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Key legislative developments affecting your human resources

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Health care, retirement, and the fiscal cliff

There is concern in the employee benefits community that lawmakers could eliminate or change the preferential tax treatment of employer-provided retirement and health benefits as a way to raise revenue. Because Congress will need to act before the end of the year to address the fiscal cliff, it is unlikely that the controversial and complex tax treatment of employer-provided retirement and health benefits will be part of any fiscal cliff deal. However, even if these tax provisions are not in immediate jeopardy, it is almost certain that this issue will be discussed during the tax reform debate in the new Congress.

What is the fiscal cliff?

The "fiscal cliff" is a combination of tax increases, triggered by expiring or new taxes, and federal spending cuts implemented as part of the Budget Control Act of 2011. Some of the expiring tax cuts include the individual tax rate, the dividend/capital gains rate, the alternative minimum tax patch, the estate tax rate and the temporary 2% FICA payroll tax decrease. New tax increases include the Medicare taxes that begin in 2013 for upper-income individuals under the Patient Protection and Affordable Care Act (ACA). If Congress and the President do not agree on a budget deficit reduction plan, the Budget Control Act of 2011 will impose across-the-board cuts on defense (10%) and non-defense (8%) spending. Some major programs such as Social Security and Medicaid are excluded from the automatic cuts in the Budget Control Act of 2011, but that does not mean that they will be excluded from any fiscal cliff negotiations.

As discussed in our October 18, 2012 *For Your Information*, the fiscal cliff does not directly impact most employer-sponsored plans. However, it could affect adoption assistance benefits and tuition reimbursement programs. After December 31, 2012, the adoption assistance credit only applies to special needs adoptions and is lowered to $6,000. In addition, the tax exclusion on amounts received under an employer-provided adoption plan is no longer available. Similarly, after December 31, 2012, the education assistance exclusion of $5,250 is no longer is available. The changes to adoption assistance and tuition assistance will take place unless either or both are extended by the end of the year.

Although technically not part of the "fiscal cliff," the debt ceiling, the federal government's legal borrowing limit as set by Congress, may also need to be increased early next year, depending on whether certain budget cuts are made.

Robbing Peter to pay Paul, but just not now

Although the preferential tax treatment of health and retirement plans is not part of the built-in changes that comprise the fiscal cliff, the chatter continues inside and outside of Washington that the favorable tax treatment of both types of plans may be under attack to find ways to pay for programs that are on the edge of the cliff, such as the expiration of

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the Bush-era income tax cuts. Although the tax preference may be safe during fiscal cliff negotiations, it is likely that they will be scrutinized as prime targets during tax reform discussions. This is because revenue lost from these tax-preferred benefits puts them in the top five tax expenditures. Perhaps in light of this potential threat to retirement plans, Senators Richard Blumenthal (D-CT) and Johnny Isakson (R-GA) recently introduced a resolution encouraging lawmakers to maintain current tax incentives that encourage retirement savings in employer-provided plans.

A number of the more popular revenue-generating proposals that policy experts have mentioned, ranging from limiting to eliminating the tax exclusions provided for retirement and health care benefits, are listed below:

Retirement

Eliminate the exclusion for some

Current law allows employers to deduct their contributions to defined contribution (DC) plans, and employees do not immediately include these amounts in their income. In addition, employee contributions currently may be made on a pre-tax basis, and a participant's account grows on a tax-free basis until the employee actually takes a distribution. Current law also allows contributions (Roth contributions) to be made on an after-tax basis that, along with earnings, are not taxed when an employee takes a distribution.

Similarly, current law does not tax the value of a person's accrued benefit under a defined benefit (DB) plan. Like DC plans, DB plan benefits are not taxed until an individual actually receives a distribution, even though an employer obtains a current deduction for contributions to fund the plan.

Over the recent months, there has been quite a bit of debate by policymakers about the income tax treatment of DC retirement plan benefits for individuals making more than $200,000 and families making more than $250,000 (although not a lot about DB plans). One suggestion has been to limit DC deductions and exclusions for these individuals. Some options that policymakers have explored include: (1) changing the retirement exclusion on DC plans to a deduction and limiting the total deductions to a certain dollar amount, or (2) only allowing a deduction at lower tax rates.

Another possible option is to limit the maximum amount that may be contributed to a DC plan on a tax favorable basis. For example, once an individual has one or two million dollars contributed on a favorable tax basis, the individual would no longer be permitted to make additional contributions.

Only allow Roth contributions

Tax experts have also put forth a suggestion to allow only after-tax Roth contributions to IRAs and 401(k) accounts. This proposal would increase revenue on contributions for budget uses going forward and preserve the tax break for investment income on those contributions because the investment income grows tax free. Existing IRA and 401(k) accounts would presumably be left in place with the option for some, depending on the terms of the plan and what makes sense for an individual, to convert certain amounts in those plans to Roth contributions.

Cut the limits for all

Current law limits the amount of money that an individual may contribute to a 401(k) plan, the total amount of contributions to a DC plan, and the total amount of compensation taken into account in determining benefits under a

DB plan. These limits have been in the Internal Revenue Code (Code) for some time, and they have been modified over the years. These modifications were not necessarily based on retirement policy, but rather federal fiscal policy, often reflecting the health of the US economy. As such, it would not be surprising to see these limits revisited and possibly reduced by policymakers.

Simpson-Bowles Commission: capping the contribution limit for DC plans

In 2010, President Barack Obama created the National Commission on Fiscal Responsibility and Reform, co-chaired by Alan Simpson and Erskine Bowles (aka Simpson-Bowles Commission), and charged it with identifying policies to improve the US fiscal crisis. The Simpson-Bowles Commission's proposal directly addressed DC plans, but did not address DB plans. Specifically, the Commission recommended limiting contributions (both employee and employer) to the lesser of $20,000 or 20% of compensation. Currently, DC plan contributions are limited to $51,000 or 100% of compensation for 2013. It appears that this proposal encompasses all contribution limits, for example the current elective deferral limit of $17,000.

Health care

Since 1954, the Code has contained a provision that excludes the dollar value of employer-provided health care coverage for employees and their dependents from an employee's income. In addition, most employees pay for their share of health care costs through a cafeteria plan (Code Section 125), which allows them to pay premiums on a pre-tax basis.

Limits for high-income individuals

Similar to the proposal for DC plan contributions, some policy experts have suggested that high-income earners should lose the current exclusion of employer-provided health care coverage from their gross income. Instead, such earners would be allowed to deduct the cost of health care coverage, but only at a lower tax rate than the one they are in.

Alternatively, some proposals would eliminate the tax exclusion altogether, but allow an individual to deduct the cost of employer-provided health care, along with all other deductions, up to a set dollar amount, such as $25,000 for all deductions (e.g., mortgage, charity, health care premiums, etc.). Some policymakers would apply this only to high-income individuals while others would apply this to all individuals

Eliminate Code Section 125

Under this proposal, Congress would repeal Section 125 and employees would no longer be allowed to pay health care premiums on a pre-tax basis. However, any amounts an employer pays directly for employees' health coverage and the value of that coverage would still be excluded from employees' gross income.

Inclusion in income

Arguably the most extreme possible change to employer-provided health care would be to include the value of such coverage in employees' income. Although this change would likely raise the most revenue, the political climate makes this option unlikely.

Not now, but when?

Although it is doubtful that either the favorable tax treatment of employer-provided retirement or health care benefits will be on the chopping block during the fiscal cliff negotiations, it is expected that they will be discussed during the tax reform debate in the new Congress. Although it is not probable that a full frontal attack on these programs will occur, it is almost certain that come 2013 or 2014, there could be a new normal for retirement and health care benefits.