ECONOMIC SECURITY: HEALTH, RETIREMENT, LIFE INSURANCE, FRINGE BENEFITS AND EXECUTIVE COMPENSATION

Senate Finance Committee Staff Tax Reform Options for Discussion

May 23, 2013

This document is the seventh in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The tax code plays an important role in individual economic security. It encourages retirement savings and facilitates access to affordable health insurance through employer-sponsored arrangements. Tax reform provides an opportunity to review all of these rules, determine which are achieving the desired goals, and which are creating economic or behavioral distortions that should be changed.

Following are several potential goals that could serve as guidelines for the Committee when reviewing the tax rules that affect the economic security of Americans:

- Minimize the disruption to business practices and employee expectations inherent in any fundamental tax reform
- Simplify the taxation of retirement savings and health insurance
- Increase the number of people with enough resources for an adequate standard of living in retirement, and expand access to health insurance
- Maximize the bang-for-the-buck of any tax incentives that are retained or reformed
- Develop neutral rules regarding compensation and fringe benefits to ensure that business needs and not tax planning drive compensation decisions, while minimizing compliance costs

Some specific concerns related to the tax rules associated with individual economic security include the following:

- **Complexity**: There are a host of provisions related to employee benefits in the tax code. For example, there are at least five different types of tax-preferred, defined contribution retirement plans in addition to defined benefit plans and individual retirement accounts (IRAs). While each has different features and requirements, employers and plan administrators are often able to simplify the process for employees. Nonetheless, there is plenty of room for improvement in making it easier for employers to choose among and administer these plans, and easier for employees to participate.

- **Low bang-for-the-buck for tax incentives:** Tax incentives in this area could potentially achieve more at a lower cost. For example, only 54% of all workers (excluding federal employees) and 65% of all such full-time workers participate in an employer-sponsored retirement plan according to the Bureau of Labor Statistics. Research has found that if employers automatically enroll new employees in a retirement savings plan unless the employee opts out, the percentage of workers who participate in the plan increases substantially, both in the short term and over time. The Pension Protection Act of 2006 encouraged more employers to adopt automatic enrollment but many still have not. Tax reform could also consider whether tax-preferred life insurance products are actually being used for insurance purposes.

- **Executive compensation**: Some believe that the rapid increase in some forms of executive compensation is, at least in part, attributable to our tax laws. According to a recent Bloomberg report, the CEOs of the S&P 500 Index top 250 companies received, on average, more than 200 times more in compensation than their rank-and-file workers, according to the most recent data. In 1950, this ratio was 42-1 instead. The current limit on corporate deductions for compensation in excess of $1 million may have had the unintended consequence of encouraging companies to award large equity compensation grants. Furthermore, many commentators believe that golden parachute agreements actually increased in number after Congress passed laws intended to curb such agreements. Others believe executive compensation is driven by market forces. They note that highly-compensated employees who are not subject to the aforementioned limit on compensation deductions, such as professional athletes, musicians and actors, have also experienced significant growth in compensation. For instance, according to the Baseball Almanac, major league baseball players' annual compensation has risen from an average of $30,000 in 1970 to $3.3 million in 2010.

REFORM OPTIONS

I. RETIREMENT

Under current law, individuals have three sources of savings for retirement. The first is Social Security. The second is employer-sponsored savings vehicles, which are sometimes called "qualified retirement plans." These plans include both defined benefit plans and defined contribution plans, such as 401(k) plans. The third is individual savings, including tax-preferred savings vehicles such as IRAs and annuity contracts.

The tax benefits for retirement savings are one of the largest of all individual tax expenditures. Under current tax law, contributions to "traditional" defined contribution plans and IRAs benefit from "deferral." Such contributions are either excluded from the employee's income or deductible to the employee. As a result, the contributions are made out of pre-tax dollars. The employee is then not taxed on either the contributions or the earnings on the contributions until a distribution takes place. In contrast, contributions to Roth defined contribution plans and Roth IRAs are made with after-tax dollars and no tax applies to the earnings thereafter. The tax rules also apply penalties for early withdrawals from defined contribution plans to prevent leakage.

Additional incentives exist to encourage individuals who are otherwise underserved in the employer-sponsored market, generally those with lower incomes, to save for retirement. For example, the saver's credit is available for low income individuals that contribute to retirement plans, including IRAs and 401(k) plans. Employers are also encouraged to start up and maintain plans through certain tax incentives and simplification measures.

There are a number of rules regarding how defined contribution and defined benefit plans must be established and administered in both the tax law and the Employee Retirement Income Security Act (ERISA). These rules limit tax preferences to a certain amount of contributions and to retirement plans that do not discriminate in favor of highly-compensated employees. These rules also limit or penalize pre-retirement withdrawals by employees from retirement plans. Employer-sponsored defined benefit and defined contribution plans are regulated by both the Department of Labor and the Treasury Department. Other, non-qualified plans, such as IRAs and private annuity contracts are not subject to ERISA and are not regulated by the Department of Labor.

1. Limit or eliminate tax preferences for retirement saving

a. Significantly reduce or repeal all tax expenditures for retirement savings and replace with automatic enrollment or expanded Social Security benefits (Farrell, "To Boost Retirement Savings, Stop Giving Tax Breaks on 401(k)s," Bloomberg, April 2013; New America Foundation, "Expanded Social Security, A Plan to Increase Retirement Security for All Americans," April 2013; Kwak, "Washington's Backward Retirement Policy: So Wrong, and Yet So Easy to Fix," The Atlantic, April 2013)
b. Reduce limits on tax-preferred contributions to retirement plans to, for example, $14,850 for defined contribution plans and $4,500 for individual retirement accounts (IRAs), or to a percentage of taxpayer's income (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011; estimated in 2011 to raise $46 billion over 10 years; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010; Bipartisan Policy Center, "Restoring America's Future," November 2010)
    i. Alternatively, could temporarily or permanently repeal inflation indexing for limits on tax-preferred contributions
c. Cap the value of deductions and exclusions for defined contribution plans to 28 cents per dollar contributed (FY2014 Administration Budget Proposal)

d. Disallow further tax-preferred contributions to defined contribution or defined benefit plans once the total value reaches the equivalent of, for example, $3 million or roughly $200,000 annual annuity at today's interest rates (FY2014 Administration Budget Proposal; estimated in 2013 to raise $5 billion over 10 years)
e. Eliminate higher "catch up" contributions limits for those age 50 years or older (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011)
f. Require inherited IRAs to be distributed within five years (with exceptions for a beneficiary within 10 years of the account holder's age, individuals who are disabled or with special needs, a minor, or the IRA holder's spouse) (FY2014 Administration Budget Proposal; estimated in 2013 to raise $5 billion over 10 years; Modifications to Chairman's Mark of the Moving Ahead for Progress in the 21st Century Act, H.R.4348 (112th Congress); Sen. Cardin, Retirement Adequacy , Access and Clarification Act Summary, 2013)
g. Repeal deduction for dividends paid by C corporations to employee stock ownership plans (FY2014 Administration Budget Proposal; estimated in 2013 to raise $8 billion over 10 years)
h. Repeal non-deductible IRAs (Joint Committee on Taxation, "Study Of The Overall State Of The Federal Tax System And Recommendations For Simplification," March 2001)

2. Replace deductions, exclusions and credits for retirement savings with a single refundable tax credit

a. Replace current exclusions, deductions and credits for defined contribution plans and IRAs with a refundable credit matching, for example, 33% of retirement savings that is directly deposited into the account (Testimony of Dr. William Gale before the Finance Committee, September 15, 2011; AARP, "New Ways to Promote Retirement Saving," October 2012*;* Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)
    i. Could replace income tax deductions and exclusions only, or could also replace payroll tax exclusions
    ii. Could repeal deduction for contributions and exclusion for Roth earnings, but not deferral of tax on accrued earnings
    iii. Could limit annual per-person contributions to, for example, $15,000 or 15% of income

3. **Increase retirement savings incentives**

    a. Expand the saver's tax credit and make it refundable (Testimony of Karen Friedman before the Finance Committee, September 15, 2011; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010; Bipartisan Policy Center, "Restoring America's Future," November 2010; FY2011 Administration Budget Proposal; estimated in 2010 to raise $10 billion over 10 years; H.R.837, (113th Congress), Savings for American Families' Future Act of 2013, sponsored by Rep. Neal and others; The Hamilton Project, "Better Ways to Promote Saving through the Tax System," February 2013)
        i. Could also double the credit if the taxpayer elects to have it deposited directly into their retirement account
    b. Expand the credit for small employer pension plan startup costs from $500 to, for example, $1,000 (S.1557 (112th Congress), Automatic IRA Act of 2011, sponsored by Sens. Bingaman and Kerry; H.R.4050 (112th Congress), Retirement Plan Simplification and Enhancement Act of 2012, sponsored by Rep. Neal)
    c. In connection with replacing existing income tax with a flat tax, repeal non-discrimination rules, contribution limits, and restrictions on distributions (S.173 (113th Congress), Simplified, Manageable, And Responsible Tax Act, sponsored by Sen. Shelby)

4. **Attempt to increase effect of tax expenditures for retirement savings on retirement security**

    a. Increase automatic retirement savings vehicles

i. Require employers that do not sponsor a qualified retirement plan to automatically enroll their workers in IRAs if, for example, the employer has more than 10 employees (FY2014 Administration Budget Proposal; estimated in 2013 to cost $11 billion over 10 years; S.1557 (112th Congress), Automatic IRA Act of 2011, sponsored by Sens. Bingaman and Kerry; H.R.4049 (112th Congress), Automatic IRA Act of 2012, sponsored by Reps. Neal and Blumenauer; The Hamilton Project, "Better Ways to Promote Saving through the Tax System," February 2013; Sen. Harkin, "The Retirement Crisis and a Plan to Solve It," U.S. Senate Committee on Health, Education, Labor, and Pensions, July 2012; Urban Institute Opportunity and Ownership Project, "Why Not a 'Super Simple' Savings Plan for the United States?" May 2008)
    1. Could provide a credit to such employers for automatically enrolling their workers in IRAs rather than imposing a fee if they do not
    2. Could also require employer to make a contribution or government could make matching contributions for low and moderate income workers
    3. Could require that IRA provide a lifetime income benefit

ii. Revise automatic enrollment safe harbor for retirement plans to encourage more savings (H.R.4050 (112th Congress), Retirement Plan Simplification and Enhancement Act of 2012, sponsored by Rep. Neal; H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)

b. Increase the use of retirement savings to purchase life annuities or long-term care insurance

i. Provide incentives for or require taxpayers to use a portion of tax-preferred retirement savings to purchase life annuities or long-term care insurance by, for example, providing an exclusion for a portion of distributions from retirement plans if the funds were used to purchase a life annuity (Testimony of Karen Friedman before the Finance Committee, September 15, 2011; Sen. Cardin, Retirement Adequacy, Access and Clarification Act Summary, 2013; H.R.2748 (111th Congress), Retirement Security Needs Lifetime Pay Act of 2009, sponsored by Reps. Pomeroy and Brown-Waite)

   ii. Automatically distribute defined contribution funds as life annuities at retirement unless accountholder opts out (Brookings Institution, “Increasing Annuitization in 401(k) Plans with Automatic Trial Income,” June, 2008)

c. Expand the defined contribution rules for long-term, part-time workers by, for example, requiring employers maintaining a 401(k) plan to allow certain part-time employees to access the plan (S.1288 (110th Congress), Women's Retirement Security Act of 2007, sponsored by Sen. Smith and others)
d. Require disclosure of total benefits accrued under a defined contribution plan as the equivalent monthly annuity payment the participant or beneficiary would receive (S.267 (112th Congress), Lifetime Income Disclosure Act, sponsored by Sens. Bingaman, Isakson, and Kohl)

5. Simplify process of selecting and administering a plan for employers

a. Consolidate existing plan options for employers
   i. Establish the “Save at Work” plan to combine all current employer-provided arrangements into a single plan with a single set of administrative rules. (President’s Advisory Panel on Federal Tax Reform, 2005)
   ii. Consolidate retirement accounts (The National Commission on Fiscal Responsibility and Reform, “The Moment of Truth,” December 2010; Bipartisan Policy Center, “Restoring America’s Future,” November 2010)
   iii. Consolidate traditional and Roth IRAs into a new tax-preferred lifetime retirement savings account (S.3018 (111th Congress), Bipartisan Tax Fairness and Simplification Act of 2010, sponsored by Sen. Wyden and others)
b. Simplify and reduce the administrative burden on plan sponsors by, for example, reducing and streamlining the number of required notices, and updating rules to better accommodate electronic delivery of notices (American Benefits Council, “Statement to the U.S. House of Representatives Committee on Ways and Means Pension/Retirement Tax Reform Working Group,” April 2013)

6. Establish new plan options for employers

a. Create multiple small employer plans (MSEPs) (H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)

7. Reduce “leakage” from retirement plans

a. Prohibit individuals from withdrawing some portion of funds in defined contribution plans and IRAs prior to retirement (Testimony of Karen Friedman before the Finance Committee, September 15, 2011)
b. Modify the existing rules regarding rollovers and withdrawals to reduce leakage (S.606 (113th Congress), Shrinking Emergency Account Losses Act, sponsored by Sens. Nelson and Enzi)
    i. Extend time to rollover loan offset amount until due date of tax return
    ii. Extend the rollover period for defined contribution plan loan amounts outstanding when employment is terminated
    iii. Allow plan participants to continue to make elective contributions to a qualified plan during the six months following a hardship withdrawal
    iv. Ban the 401(k) debit or credit card

8. Allow more flexibility in distributions from retirement savings accounts

a. Allow taxpayers to withdraw money from a qualified retirement account penalty-free to make mortgage payments toward a primary residence (S.1656 (112th Congress), Hardship Outlays to protect Mortgage Equity Act of 2011, sponsored by Sen. Isakson)
b. Relax distribution limits for SIMPLE IRA plans and change contribution limits to resemble those of 401(k) plans (H.R.1534 (112th Congress) SAVE Act, sponsored by Reps. Kind and Reichert)
c. Eliminate the minimum distribution rules for individuals and couples whose vested interests in tax-qualified plans are less than, for example, $100,000 (American Bar Association, Section on Taxation, “Options for Tax Reform Regarding Employee Benefits and Executive Compensation,” October 2012)
d. Allow penalty-free withdrawals from IRAs of up to, for example, $10,000 if used to pay adoption expenses, and unlimited withdrawals for expenses related to adopting a special needs child (H.R.1476 (113th Congress), Dave Thomas Adoption Act of 2013, sponsored by Rep. King and others)
e. Adjust rules relating to spousal access to retirement benefits, for example by allowing a participant and current spouse to lock into a deferred life annuity as part of a qualified domestic relations order (American Bar Association, Section on Taxation, “Options for Tax Reform Regarding Employee Benefits and Executive Compensation,” October 2012)

9. **Other long-term savings vehicles**

    a. Establish "Lifetime Savings Account" for each child born in the U.S. starting with a federal government contribution of, for example, $500 (S.3577 (111th Congress), America Saving for Personal Investment, Retirement and Education Act of 2010, sponsored by Sens. Schumer and Dodd)
    b. Expand section 529 to give individuals with disabilities and/or their families access to tax-preferred savings (S.313 (113th Congress) Achieving a Better Life Experience Act of 2013, sponsored by Sen. Casey, Burr, Rockefeller, Roberts, Schumer, Stabenow, Cardin, and others)

II. HEALTH

Under current law, individuals who receive health insurance through their employer do not include the cost of their health insurance in income. These individuals are also able to deduct amounts they pay for health insurance premiums and funds they transfer to health accounts. The exclusion from income of employer-sponsored health insurance is the single largest tax expenditure in the tax code.

Individuals may deduct medical and dental expenses that are greater than 10% of their adjusted gross income. Premiums, including those for Medicare, qualify as a medical expense. In addition, starting in 2014, some individuals will be eligible for the refundable health insurance premium tax credits to help purchase health insurance through the new health insurance Exchanges.

Individuals may also take advantage of medical spending accounts to accumulate money for health expenses on a tax-preferred basis. Contributions to Flexible Spending Accounts (FSAs) and Health Savings Accounts (HSAs) are deductible and, as along as the monies are used for qualified medical expenses, no tax is ever collected on the money deposited in the accounts. The annual cap on individual contributions to FSAs is $2,500. Each year, FSAs are reset to zero and any unused money is lost by the individual. For 2013, HSA contributions are capped at $3,250 for an individual and $6,450 for a family. HSAs can only be established in connection with a high-deductible health plan.

1. **Reduce tax expenditures for employer-provided health benefits**

    a. Repeal tax incentives for employer-provided health benefits

    i. Repeal the exclusion for employer-provided health benefits by imposing a cap which decreases over time until all employer contributions are subject to tax (Bipartisan Policy Center, "Restoring America's Future," November 2010; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010)
    ii. Disallow new contributions to health savings accounts and flexible spending accounts (Bipartisan Policy Center, "Restoring America's Future," November 2010; Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)
b. Limit the employer-provided health insurance exclusion to the average cost of health coverage and either (President's Advisory Panel on Federal Tax Reform, 2005):
    i. Allow a deduction for the purchase of health insurance in the individual market up to the average cost for health insurance, or
    ii. Provide a deduction equal to the exclusion for employer-provided insurance for workers without employer-provided plans

2. Modify the Affordable Care Act (ACA)

a. Refine certain provisions of ACA
    i. Make certain over-the-counter drugs payable through a health savings account or flexible spending account and repeal the provider's prescription requirement (H.R.4224 (112th Congress), Offering Patients True Individualized Options Now Act of 2012, sponsored by Rep. Broun)
    ii. Accelerate the excise tax on high-premium health insurance plans (Goldsmith, "Letting Go of Employer-Based Health Insurance," Health Affairs Blog, July 2011)
    iii. Reduce the excise tax on high-premium health insurance plans in conjunction with reducing the exclusion for employer-sponsored health insurance to, for example, the 80th percentile for single and family employer-sponsored premiums (Bipartisan Policy Center, "A Bipartisan Rx for Patient-Centered Care and System-wide Cost Containment," April 2013; The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010)
    iv. Replace the medical device fee with a fee on the medical device industry structured similarly to the pharmaceutical and health insurance fees (S.1796 (111th Congress), America's Healthy Futures Act of 2009, sponsored by Sen. Baucus)

                1. Create an exemption for small domestic manufacturers

    v. Replace the annual fee on health insurance providers with a tax on all paid health insurance claims (Bipartisan Policy Center, "A Bipartisan Rx for Patient-Centered Care and System-wide Cost Containment," April 2013)
        1. Would apply to claims paid by a commercially-insured plan or a third-party administrator working on behalf of a self-insured employer
    vi. Extend the requirement that employers provide minimum essential health insurance coverage to part-time employees (H.R.675 (113th Congress), Part-Time Worker Bill of Rights Act of 2013, sponsored by Rep. Schakowsky and others)
    vii. Ease the burden on employers by, for example, modifying reporting requirements and the definitions of full-time employee and large employers (National Association of Health Underwriters, Employers for Flexibility in Health Care Coalition, April 2013)

b. Repeal certain provisions of the ACA
    i. Repeal the shared responsibility for employers regarding health coverage (S.399 (113th Congress), American Job Protection Act, sponsored by Sen. Hatch and others)
    ii. Repeal the requirement that individuals maintain minimum essential coverage (section 1501 of ACA) (S.12 (112th Congress), Job Creation Act of 2011, sponsored by Sen. Portman)
    iii. Repeal the medical device tax (S.232 (113th Congress), Medical Device Access and Innovation Protection Act, sponsored by Sens. Hatch, Klobuchar, Crapo, Casey, Roberts, Enzi, Cornyn, Thune, Isakson, Portman, Toomey, and others)

c. Replace the employer-provided health insurance exclusion with a refundable or non-refundable tax credit for employer-provided health insurance (Roosevelt Institute Campus Network, "Budget for a Millennial America," May 2011)
    i. Alternatively, replace the premium assistance credit as well and allow the new credit for both employer-provided health insurance and health insurance purchased through the exchanges (Peter G. Petersen Foundation, "The 2011 Fiscal Summit: The Solutions Initiative," May 2011)

3. **Expand the tax benefits for health**

   a. Expand health savings accounts (S.1098 (112th Congress), Family and Retirement Health Investment Act of 2011, sponsored by Sens. Hatch, Inhofe and others)
   b. Repeal the $2,500 annual cap for health flexible spending arrangements under cafeteria plans (S.24 (113th Congress), Small Business Health Relief Act of 2013, sponsored by Sen. Portman)
   c. Allow the self-employed to deduct health insurance premiums for purposes of self-employment taxes (H.R.886 (113th Congress), America's Small Business Tax Relief Act of 2013, sponsored by Reps. Gerlack and Kind)
   d. Repeal the floor on deducting medical expenses for individuals under age 65 who have no employer health coverage (H.R.99 (112th Congress), The Fair and Simple Tax Act of 2011, sponsored by Reps. Drier, Ross, and Sessions)
   e. Exclude from an employee's income the fees paid by an employer to an athletic or fitness facility on the employee's behalf (S.39 (113th Congress), Healthy Lifestyles and Prevention America Act, sponsored by Sen. Harkin)
   f. Harmonize treatment of local and state government employees when passing on tax-preferred health accounts to non-dependents (S.1366 (112th Congress), A bill to broaden the special rules… to include plans established by political subdivisions, sponsored by Sens. Cantwell, Crapo and others)

4. **Expand long-term care benefits** (The Jerome Levy Economics Institute, "Financing Long-Term Care: Options for Policy," January 2000)

   a. Subsidize the purchase of long-term care insurance through an income tax credit or tax deduction for premiums
   b. Require individuals to carry long-term care insurance and provide a refundable tax credit for purchase

5. **Reform excise taxes and other tax provisions that may affect health**

   a. Increase tobacco taxes (FY2014 Administration Budget Proposal; S.826 (113th Congress), Tobacco Tax and Enforcement Reform Act, sponsored by Sen. Lautenberg and others; Robert Wood Johnson Foundation, "The Impact of Tax and Smoke-Free Air Policy Changes," April 2011)
      i. Establish parity in the tax rate between all types of tobacco including smokeless, roll-your-own, and pipe tobacco

    ii. Require electronic tax stamps on every package of tobacco product to address smuggling and evasion
    iii. Provide a tax credit to help defray costs of use of tobacco cessation products and services (H.R.2876 (108th Congress), The Quit Smoking Incentive and Opportunity Act of 2003, sponsored by Rep. LaTourette and others)

b. Modify alcohol taxes
    i. Increase alcohol taxes (Minnesota H.F. 677 (88th Legislature), Omnibus Tax Bill, sponsored by state Rep. Lenczewski)
    ii. Establish a uniform tax rate based on the alcohol content of the product (Joint Committee on Taxation, “Options to Improve Tax Compliance and Reform Tax Expenditures,” January 2005)
    iii. Reduce the excise tax rate on beer to pre-1991 levels (S.958, (113th Congress), the "Brewers Excise and Economic Relief "BEER" Act of 2013," sponsored by Sens. Udall, Bennet, and others)
    iv. Reduce the excise tax rate on small production brewers (S.917 (113th Congress), Small Brewer Reinvestment and Expanding Workforce Act of 2013, sponsored by Sens. Cardin, Bennet, Carper, Menendez, Portman, Schumer, Wyden, and others)

c. Institute a tax on recreational marijuana use (Colorado H.B.1318 (69th General Assembly), A Bill … Implementing Certain State Taxes on Retail Marijuana, sponsored by state Rep. Singer)

d. Impose an excise tax on sales of sugary beverages (Wang et al., “A Penny-Per-Ounce Tax on Sugar-Sweetened Beverages Would Cut Health and Cost Burdens of Diabetes,” Health Affairs, January 2012; New England Alliance for Children’s Health, “Sugar-Sweetened Beverage Tax Policy Brief,” October 2010; Yale University Rudd Center, “Soft Drink Taxes Policy Brief,” Fall 2009)

e. Modify other tax provisions
    i. Deny deductions for the cost of direct-to-consumer advertising for prescription drugs (H.R.923, (113th Congress), Say No to Drug Ads Act, sponsored by Rep. Nadler)
    ii. Deny deductions for advertising and marketing expenses primarily directed at children that promote food of poor nutritional quality (H.R.6599 (112th Congress), Stop Subsidizing Childhood Obesity Act, sponsored by Rep. Kucinich and others; Institute of Medicine, “Food Marketing to Children and Youth,” 2006)

III. LIFE INSURANCE AND ANNUITIES

Under current law, earnings that accrue on cash values of life insurance policies and annuity contracts are not taxed until they are distributed. Further, death benefits paid from a life insurance contract are excluded from the beneficiary's income, and if there has been no prior distribution of the accrued earnings those earnings are never taxed. Employers may also currently provide up to $50,000 in group term life insurance to their employees without the employees including the value of that coverage in their income. If the owner of a life insurance contract cashes out the contract prior to the insured's death, current IRS rulings require that the gain on the contract be increased by the value of the insurance coverage to date (called the "cost of insurance"), although that value is undefined.

1. Reduce tax expenditures for life insurance products

a. Currently tax the annual increase in the inside build-up on life insurance contracts (Center for American Progress, "Budgeting for Growth and Prosperity," May 2011)
b. Deny exclusion for death benefit payments above a specified amount (Geier, "The Taxation of Income Available for Discretionary Use," Virginia Tax Review, April 2006)

2. Reduce tax expenditures for annuities

a. Currently tax the annual increase in the inside build-up on annuity contracts (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011; estimated in 2011 to raise $260 billion over 10 years)

3. Other

a. Expand pro rata interest expense disallowance for corporate-owned life insurance (COLI) (FY2014 Administration Budget Proposal; estimated in 2013 to raise $7 billion over 10 years)
b. Clarify impact of cost of insurance on the investor's gain (S.2048 (112th Congress), A bill to … clarify the tax treatment of certain life insurance contract transactions …, sponsored by Sen. Casey)

c. Increase the $50,000 limit for employer-provided group term life insurance (H.R.1618 (113th Congress), A bill to … to increase the dollar limitation on employer-provided group term life insurance that can be excluded from the gross income of the employee, sponsored by Rep. Burgess)

IV. OTHER EMPLOYEE FRINGE BENEFITS

The tax law provides for numerous employer-provided fringe benefits that are either partially or completely non-taxable to employees. In some cases, these exclusions are for administrative convenience; in others, they are to promote various policies, such as supporting education.

1. Limit exclusions for other employee fringe benefits

a. Impose a 50% tax on employers for the net cost of meals, entertainment, gyms, and dining facilities provided to employees and customers, unless the cost is included in the employee's income and reflected on their Form W-2 (Johnson, "An Employer-level Proxy Tax on Fringe Benefits," Tax Notes, April 2009)
b. Repeal or reduce the exclusion for employer reimbursement of parking expenses to, for example, $100 (Center for American Progress, "Budgeting for Growth and Prosperity," May 2011; Mann, "On the Road Again: How Tax Policy Drives Transportation," Virginia Tax Review, 2005)
c. Repeal exclusion for certain employee achievement awards (S.3018 (111th Congress), The Bipartisan Tax Fairness and Simplification Act of 2010, sponsored by Sens. Wyden, Gregg, and others)
d. Increase the amount of taxable income that an employee or executive must report for the personal use of a corporate jet to better reflect the economic value of such benefit by (S.2031 (109th Congress), A bill to provide for the valuation of employee personal use of noncommercial aircraft for purposes of Federal income tax inclusion, sponsored by Sen. Dayton)
    i. Increasing the existing Standard Industry Fare Level (SIFL) rates used to compute taxable income based on an IRS formula for determining what a first-class seat on a comparable commercial flight would have cost
    ii. Using the proxy rules, or
    iii. By using the actual costs of operating the jet

e. Repeal or modify exclusions for housing, for example for clergy, university employees or nonprofit executives (Reilly, “Cash Parsonage Allowances - Constitutional But Bad Tax Policy - Law Professor Argues,” Forbes, March 2012; Aprill, “Parsonage and Tax Policy: Rethinking the Exclusion”, Loyola Law School, Los Angeles, June, 2010; Flynn and Strom, Plum Benefit to Cultural Post: Tax-Free Housing, New York Times, August 9, 2010)

2. Expand tax preferences for other employee fringe benefits

a. Allow employees to exclude up to, for example, $5,000 in payments by employer under a student loan repayment assistance program (H.R.395 (113th Congress), Student Loan Employment Benefits Act of 2013, sponsored by Rep. Israel and others)
b. Allow employees to exclude up to, for example, $600 in employer contributions to a qualified tuition program (H.R.529 (113th Congress), Savings Enhancement for Education in College Act, sponsored by Reps. Jenkins and Kind)
c. Permit election to include award plans for bona fide safety service volunteers based upon the volunteer’s length of service to be treated as deferred compensation (H.R.1009 (113th Congress), Volunteer Emergency Services Recruitment and Retention Act, sponsored by Rep. King and others)

3. Harmonize employee fringe benefit rules

a. Equalize exclusion for employer-paid parking and transportation benefits (Tax Foundation, “Income Tax Code No Longer Favors Parking over Transit... For Now,” January 2013)

V. EXECUTIVE COMPENSATION

Executive compensation generally refers to compensation of the members of the senior management team. Some forms of executive compensation include salaries, short term incentive pay (such as bonuses), long-term incentive pay (such as stock awards) and option awards, extra benefits (such as club memberships), and deferred compensation. The tax treatment of the various components of executive compensation varies depending on the specific item of compensation.

1. **Revise the limits on the deductibility of executive compensation**

Businesses can deduct the cost of reasonable compensation paid to employees. However, Section 162(m) limits the deduction for compensation to $1 million for the top four executives of public companies, with an exception for certain performance-based compensation, which includes stock options. (Special, more restrictive rules apply to companies that have received government bailout funds and certain health insurance companies.) In many cases, companies are able to plan around the limits of Section 162(m) through the use of performance-based compensation.

   a. Repeal the Section 162(m) limitation (Joint Committee on Taxation, "Report Of Investigation Of Enron Corporation And Related Entities Regarding Federal Tax And Compensation Issues, And Policy Recommendations," February 2013; Congressional Research Service, "The Economics of Corporate Executive Pay," December 2007)
   b. Modify the definition of covered employee for purposes of Section 162(m) to expand the limitation on deductibility of compensation to a larger group of executives (S.349 (110th Congress), Small Business and Work Opportunity Act of 2007, sponsored by Sen. Baucus)
   c. Apply the Section 162(m) limitation to all equity compensation, including stock options (S.268 (113th Congress), CUT Loopholes Act, sponsored by Sens. Levin and Whitehouse)
   d. Cap deduction for total executive compensation at multiple of (e.g., 25 times) the lowest compensation paid to any other employee or a set dollar amount (e.g., $500,000), whichever is lower (H.R.199 (113th Congress) Income Equity Act of 2013, sponsored by Reps. Lee, Ellison, and Schakowsky)

2. **Revise the rules related to non-qualified deferred compensation**

Deferred compensation is compensation that an employee earns in one period but will not receive until a future period. Many deferred compensation plans are "qualified plans," such as 401(k)s, which were discussed in Part I. In order to be a qualified plan, these plans must meet a number of requirements, such as limiting contributions to a certain amount and not discriminating in favor of highly-compensated employees. Non-qualified plans are simply deferred compensation arrangements that do not meet these requirements.

Employees are generally not taxed on non-qualified deferred compensation as long as there is a risk that the employee will not receive the compensation. For example, if the employee will not receive the deferred compensation if he leaves the company within five years, he will not be taxed on the compensation until the end of that five year period. Under a nonqualified deferred compensation plan, the employer's deduction is deferred until the employee has income.

There is, however, an exception to these rules for non-qualified deferred compensation plans that do not comply with various rules regarding the timing of deferrals and distributions under Section 409A. The penalty for non-compliance with the 409A requirements is that all amounts deferred under the plan to date are immediately taxed and subject to a 20% penalty tax, with interest.

a. Modify or repeal Section 409A (Polsky, "Fixing Section 409A: Legislative and Administrative Options," Villanova Law Review, 2012)
    i. Repeal Section 409A and replace with rules (or authority to Treasury to promulgate rules) that tax the value of deferred compensation when it is effectively received
    ii. Repeal Section 409A for employees of private companies
    iii. Repeal the 20% penalty tax
b. Tax employees on non-qualified deferred compensation (and earnings on such compensation) in the year it is earned (i.e., repeal deferral) (Doran," Time to Start Over on Deferred Compensation," Virginia Tax Review, 2008)
    i. Alternatively, require employers to pay a special tax on the investment earnings attributable to non-qualified deferred compensation (Halperin and Yale, "Deferred Compensation Revisited," Tax Notes, February 2007)
    ii. Alternatively, provide a default rule that requires executives to pay tax on the earnings on non-qualified deferred compensation, but allow companies to elect to pay a special tax on the investment income attributable to the deferred compensation in lieu of the executive (Urban Brookings Tax Policy Center, "Executive Compensation Reform and the Limits of Tax Policy," November 2004)
c. Impose a $1 million limit on non-qualified deferred compensation that can be deferred in a single year (S.2866 (110th Congress), Corporate Executive Compensation Accountability and Transparency Act, sponsored by Sen. Clinton)

3. Revise the rules related to equity-based compensation

The taxation of equity-based compensation varies depending on the type of equity, such as stock options or restricted stock, and the conditions associated with its transfer to the employee. For tax purposes, stock options are classified as either non-statutory stock options or statutory stock options (including 'incentive stock options'). Employees are taxed on non-statutory stock options when the options are exercised. The amount of income the employee must pay tax on is the fair market value of the stock less the exercise price. The employer can deduct a corresponding amount at the same time.

In contrast, employees are generally taxed on incentive stock options when the employee sells the underlying shares after exercising the options. For incentive stock options, the employee is generally taxed at ordinary rates if the employee did not meet certain holding period requirements and at capital gain rates if the holding period requirements were met. The employer generally only can deduct the value of incentive stock options if the holding period requirements are not met. The alternative minimum tax neutralizes the tax benefits of incentive stock options in many cases.

Other types of equity-based compensation, such as restricted stock, are generally taxable when the employee's ownership of the equity has vested, and the corporation can take a corresponding deduction at the same time. The amount of income that the employee must pay tax on (and the employer's corresponding deduction) are measured based upon the fair market value of the stock at the time of vesting less the amount, if anything, that the employee paid for the stock.

a. Repeal incentive stock options (Treasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984)
b. Modify the tax deductibility of stock options (S.268 (113th Congress), CUT Loopholes Act, sponsored by Sens. Levin and Whitehouse):
    i. Limit the deduction for an employer to the value of the stock option as recorded on the employer's books at the time such options are granted
    ii. Require the employer to deduct the stock option in the year when it expenses the compensation on its books

4. **Revise the rules related to golden parachute payments to executives upon a change in control**

   Under current tax law, if there is a change in control of a corporation, executives are required to pay a 20% excise tax on certain excess payments made that are contingent upon such change in control (sometimes called "parachute payments"). In addition, some portion of the company's tax deduction related to such payments may be disallowed.

   a. Repeal limitations on employer's deducting excess parachute payments and repeal the excise tax on the employee for such payments (Ginsburg and Levin, Mergers, Acquisitions and Buyouts, February 2012; Lazar, "The Unreasonable Case for a Reasonable Compensation Standard in the Public Company Context," Buffalo Law Review, 2011)