DAVIS & HARMAN LLP

ATTORNEYS AT LAW

THE WILLARD
1455 PENNSYLVANIA AVENUE, NW, SUITE 1200
WASHINGTON, DC 20004

TEL 202-347-2230
FAX 202-393-3310 WWW.DAVIS-HARMAN.COM

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Ways and Means Committee Releases Retirement Revenue Raising Proposals

On September 13, 2021, Richard Neal, Chairman of the House Ways and Means Committee released his proposed "revenue raisers" for consideration during the mark-up of the reconciliation bill. Below is a summary of the retirement and compensation-related raisers, including most notably a $10 million cap on IRA/defined contribution balances, changes in the Roth conversion rules, significant limits on IRA investment in non-traditional assets, limited expansion of the rule denying deductions for compensation over $1 million, and small reform of the 20% deduction under Code section 199A.

One point regarding what is *not* in the proposal. Despite rumors to the contrary, there is no proposal regarding nonqualified deferred compensation.

Important to reiterate that the process of getting a final bill has a long way to go, but this is an important development. Also important to note that changes to income tax rates, capital gains, and business taxes are not covered below.

Here is a link to the text of the revenue raisers: Subtitle I, Legislative Recommendations Relating to Funding Our Priorities. A link to the section by section explanation of the raisers is here.

Impact on Professional Employer Organizations: On initial review, the revenue raising provisions described below do not appear to have a particular impact on PEO-sponsored retirement plans. However, some of these provisions have never been seen publicly before, so further study is needed.

Cap on IRA/defined contribution plan vested balances, effective for 2022

- **Cap of $10 million with no grandfathering of existing amounts.** Under the proposal, there would be a cap on an individual's total vested balances (as of the close of preceding calendar year) in IRAs and defined contribution plans (including 401(a), 403(a), 403(b), and governmental 457(b) plans) of $10 million (indexed). Existing amounts are *not* grandfathered.
- **Applies only to higher income individuals.** The cap only applies to "applicable taxpayers," which means taxpayers who have "adjusted taxable income" ("ATI") in excess of $450,000 (joint filers), $425,000 (heads of household), or $400,000 (other

taxpayers) (all figures indexed). Thus, if an individual is over the cap, but happens not to have significant income, the cap would not apply for that year.

- **Required distribution**. A portion of the excess is treated as a required minimum distribution in the succeeding year. There are two rules that would apply. First, the minimum distribution generally is 50 percent of the amount by which the individual's prior year aggregate traditional IRA, Roth IRA and defined contribution account balance exceeds the $10 million limit. In addition, if the individual's combined balance exceed $20 million, the excess is required to be distributed in an amount equal to the lesser of (a) the amount needed to bring the total to 100% (i.e. the 50% rule doesn't apply) or (b) the aggregate amount in the individual's Roth IRAs and designated Roth accounts. In other words, the individual needs to distribute up to his/her entire Roth balances to bring the total aggregate balances down to $20 million.
    - **Example**: Assume that an individual has a Roth IRA account of $30 million, a traditional IRA account of $10 million, and a pre-tax 401(k) vested account of $40 million as of the end of 2021, for an aggregate vested amount of $80 million. Very general example of the required distribution for 2022, skipping some less significant details.
        - **Roth excess amount**. The first step is to calculate the total applicable Roth excess amount. That amount is the lesser of (1) excess of the total amount in all accounts over an amount equal to double the cap (i.e., $80 million minus $20 million, which equals $60 million), or (2) the total Roth amounts (which is $30 million). So the applicable Roth excess amount is $30 million. This entire $30 million must be fully distributed.
        - **Remaining excess amount**. The second step is to calculate the total excess over the cap, which is $70 million. The next step is multiply $70 million by 50%, which is $35 million. Then that $35 million amount is then reduced by the applicable Roth excess amount, which is $30 million. So the remaining excess amount, as I call it, is $5 million.
        - **Total required to be distributed in this example**. The $30 million applicable Roth excess amount plus the $5 million remaining excess amount for a total of $35 million. This process would be repeated for 2023 and subsequent years.
- **Allocation of required distribution among plans and IRAs.** Generally, an individual would be able to decide which accounts should be distributed, with two exceptions. First, applicable excess Roth amounts are allocated first to Roth IRAs and then to Roth accounts in plans. Second, the excess is allocated last to ESOPs that are invested in employer securities that are not readily tradable on an established securities market. In addition, Treasury is directed to issue regulations allowing excesses otherwise required to be distributed from such ESOPs in 2022 to be distributed over a period of years. For purposes of calculating excesses after 2022, the amounts to be distributed for 2022 shall be disregarded.
- **Beneficiaries**. This cap rule applies both to participants and beneficiaries to the extent the individual has died and the beneficiary is entitled to the money.
- **Excise tax.** Similar to the rule for RMDs, this required distribution is enforceable by the 50% excise tax on underpayments of required minimum distributions under Code section 4974.

- **Plan compliance**. A plan would be required to provide for a distribution based on an employee's certification that a distribution is needed, and this would not violate the otherwise applicable distribution restrictions. Plan amendments not required until 2023.
- **Penalty tax**. These distributions are not subject to the 10% early distribution tax.
- **Increased withholding**. These distributions are subject to mandatory 35% withholding.
- **Restriction on contributions.** IRA contributions may be made that would cause the cap to be exceeded or further exceeded. This would not, however, prohibit rollover contributions, and any amount received by death, divorce or separation are not counted as "contributions." Of course, as noted above, amounts received in this way may still need to be distributed as described above. Note that even though the contribution prohibition only applies to IRAs, the determination of whether the cap is exceeded takes into account all plans and IRAs, as in the case of the required distribution rule. Contributions to IRAs under SEPs and SIMPLEs are not treated as IRA contributions for this purpose. But they are taken into account indirectly by effectively reducing the cap by the amount of such contributions. The restriction on contributions is enforceable by the 6% annual excise tax on excess contributions under Code section 4973.
- **New reporting.** All plans, including those exempt from ERISA must report to the IRS with respect to vested accounts of at least $2.5 million (indexed).

Eliminating backdoor Roth contributions, effective for 2022. Under current law, "backdoor" Roth contributions are permitted under both plans and IRAs. Some individuals are precluded from making Roth IRA contributions due to the income limits. The income limits can be avoided by making an after-tax contribution to a traditional IRA and then converting that traditional IRA to a Roth IRA. If this is done quickly enough, and if the individual does not have any other traditional IRA assets, this conversion can be done without any tax consequences. On the plan side, an individual who has already made the maximum permitted 401(k) contributions (Roth and/or pre-tax) may effectively exceed that limit by making after-tax contributions to the plan and then converting those contributions to Roth. The bill would preclude both types of backdoor Roth contributions by prohibiting rollovers of after-tax amounts to Roth IRAs or Roth plan accounts. This restriction applies to all taxpayers, not just higher income individuals. Subject to the next paragraph, Roth conversions of pre-tax amounts are not restricted.

Eliminating all Roth conversions for high-income taxpayers. Applicable taxpayers (as defined above in the context of the $10 million cap) would be prohibited from doing Roth conversions, beginning in 2032. The delayed effective date was chosen to raise revenue. The idea is to encourage individuals who may want to do a conversion in the future to do it by the last year in the budget window.

Limiting IRAs investments. A new very significant restriction on IRA investments is included. IRAs may not be invested in securities if the issuer of such security requires the IRA owner or beneficiary to make a representation to the issuer that the owner or beneficiary (1) has a specified minimum amount of income or assets, (2) has completed a specified minimum level of education, or (3) holds a specific license or credential. The impact of this is to prevent IRAs from holding any investment issued under Reg D and similar exemptions from registration, and possibly many other investments. Because this is a new provision that has never been discussed or released, its impact is unknown. This provision is effective for 2022, and 2024 in the case of

otherwise prohibited investments held in an IRA on the date of enactment. Thus, IRAs would need to sell any investment that is not consistent with this rule by 2024.

Six-year statute of limitations in certain cases. A six-year statute of limitations would apply:

- In the case of a substantial error in reporting on a return the value of IRA assets.
- In the case of a prohibited transaction. (The heading suggests that this provision is limited to IRA-related prohibited transactions, but the text of the statute is not so limited.)

Prohibition on investment of IRA assets in entities in which the IRA owner or beneficiary has a substantial interest. An IRA may not hold interest in a corporation, partnership or other unincorporated enterprise, or trust or estate if the IRA owner or beneficiary (if the owner has died) (1) has a 10% or greater interest in such entity (taking into account constructive ownership rules) and the entity is not readily traded on an established securities market, or (2) is an officer or director of such entity. Effective for investments made in 2022 (2024 in the case of otherwise prohibited investments held on the date of enactment.)

IRA Prohibited Transaction. Under the bill, IRA owners and beneficiaries (if owner has died) treated as disqualified persons for purposes of prohibited transaction rules, effective for transactions after 2021. This probably does not have much impact, because in almost all cases an IRA owner is treated as a disqualified person because he/she has control over the account and is thus a fiduciary.

Expansion of limit on compensation deduction (Code section 162(m)). Prior to the American Rescue Plan Act ("ARPA") this year, very generally, public companies were not permitted to deduct compensation in excess of $1 million for any of their top five employees. ARPA generally increased the employees with respect to which this rule applied to the top 10 employees of public companies, effective for 2027. Under the new proposal:

- The effective date of the ARPA expansion would be accelerated to 2022.
- Corporations in a parent/subsidiary controlled group would be aggregated.
- The definition of compensation would be modified to explicitly include: "performance-based compensation, post-termination compensation, and beneficiary payments" and to include indirect payments.
- Treasury has the authority to issue guidance to prevent avoidance of the purposes of the rule, "including through the performance of services other than as an employee or by providing compensation through a pass-through or other entity."

199A reform.

- **Background.** Under the 2017 tax reform legislation, partners, S corporation shareholders, and sole proprietors, including owners of LLCs and LLPs, got a special deduction very generally equal to 20% of their business income. (For the sake of presentation, we are leaving out a lot of detail and some exceptions.) But the legislation phased this deduction out for high-income taxpayers ***in certain industries (a "specified service trade or business"), including the brokerage (but not insurance agents) and financial advice industries.*** For taxpayers in such a business filing jointly, the ability to

take the deduction phases out as the taxpayers' income exceeds $329,800 (in 2021) and is completely phased out when the taxpayers' taxable income hits $429,800. For other taxpayers, the phase-out starts at income of $164,900 and the phase-out is complete at $214,900.

- **Proposal.** The only thing that the bill would do is, effective for 2022, limit the deduction to $500,000 in the case of joint returns, $250,000 in the case of a married individual filing separately, $10,000 in the case of an estate or trust, or $400,000 for all other taxpayers.