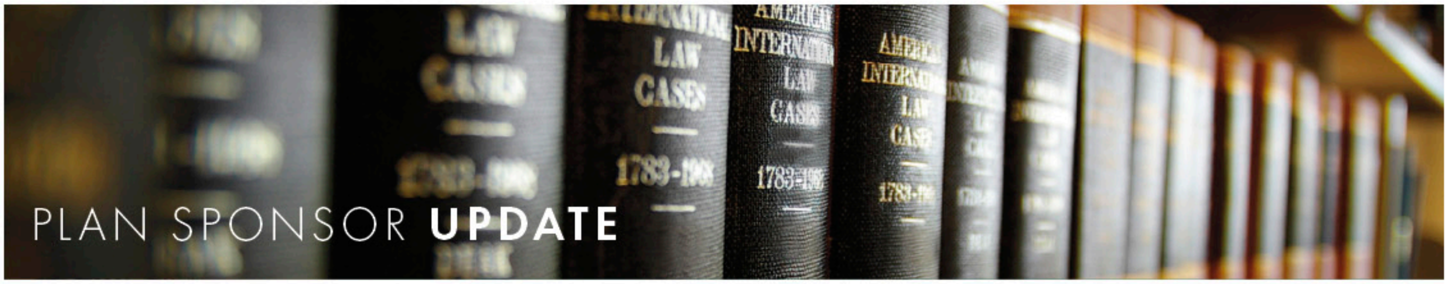

AN ANALYSIS OF LEGISLATIVE AND REGULATORY ISSUES AFFECTING PENSIONS

December 2016

HOW TAX REFORM MIGHT AFFECT RETIREMENT SAVINGS INCENTIVES – INCOME AND INVESTMENT

Summary of the Situation

It looks like tax reform will be a high legislative priority for President-Elect Trump and the Republican-controlled Congress. In the first of two articles on the effect of tax reform on retirement savings tax incentives we discuss: the tax reform process and the challenges it will present; current income and investment taxes and the incentives they provide for retirement saving; and the income and investment tax proposals of House Republicans and of President-Elect Trump and how they might change the retirement savings tax deal.

Who is most impacted by this?

Sponsors of DB and DC plans.

Key takeaways for clients

- *Process*: Republicans control both the House and the Senate, but Democrats can still block "normal" legislation with 41 votes in the Senate. Republicans can, however, move legislation in the Senate with only 51 votes through a Reconciliation Bill – that, in fact, was how the Bush 2001 tax cuts were passed. But the Republicans will only get one shot at Reconciliation, and they are probably going to want to include Affordable Care Act legislation in a Reconciliation Bill.

- Complications with a Reconciliation Bill and negotiations between House Republicans, Senate Republicans, House and Senate Democrats and the White House all will take time. And the complexity of the process – and the number of different "players" – makes any prediction now of what tax reform will ultimately look like pretty speculative. It does, however, give a feel for the moving parts in this process and how they may affect retirement benefits.

- *Retirement savings tax benefits – current law*: Generalizing, under the current income/investment tax system, (non-Roth) contributions to a tax qualified retirement plan are excluded from taxable income; earnings accumulate tax free; and contributions plus earnings are taxed at ordinary income tax rates when distributed.

- There are two direct tax benefits this system of taxation provides. *First*, assuming the participant's tax rate is the same at the time of contribution and distribution, the value of the retirement savings tax benefit is the value of the non-taxation of trust earnings. *Second*, where the participant's tax rate is higher at the time of (a non-Roth) contribution than it is at the time of distribution, the value of the retirement savings tax benefit is also the difference between those two tax rates.

- *Proposed changes to the current system that affect the value of retirement savings tax benefits*: Following this analysis, two sorts of changes currently under consideration will have an effect on the retirement savings tax benefits provided by the current system: (1) Reductions in the tax on investment earnings will reduce the relative value of the non-taxation of trust earnings. (2) Reductions in marginal tax rates, and, especially, reductions in the progressivity of the current income tax system, will reduce the value of being able to shift income from a high tax year to a low tax year.

- *Income and investment taxes*: The following chart summarizes current law income and investment tax rates and the rates House Republicans are proposing.

Current and Proposed (by House Republicans) Income and Investment Tax Rates (2016 tax rates)

Taxable Income	*Current Income Tax Rates*	*House Republicans Proposed Income Tax Rates*	*Current CG/Dividends Tax Rates*	*House Republicans Proposed CG/Dividends Tax Rates*
$0 – 18,550	10%		0%	
$18,551 – $75,300	15%	0%/12%		0%/6%
$75,301 – $151,900	25%		15%	
$151,901 – $231,450	28%	25%		13%
$231,451 – $413,350	33%			
$413,351 – $466,950	35%			
$466,951+	39.6%	33%	20%	17%

- President-elect Trump would (more or less) adopt the House Republicans' proposed income tax rates. But he is likely to keep the current investment (capital gains and dividends) tax rates. In addition, under current law there is a 3.8% Medicare Net Investment Income tax that (oversimplifying somewhat) applies to joint filers making over $250,000. Both House Republicans and President-Elect Trump would eliminate that tax.

- *Connecting the dots … effect of proposed changes to investment taxes*: Thus, both the House Republicans and President-Elect Trump would reduce taxes on investment by eliminating the 3.8% Medicare NII tax. House Republicans would go further, significantly reducing investment taxes across the board. These changes will reduce the value of the retirement savings tax benefit and make, e.g., contributing to a 401(k) marginally less attractive for taxpayers in those brackets in which the investment tax would be reduced.

- *… effect of proposed changes to income taxes*: Some general observations about this issue. When considering the value of being able to shift income from one (higher tax) year/bracket to another (lower tax) year/bracket, the key factor is the difference between the two rates. Thus, the value of income shifting could go up even if marginal rates go down, if the difference between the rates is greater. In this regard, the House Republican proposal (which President-Elect Trump has endorsed) is a mixed bag. Rates overall will be squeezed. But consider the different tax rate a taxpayer earning $85,000 will pay if she is able to shift $10,000 in income from the current year to a year when she will earn, say, only $50,000. Under current rules, she shifts income from a 25% tax rate year to a 15% tax rate year. Under the House Republican proposal, she would shift income from a 25% tax rate year to a 12% tax rate year, which is, in effect, a better deal.

- *Deduction cap*: The House Republicans' and President-Elect Trump's tax proposals have been criticized for, among other things, reducing tax revenues and thus threatening to increase federal debt. It is very possible that, in response to those criticisms, the parties to negotiations will, e.g., modify some proposals and look for revenues elsewhere, e.g., by "closing loopholes." With respect to retirement savings tax incentives, this may take the form of capping tax benefits for higher paid individuals. In that regard, the Obama Administration has proposed capping the value of the exclusion for defined contribution (and IRA) contributions at 28% – so that, e.g., a taxpayer in the 33% bracket would only get a 28% exclusion and would pay, in effect, a 5% tax on a 401(k) contribution. It is possible – perhaps in negotiations with Democrats – that a proposal for such a cap may come up, and its inclusion in any final tax reform deal would significantly reduce the tax value of retirement savings for some taxpayers.

What's next?

We will continue to follow this issue as it develops.