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Tax Expenditure Caps for High Earners in our Future?

Last week's edition of *Legislate* covered a recent congressional report on the cost of tax expenditures for employee benefits. This week's edition highlights two proposals — one from each side of the political aisle — that would reduce the value of tax expenditures for high earners, including expenditures for certain employee benefits. Neither is likely to be enacted this year, but both have the potential to raise significant amounts of revenue, which could be used for tax reform or federal deficit reduction. Both tax reform and deficits are likely to be key topics for the 114th Congress — scheduled to begin in January 2015.

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Background

President Barack Obama's last five proposed annual budgets (FY 2011, 2012, 2013, 2014, and 2015) have included a provision that would limit the value of certain tax exclusions and deductions to the 28% tax bracket. Tax preferences for certain employee benefits are among the exclusions and deductions that would be subject to the proposed limit. (See our March 7, 2014 *Legislate* for more information about other employee benefits provisions in the president's FY 2015 proposed budget.)

According to the administration's most recent budget materials (FYI 2015), the policy advantages of reducing the value of itemized deductions and other tax preferences to 28% for the wealthiest are:

- Deficit reduction from increased revenues
- Increased progressivity of the income tax, with fairer distribution of the cost of government among taxpayers of various income levels
- Closing the gap between the value of tax expenditures for high-income and middle-class earners

Amount of Revenue Raised?

President Obama's proposed 28% limitation is estimated by the Joint Committee on Taxation (JCT) to raise $497.6 billion over ten years.

The amount raised by Chairman Camp's 10% surcharge has not been separately estimated by JCT. In JCT's estimate of the Camp tax reform plan, the revenue raised by the surcharge is netted with the revenue lost by replacing the current 7-tier rate structure with a lower 3-tier rate structure. The net result is a $543.8 billion tax cut over ten years.

Earlier this year, Rep. Dave Camp (R-MI) — chairman of the tax-writing Committee on Ways and Means in the House of Representatives — released a comprehensive tax reform draft. Both a section-by-section summary prepared by the Ways and Means Committee Majority Tax Staff and a technical explanation prepared by JCT are available. Among the provisions in the draft is a 10% surcharge that would apply to the wealthiest taxpayers using an expanded definition of income. This expanded definition would include favorable tax preferences for certain employee benefits. Similar to the Obama proposal, the result of this expanded definition of income would be that certain tax preferences could only be taken against taxes imposed under lower rate brackets. (Please see our February 27, 2014 *FYI Alert* for more information on other employee benefits provisions in Chairman Camp's draft.)

The Obama and Camp Proposals Side-by-Side

	President Obama's Limitation	**Chairman Camp's Surcharge**
Basic rule	The tax value of specified deductions and exclusions (and all itemized deductions) would be limited to 28%	The current seven tax brackets would be consolidated and simplified into three brackets: 10%; 25%; and 35% The 35% bracket would be comprised of two rates: • The 25% rate on taxable income that applies to taxpayers in the 25% bracket, plus • A surcharge equal to 10% of a taxpayer's "modified adjusted gross income" (see row below) above the 35% bracket threshold
Employee benefits affected	Among the specified exclusions and deductions subject to the 28% limit would be: • Employer and pre-tax employee contributions for employer-sponsored health insurance • Health insurance costs of the self-employed • Employee (but not employer) contributions to defined contribution retirement plans (e.g., 401(k) elective contributions) and IRAs • Deduction for contributions to HSAs	Modified adjusted gross income would be defined more expansively than taxable income and would include the following: • Any amounts excludable as a cost of employer-sponsored health coverage (would include premium conversion benefits under a cafeteria plan) • Health insurance costs of the self-employed • Pre-tax contributions to defined contribution retirement plans — would include employer and employee contributions • Deduction for contributions to HSAs

Taxpayers affected	Those paying income taxes at the 33, 35, or 39.6% rates; for 2014, the 33% bracket begins at: • $226,850 for married filing jointly • $186,350 for single taxpayers	The 35% bracket would begin at the same income levels as the current law 39.6% bracket, which for 2014 begins at: • $457,600 for married filing jointly • $406,750 for single taxpayers
AMT	A similar rule would apply for AMT purposes	AMT would be repealed for individuals, pass-through businesses, and corporations
Basis adjustment	Basis would be adjusted for retirement plan and IRA contributions to reflect the additional tax imposed	No provision for basis adjustment

Conclusion

While both President Obama and Chairman Camp's proposals are somewhat similar in the scope of employee benefits that would be taxed, the contexts in which they were offered are starkly different. President Obama's proposal was offered as part of a budget plan that sought approximately $650 billion in additional revenue over the next decade for deficit reduction.

In contrast, Chairman Camp's proposal was offered as part of a tax reform plan that was not focused on raising additional revenue. Rather, the plan's goals were to reduce rates and make the tax code simpler and fairer. Chairman Camp's tax reform plan is roughly "revenue neutral" over the budget window, raising only $3 billion over ten years.

Both tax reform and federal deficits are likely to form the basis for key policy debates in the next Congress — which will begin in January 2015. As these two proposals demonstrate, limitations on federal tax expenditures may be offered on either side of the political aisle as a possible solution to tax reform or deficit reduction.

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