MEMO# 27984

March 25, 2014

Camp 2014 Tax Reform Proposal

[27984]

March 25, 2014

TO: BANK, TRUST AND RETIREMENT ADVISORY COMMITTEE No. 14-14
BROKER/DEALER ADVISORY COMMITTEE No. 15-14
OPERATIONS COMMITTEE No. 15-14
TRANSFER AGENT ADVISORY COMMITTEE No. 18-14 RE: CAMP 2014 TAX REFORM PROPOSAL

As we previously informed you, Chairman Dave Camp (R-MI) of the House of Representatives Committee on Ways & Means released a draft proposal for comprehensive tax reform on February 26, 2014. [1] The proposal aims to simplify the Internal Revenue Code, by:

- Replacing the current seven tax brackets for individuals with three brackets (10%, 25%, and 35%).
- Repealing the Alternative Minimum Tax (AMT).
- Eliminating the capital gains rate structure and replacing it with a deduction from gross income equal to 40 percent for net capital gains and qualified dividends. This effectively would increase the top marginal rate on capital gains from 20% to 21%. [2]
- Providing a flat corporate tax rate of 25%, to be phased in over 5 years.
- Eliminating or consolidating deductions for both individuals and businesses.
- Providing a "participation exemption" system for foreign income. Under this system, U.S. corporations effectively would receive a 95% deduction for the foreign-source portion of dividends received from "specified 10-percent owned foreign corporations." A specified 10-percent owned foreign corporation is any foreign corporation if any U.S. corporation owns directly or indirectly 10 percent or more of the voting stock of that foreign corporation.

Provisions Affecting Mutual Funds and their Shareholders

Chairman Camp's proposal contains a number of provisions that would affect mutual funds and their shareholders. Described below are some of the provisions that may be of interest to the Institute's members.

10% surtax on municipal bond income received by high earners. The draft legislation would limit most deductions and exemptions, including interest from municipal bonds, for income above the 25% bracket. Effectively, this would result in a 10% tax on any municipal bond interest received by taxpayers in the 35% bracket.

Capital contributions included in gross income. The draft legislation would change current law by requiring contributions to capital (not in exchange for stock) to be included in the receiving corporation's gross income. This change could affect payments to mutual funds by their sponsors (e.g., payments from the management company to a money market fund to maintain a $1 net asset value).

Income inclusion according to GAAP. This proposal would require accrual method taxpayers, including funds, to include an item of income for tax purposes no later than the tax year in which the item is included under GAAP.

Modification of Passive Income Exception for Publicly Traded Partnerships. The proposal would restrict qualifying passive income to income from certain mining and natural resources interests. The exception from corporate taxation thus would apply only to publicly traded partnerships with 90 percent of gross income from such interests.

Mandatory mark-to-market for derivatives. As was originally proposed by Chairman Camp last year, this provision would require most derivatives to be marked to market annually, and any gain or lost would be ordinary. [3] The proposal does carve out from this requirement convertible debt, securities lending transactions, repos, and ADRs.

Mandatory FIFO basis method. The proposal would require all taxpayers to use the first-in, first-out method for determining basis. The legislation permits the Treasury Department, however, to allow mutual fund shareholders to continue using average cost. This is a change from Chairman Camp's original proposal, which would have required average cost for all taxpayers, including mutual funds with respect to their own portfolios.

Repeal of tax credit bond rules. The proposal would repeal prospectively all existing authority for issuing tax credit bonds and direct-pay bonds.

Recognition of tax on built-in gain when C corporation elects RIC status. The proposal would require a corporation to recognize currently any built-in gain on assets when a C corporation converts to a REIT or RIC, or when a REIT or RIC acquires assets from a C corporation in a carryover basis transaction. Under current law, a corporation can elect to recognize such gain over 10 years.

Extension of tax return filing dates. The proposal would extend the due date for filing corporate tax returns to the 15th day of the 4th month following the close of the taxpayer's taxable year, or April 15 for calendar-year taxpayers. It also would provide an automatic 6-month extension.

Increased information return filing penalties. The proposal would increase the penalties for failure to file information returns and failure to furnish payee statements as follows:

> Failure to File Amount per Return Maximum per Year Maximum for Small Business Corrected within 30 days of due date Current: $30
>
> Proposed: $50 Current: $0.25M

Proposed: $0.5M Current: $0.075M

Proposed: $0.175M   Corrected after 30 days but before 9/1 Current: $60

Proposed: $100 Current: $0.5M

Proposed: $1.5M   Current: $0.2M

Proposed: $0.5M   Not filed on or after 9/1 Current: $100

Proposed: $250   Current: $1.5M

Proposed: $3.0 M   Current: $0.5M

Proposed: $1.0 M   Intentional failure Current: $250

Proposed: $500 Current: no limit

Proposed: no limit   Current: no limit

Proposed: no limit

Excise tax on SIFIs. The proposal would impose a 0.035% tax each calendar quarter on systemically important financial institutions ("SIFIs"), as defined by the Dodd-Frank Act. The tax would be imposed on the total consolidated assets of a SIFI exceeding $500 billion.

Retirement Provisions

Chairman Camp's tax reform proposal also contains several provisions that would modify the tax incentives for retirement savings, both with respect to individual retirement arrangements and employer-sponsored plans.

Individual Retirement Account Provisions

No new traditional IRA contributions.   The proposal would prohibit new contributions (not including rollovers) to traditional and non-deductable traditional IRAs after 2014. To facilitate application of this new requirement, the proposal eliminates the current income eligibility limits for contributing to Roth IRAs. [4]

Suspension of annual limit inflation adjustment. Effective for tax years beginning after 2014, the proposal would suspend the inflation adjustment of the annual limit on Roth IRA contributions until tax year 2024, at which time inflation adjustment would recommence based off of the frozen level.

Repeal of traditional/Roth IRA recharacterizations. The proposal would repeal the current rules allowing for recharacterization of a contribution to a traditional IRA as a contribution to a Roth IRA (and vice versa) and recharacterization of a conversion of a traditional IRA to a Roth IRA.

Repeal of exception to 10 percent penalty for first-time homebuyers. The proposal would repeal the current exception to the 10 percent early withdrawal penalty for first-time homebuyers. Under current law, an IRA holder generally may not withdraw funds from his

IRA prior to age 59½ without incurring a 10 percent penalty (in addition to applicable federal and state taxes). One exception to this rule is the ability of an IRA holder to withdraw up to $10,000 for pay for first-time homebuyer expenses.

Employer-Sponsored Plan Provisions

Fifty percent limitation on pre-tax plan deferrals. Under the proposal, pre-tax elective deferrals (including catch-up contributions) to 401(k), 403(b) and 457(b) plans would be limited to 50 percent of the maximum annual elective deferral. Any contribution in excess of this amount would be required to be contributed to a Roth account. [5] Employer contributions would continue to be made to traditional, pre-tax accounts. Employees would be able to contribute their entire deferral to a Roth account and the provision would not apply to employers with 100 or fewer employees .

Additionally, employers may choose to have Roth accounts in a SIMPLE IRA. If an employer with a SIMPLE IRA elects to limit pre-tax contributions to 50 percent of the annual contribution limit, the SIMPLE IRA employee contribution limit would be increased to the 401(k) plan contribution limit.

Surtax for taxpayers in 35 percent tax bracket. In addition to the above limitation, the proposal includes a 35 percent tax bracket that would begin at the same income levels as the current 39.6 percent bracket ($400,000 for single filers and $450,000 for joint filers in 2013). Under the proposal, individuals in the 35 percent tax bracket would be subject to a 10 percent surtax on amounts contributed to a defined contribution plan – including both employer contributions and employee contributions. As a result, employees in this tax bracket presumably would be subject to both the 10 percent surtax on contributions made to a plan, and tax at the time of distribution. The 10 percent surtax would likely encourage taxpayers in this tax bracket to contribute 100 percent of their elective deferrals to a Roth account.

Ten-year freeze on annually indexed contribution and benefit limits. The proposal would freeze the contribution and benefit limits for tax-qualified retirement plans, including the catch-up contribution limits, at the 2014 limits, for a 10-year period. In 2024, inflation indexing would resume, based off of the frozen limit.

No new SEPs or SIMPLE 401(k)s. Under the proposal, employers would not be able to establish a new Simplified Employee Pension (SEP) IRA or Savings Incentive Match Plan for Employees (SIMPLE) 401(k) plan after 2014. SIMPLE IRAs would continue to be available.

Modification of required minimum distribution rules. The proposal includes a provision designed to limit the ability to “stretch” the tax deferral on retirement savings well past the account owner’s life. The proposal would require the entire balance of an inherited IRA or employer sponsored plan be distributed within 5 years after the IRA owner’s or employee’s death, regardless of whether the IRA owner or employee dies before required minimum distributions have begun. The proposal includes an exception for a beneficiary who is a spouse, disabled, chronically ill, not more than 10 years younger than the deceased, or a child. The exception would permit distributions to begin within one year of death and be spread over the life expectancy of the beneficiary. However, if the beneficiary dies or a child beneficiary reaches age 21, the general five-year distribution rule would apply.

Modification of rules governing hardship distributions. The proposal would require Treasury to change its regulations currently requiring a suspension of contributions for six months following a hardship distribution (under the safe harbor for whether a distribution is necessary to satisfy an immediate and heavy financial need). The revised regulations would allow employees to continue making contributions after a hardship distribution.

Extended period for rollover of certain plan loan offset amounts. The proposal would extend the period of time allowed for employees to roll over an outstanding loan balance to an IRA after their plan terminates or after they separate from employment. Instead of the current 60-day rollover period, individuals would have until the due date (including extensions) for filing their tax return for the year in which the plan loan offset occurs.

Additional employer-sponsored plan provisions. The proposal includes other provisions relating to employer-sponsored plans. The proposal would: modify the minimum age rules for in-service distributions from defined benefit plans and state/local government defined contribution plans; harmonize the contribution limits across 401(k), 403(b), and 457(b) plans (regardless of the class of employee or the type of employer); and apply a 10 percent penalty to early distributions from a governmental 457 plan.

Howard Bard
Associate Counsel

Elena Barone Chism
Associate Counsel

Karen Lau Gibian
Associate Counsel

endnotes

[1] See Institute Memorandum (27917) dated February 26, 2014. The legislative language and technical explanations can be found on the website tax.house.gov.

[2] The draft proposal does not repeal the 3.8% tax on net investment income ("NII").   The top effective rate thus would be 24.8% if the tax on NII is included.

[3] See Institute Memorandum (26948) dated January 25, 2013. The draft tax reform bill incorporates all of the financial products provisions originally proposed in the 2013 discussion draft.

[4] Current law imposes income eligibility limitations for contributing to a Roth IRA. For 2014, the contribution limit phases out over a range of $114,000 to $129,000 for single, head of household or married filing separately taxpayers and $181,000 to $191,000 for married filing jointly taxpayers.

[5] A section-by-section summary prepared by the Ways and Means Committee majority tax staff states that only approximately 17 percent of those making contributions to a 401(k) plan in a given year contribute more than 50 percent of the maximum amount and thus would be affected by the provision. The summary is available here: http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf. In its 2013 "How American Saves" report, Vanguard states that during 2012, only 11 percent of participants saved the statutory maximum. https://pressroom.vanguard.com/nonindexed/2013.06.03_How_America_Saves_2013.pdf.