice and election form informing them of the automatic IRA option and allowing them to elect to participate or opt out. Any employee who did not provide a written participation election would be enrolled at a default rate of three percent of the employee's compensation in an IRA. Employees could opt out or opt for a lower or higher contribution rate up to the IRA dollar limits. Employees could choose either a traditional IRA or a Roth IRA, with Roth being the default. For most employees, the payroll deductions would be made by direct deposit similar to the direct deposit of employees' paychecks to their accounts at financial institutions.

Payroll-deduction contributions from all participating employees could be transferred, at the employer's option, to a single private-sector IRA trustee or custodian designated by the employer. Alternatively, the employer, if it preferred, could allow each participating employee to designate the IRA provider for that employee's contributions or could designate that all contributions would be forwarded to a savings vehicle specified by statute or regulation.

Employers making payroll deduction IRAs available would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. In addition, this approach would involve no employer contributions, no employer compliance with qualified plan requirements, and no employer liability or responsibility for determining employee eligibility to make tax-favored IRA contributions or for opening IRAs for employees. A national web site would provide information and basic educational material regarding saving and investing for retirement, including IRA eligibility, but, as under current law, individuals (not employers) would bear ultimate responsibility for determining their IRA eligibility.

Contributions by employees to automatic IRAs would qualify for the saver's credit to the extent the contributor and the contributions otherwise qualified.

Small employers (those that have no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable tax credit for the employer's expenses associated with the arrangement up to $500 for the first year and $250 for the second year. Furthermore, these employers would be entitled to an additional non-refundable credit of $25 per enrolled employee up to $250 for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have ten or fewer employees).

In conjunction with the automatic IRA proposal, to encourage employers not currently sponsoring a qualified retirement plan, SEP, or SIMPLE to do so, the non-refundable "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE would be doubled from the current maximum of $500 per year for three years to a maximum of $1,000 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified retirement plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This expanded

"start-up costs" credit for small employers, like the current "start-up costs" credit, would not apply to automatic or other payroll deduction IRAs. The expanded credit would encourage small employers that would otherwise adopt an automatic IRA to adopt a new 401(k), SIMPLE, or other employer plan instead, while also encouraging other small employers to adopt a new employer plan.

The proposal would become effective after December 31, 2014.

UPPER-INCOME TAX PROVISIONS

REDUCE THE VALUE OF CERTAIN TAX EXPENDITURES

Current Law

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income (AGI), and claiming either itemized deductions or a standard deduction. The tax reduction from the last dollar excluded or deducted is $1.00 times the taxpayer's marginal income tax rate (e.g., if the marginal tax rate were 39.6 percent, then the tax value of the last dollar deducted would be 39.6 cents).

Certain types of income are excluded permanently or deferred temporarily from income subject to tax. These items include interest on State or local bonds, amounts paid by employers and employees for employer-sponsored health coverage, contributions to health savings accounts and Archer MSAs, amounts paid by employees and employers for defined contribution retirement plans, certain premiums for health insurance for self-employed individuals, certain income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, interest on education loans, and certain higher education expenses.

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. In general, itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI in 2013 for taxpayers age 65 or over and 10 percent of AGI for other taxpayers), state and local property taxes and income taxes (and, in 2013 sales taxes), interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of 2 percent of AGI).

For higher-income taxpayers, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) are reduced if AGI exceeds a statutory floor that is indexed annually for inflation (so called Pease limitation).

Reasons for Change

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels. In particular, limiting the value of tax expenditures including itemized deductions, certain exclusions in income subject to tax, and certain deductions in the computation of AGI, would reduce the benefit that high-income taxpayers receive from those tax expenditures and help close the gap between the value of these tax expenditures for high-income Americans and the value for middle-class Americans.

Proposal

The proposal would limit the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28 percent of the specified

exclusions and deductions that would otherwise reduce taxable income in the 33-percent, 35-percent, or 39.6-percent tax brackets. A similar limitation also would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision would include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade or business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher education expenses.

The proposal would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher-income taxpayers. If a deduction or exclusion for contributions to retirement plans or individual retirement arrangements is limited by this proposal, then the taxpayer's basis will be adjusted to reflect the additional tax imposed.

The proposal would be effective for taxable years beginning after December 31, 2013.

LIMIT THE TOTAL ACCRUAL OF TAX-FAVORED RETIREMENT BENEFITS

Current Law

Under current law, the maximum benefit permitted to be paid under a qualified defined benefit plan in 2013 is generally $205,000 per year and is adjusted for increases in the cost of living. The maximum benefit limit is reduced if distributions begin before age 62 and is increased if distributions begin after age 65. The maximum benefit is also adjusted if it is paid in a form other than a straight life annuity or a qualified joint and survivor annuity.

For a defined contribution plan, current law limits the amount of annual contributions or other additions to the account and applies a separate limit to elective deferrals made by taxpayers to the plan, but does not limit the amount that can be accumulated within the account. For 2013, the annual contribution limit is $51,000, and the elective deferral limit is $17,500. Each of these limits is adjusted for increases in the cost of living, and each limit is increased by $5,500 for taxpayers who are 50 or over. Similarly, current law limits the amount of the annual contribution to an individual retirement account or annuity (IRA), but does not limit the amount that can be accumulated within the IRA. The annual contribution limit for 2013 is $5,500 (adjusted for changes in the cost of living) with an additional $1,000 for taxpayers who are 50 or over.

While the limitations on the extent to which a taxpayer can make contributions to an IRA are applied based on aggregating all of the taxpayer's IRAs, the limitations on accruals under defined benefit plans and the limitations on contributions under defined contribution plans are not applied by aggregating all such arrangements. Instead, the aggregation is applied solely for multiple plans sponsored by the same employer or related employers, and for this purpose defined benefit plans are not aggregated with defined contribution plans. (Under a combined limit that was in effect from 1976 to 1996, an individual's projected benefits under defined benefit plans were combined with the individual's cumulative contributions under defined contribution plans maintained by the same employer). Furthermore, there is no aggregation for plans that are sponsored by unrelated employers and no coordination between the contribution limits that apply to IRAs and the limits that apply to plans. However, the Tax Reform Act of 1986 imposed an excise tax on excess distributions (and accumulations remaining at death in excess of approximately $1 million) from (or accumulated in) all qualified plans in which a taxpayer participated (including both defined contribution and defined benefit plans and both related and unrelated employers) and all of the taxpayer's IRAs. The excise tax was repealed in 1997.

Under current law, the annual limit on elective deferrals for a plan also serves as an overall limit on elective deferrals for a taxpayer who participates in 401(k) plans sponsored by unrelated employers. If a taxpayer's aggregate elective deferrals for a year exceed the limit for the year, the taxpayer must include the excess in income for the year of the excess deferral. A grace period is provided to allow taxpayers the opportunity to remove the excess deferrals. If the taxpayer fails to avail himself of this grace period and leaves the excess deferrals in the 401(k) account, then the excess deferrals and attributable earnings will be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a designated Roth account within a plan).

Reasons for Change

The current law limitations on retirement contributions and benefits for each plan in which a taxpayer may participate do not adequately limit the extent to which a taxpayer can accumulate amounts in a tax-favored arrangement through the use of multiple plans. Such accumulations can be considerably in excess of amounts needed to fund reasonable levels of consumption in retirement and are well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts. Requiring a taxpayer who, in the aggregate, has accumulated very large amounts within the tax-favored retirement system to discontinue adding to those accumulations would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels, while still providing substantial tax incentives for reasonable levels of retirement saving.

Proposal

A taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of $205,000 payable in the form of a joint and 100% survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 is approximately $3.4 million.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, where actuarial equivalence is determined by treating the individual as if he or she was still 62; the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation will automatically increase as well. This also could allow a resumption of contributions for a

taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The proposal would be effective with respect to contributions and accruals for taxable years beginning on or after January 1, 2014.

ELIMINATE MINIMUM REQUIRED DISTRIBUTION (MRD) RULES FOR INDIVIDUAL RETIREMENT ACCOUNT OR ANNUITY (IRA)/PLAN BALANCES OF $75,000 OR LESS

Current Law

The MRD rules generally require participants in tax-favored retirement plans, including qualified plans under section 401(a), section 401(k) cash or deferred arrangements, section 403(a) annuity plans, section 403(b) programs for public schools and charitable organizations, eligible deferred compensation plans under section 457(b), Simplified Employee Pensions (SEPs), and SIMPLE plans, as well as owners of IRAs, to begin receiving distributions shortly after attaining age 70½. The rules also generally require that these retirement assets be distributed to the plan participant or IRA owner (or their spouses or other beneficiaries), in accordance with regulations, over their life or a period based on their life expectancy (or the joint lives or life expectancies of the participant/owner and beneficiary).[5] Roth IRAs are not subject to the MRD rules during the life of the Roth IRA holder, but the MRD rules do apply to Roth IRAs after the death of the holder.

If a participant or account owner fails to take, in part or in full, the minimum required distribution for a year by the applicable deadline, the amount not withdrawn is subject to a 50-percent excise tax.

Reasons for Change

The MRD rules are designed largely to prevent taxpayers from deferring taxation of amounts that were accorded tax-favored treatment to provide financial security during retirement and instead leaving them to accumulate in tax-exempt arrangements for the benefit of their heirs. Therefore, in the case of taxpayers who have accumulated substantial tax-favored retirement assets, the MRD rules help ensure that tax-favored retirement benefits are in fact used for retirement. Under current law, however, millions of senior citizens with only modest tax-favored retirement benefits to fall back on during retirement also must calculate the annual amount of their minimum required distributions, even though they are highly unlikely to try to defer withdrawal and taxation of these benefits for estate planning purposes. In addition to simplifying tax compliance for these individuals, the proposal permits them greater flexibility in determining when and how rapidly to draw down their limited retirement savings.

Proposal

The proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA[6] and tax-favored retirement plan accumulations does not exceed $75,000 (indexed for inflation) on a measurement date. However, benefits under qualified defined

[5] Participants in tax-favored retirement plans (excluding IRAs) other than owners of at least 5 percent of the business sponsoring the retirement plan may wait to begin distributions until the year of retirement, if that year is later than the year in which the participant reaches age 70 ½ .

[6] While Roth IRAs are exempt from the pre-death MRD rules, amounts held in Roth IRAs would be taken into account in determining whether an individual's aggregate retirement accumulations exceed the $75,000 threshold.

benefit pension plans that have already begun to be paid in life annuity form (including any form of life annuity, such as a joint and survivor annuity, a single life annuity, or a life annuity with a term certain) would be excluded. The MRD requirements would phase in ratably for individuals with aggregate retirement benefits between $75,000 and $85,000. The initial measurement date for the dollar threshold would be the beginning of the calendar year in which the individual reaches age 70½ or, if earlier, in which the individual dies, with additional measurement dates only at the beginning of the calendar year immediately following any calendar year in which the individual's IRAs or plans receive contributions, rollovers, or transfers of amounts that were not previously taken into account.

The proposal would be effective for taxpayers attaining age 70½ on or after December 31, 2013 and for taxpayers who die on or after December 31, 2013 before attaining age 70 ½.