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JCT Report Highlights Tax Cost of Employee Benefits

With Congress on its August recess — due to return September 8 — this week's *Legislate* examines the Joint Committee on Taxation's recent tax expenditure estimate for fiscal years 2014 to 2018. While tax reform is highly unlikely to be enacted in this Congress, it could be a key priority for the next Congress — scheduled to begin in January 2015. Given their size, several key tax expenditures for employee benefits may be an irresistible source of revenue in future tax reform proposals.

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Tax Expenditure Analysis

The Joint Committee on Taxation (JCT) periodically publishes five-year estimates of federal tax expenditures, intended to brief lawmakers on the magnitude of various economic benefits delivered to individuals and corporations through the tax code. Last week, JCT published an estimate for federal fiscal years 2014 to 2018.

For these purposes, JCT generally defines a "tax expenditure" as the revenue loss of at least $50 million over five fiscal years resulting from income tax provisions that allow for a special exclusion, exemption, or deduction or that provide a special credit, tax rate, or deferral of liability. A tax expenditure may also be negative if it produces tax treatment that is less favorable than under normal tax rules. Among other things, the JCT estimate includes tax expenditures for employer-provided benefits such as health insurance and qualified retirement plans, and several income tax provisions applicable to executive compensation that qualify as negative expenditures.

What is the Joint Committee on Taxation?

JCT is a joint committee of both chambers of Congress, with its members chosen from the two tax-writing committees — the House Ways and Means Committee and the Senate Finance Committee. JCT **prepares** the official revenue estimates and legislative history for all tax legislation for Congress.

JCT's analysis only takes into account revenue losses (or gains) for purposes of the federal income tax, and measures each tax expenditure by the difference between tax liability under present law and the tax liability that would result if the expenditure provision was repealed and taxpayers claimed the next best tax treatment. It does not include employment, excise, estate, and gift taxes.

As described below, the special tax rules for various employee benefits are among the largest tax expenditures in the federal tax code.

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Health Care

The income tax exclusion for employer-provided health coverage (including long-term care coverage) is the largest single line item tax expenditure identified by JCT — at a cost of $785 billion. The next largest single line item — at $633 billion — is the expenditure for reduced tax rates on dividends and capital gains.

The estimate for employer-provided health would be larger if it included military retiree coverage and the deduction for the cost of health care coverage for the self-employed — estimated as separate line items in the JCT report at $12 billion and $29 billion respectively.

Health savings accounts are estimated by JCT to cost $12 billion, and the Affordable Care Act's premium credits — for coverage purchased on the public marketplaces — are estimated at $318 billion.

Retirement

JCT divides the tax expenditure for employer retirement plans into four separate line items: defined benefit plans at $248 billion, defined contribution plans at $399 billion, plans covering the self-employed at $52 billion, and special rules for ESOPs at $5 billion. Aggregated as a single line item, the tax expenditure would cost $704 billion—and would rank second only to the exclusion for employer-provided health coverage. IRAs — both Roth and traditional — are estimated to cost an additional $100 billion, which would push the combined expenditure for private retirement savings ahead of the employer-provided health coverage cost.

Fringe Benefits

The tax expenditure estimates for employer-provided fringe benefits are generally much smaller in magnitude as compared to health and retirement — for example, employer-provided term life insurance coverage costs $16.8 billion. The exception is the cost of benefits provided under a cafeteria plan, such as a premium conversion benefit and FSAs — estimated to cost $193 billion. It should be noted that this estimate includes amounts of employer-provided health coverage paid for through a cafeteria plan, which are also included in the estimate of the tax expenditure for employer-provided health coverage described above.

Executive Compensation

The tax code's limits on executive compensation qualify as negative tax expenditures, but the size of these expenditures is relatively small. For example, the $1 million limitation on deductible compensation for certain employers is estimated to increase federal income taxes by $4.1 billion. The deduction limits on parachute payments is estimated to increase income taxes by $1.2 billion.

Implications for Tax Reform

Tax reform — from either a conservative or liberal perspective — is likely to require raising significant amounts of revenue. The revenue will be needed to either pay for rate reductions or pay for federal spending and deficit reduction. Earlier this year, Chairman Dave Camp (R-MI) of the Ways and Means Committee in the House of Representatives released a draft tax reform plan intended to reduce tax rates while maintaining a constant net level of federal revenue.

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That plan — described in our February 27, 2014 *FYI Alert* — raised significant amounts of revenue by reducing the tax expenditures for employee benefits — over $200 billion. While Chairman Camp's tax reform proposal is not likely to become law, it offers a hint of what may be included in future proposals or as spending offsets in other bills.

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