Legislate®
Key Legislative Developments Affecting Your Human Resources

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President Obama Releases FY 2017 Budget Proposal

President Obama's FY 2017 budget proposal was sent to Congress last week. It is a $4.15 trillion package that includes many labor, employment and employee benefits provisions. These provisions, which the president is calling a roadmap to "a future of opportunity and security for all of our families; [and] a rising standard of living," would impact employers and are discussed below.

What Happens with the President's Budget Proposal?

The president's 2017 FY budget proposal reflects the administration's views on amounts to be spent for governmental programs and on changes to tax provisions to pay for those programs. His proposal starts the complex congressional process with a number of committees. Central to the process is the coordination among separate House and Senate budget and appropriations committees. The result will be legislation for the president to sign or veto. (For additional detail, together with a flowchart, see the overview as described by the Congressional Research Service.)

To ensure that FY 2017 funding is secured timely, the congressional process should be completed before September 30, 2016 — the last day of the 2016 fiscal year. It will be an uphill battle to meet this deadline with a Republican controlled Congress and a Democrat president who is finishing his second term. With fewer obstacles last year, Congress and the president relied on continuing resolutions to bridge the gaps between the end of FY 2015 and November 2, 2015 (when the Bipartisan Budget Act of 2015 was enacted) and December 18, 2015 (when the Consolidated Appropriations Act, 2016 was enacted). This year may be no different.

Passing of Justice Antonin Scalia

Justice Antonin Scalia, a conservative justice nominated by President Reagan, died on February 13. President Obama's pending nomination to fill the vacancy is expected to be met with enormous resistance by the Republican controlled Congress. Meanwhile, any 4-4 decisions rendered by the Court will result in the lower court's decision remaining in place. One of the cases currently on the Supreme Court docket that could result in a tie is ***Gobeille v. Liberty Mutual Insurance Co.*** It arises out of a 2nd Circuit Court of Appeals decision holding that a Vermont law requiring third-party administrators of self-insured plans to provide health care claims data to a state-run database is pre-empted by ERISA. A Supreme Court decision upholding the lower court's ruling by a tie vote would invalidate the Vermont law. It would also leave open the issue of the breadth of a state law and ERISA pre-emption.

It's likely Congress will rely on continuing resolutions to effectively extend the FY 2016 budget, thereby delaying enactment of a FY 2017 budget until the next administration takes office.

Comment. Employers might be thinking: "Does the budget proposal matter for my company?" Yes! These proposals may drive (or at least influence) other legislative and regulatory activity. Therefore, understanding the budget proposal is important as companies consider workplace strategies and employee benefit plan designs for 2017 and beyond.

Cadillac Tax and Health Care Provisions

The president has proposed three changes to the so-called Cadillac tax — the 40% deductible excise tax on high-cost plans scheduled to begin in 2020. Each of these proposals is described below.

High-Cost Regions. Recognizing that the cost of health care varies between and among geographic areas, the budget proposal seeks to raise the threshold that triggers that tax in states with higher health care costs. Rather than a single threshold across the country, employers could offer more generous coverage in states where ACA marketplace "gold"-level plans cost more than the current tax limits.

Tweaks to the Tax

If these proposals are adopted, they would expand the modifications that may arise from the **Consolidated Appropriations Act, 2016** enacted in December 2015. Pursuant to that law, there is a mandate to evaluate the suitability of potential benchmarks for age and gender adjustments to the Cadillac tax thresholds.

Comment. The purpose of this proposal is to avoid imposing the tax on employers simply because they are in regions where health care is expensive. The effect would be that fewer employers would pay the tax, but also that the tax could vary from state to state for a single national employer.

Unusually Sick Employees. A Government Accountability Office (GAO) study examining the effects of the excise tax on "firms with unusually sick employees" is also included in the budget proposal.

FSAs and HSAs

Health FSAs are not to be confused with health savings accounts (HSAs). There are many differences between the two types of accounts — including how they can be coordinated with high-deductible health plans (HDHPs). For additional information on health FSAs and HSAs, please see our **January 5, 2015** *FYI In-Depth*.

Flexible Spending Accounts. To simplify the tax, the president proposes a modification relating to health flexible spending arrangements (FSAs). The proposal seeks to modify the calculation of the tax for employers offering health FSAs: the cost of coverage under a health FSA would be equal to the sum of (1) the average salary reduction amount elected by such employees for the year, and (2) the average employer contribution for such employees for the year. This proposal is different from the changes proposed in the Health Savings Act of 2016 (H.R. 4469 and S. 2499). In that bill, HSA and health FSA contributions would be excluded from the excise tax. (For additional information on S. 2499, please see our *Legislate* from February 8.)

Comment. Although the changes included in the president's budget proposal would be a welcome change for employers, some in Congress have vowed to continue their efforts to secure a full repeal of the tax. In addition to tremendous bipartisan support to pass two House bills and two Senate bills, all of which call for full repeal of the tax, at a House Ways and Means Committee hearing last week, Chairman Kevin Brady (R-TX) stated that the tax "simply is not workable."

Retirement Provisions — PBGC Premiums

During recent years, PBGC premiums have been increased many times, jeopardizing the continuation of employers' commitment to voluntarily sponsor defined benefit pension plans. The president's proposal requests additional premium revenue, but not from single employer plans. Specifically, the proposal seeks $15 billion additional revenue from the multiemployer program, through variable rate premiums as well as an exit premium that would be assessed on employers that withdraw from multiemployer plans. For additional background on legislated PBGC premium rate increases, see our November 2, 2015 *FYI Alert.*

Retirement Provisions — Expanding Coverage

The president's retirement related proposals focus on access, coverage and portability. These themes have been highlighted in his prior budget proposals and are reflected in the administration's DOL guidance and legislation (past, current and proposed). Fostering the development of state-run retirement programs, expansion of open multiple employer plans (open MEPs), portability, automatic enrollment and inclusion of part-time workers, together with certain tax credits are key elements of his proposal.

State-Run Retirement Programs. As described in detail in our December 4, 2015 *For Your Information,* the DOL issued guidance, in the form of proposed regulations and an interpretive bulletin, encouraging states to run retirement programs for private employers. The president proposes to set aside $6.5 million to states to pilot and evaluate such programs.

Open MEPs. Open multiple employer plans (MEPs) are retirement vehicles in which employers that do not share a nexus or "common bond" participate in the same plan for tax purposes. Each employer is considered to have a separate plan for ERISA purposes. The president's proposal would foster expansion of open MEPs by treating the plans as single plans for ERISA purposes to allow employers to realize cost savings and administrative simplification due to economies of scale. The proposal would only apply to employers who had not maintained a qualified plan in the last three years and would set the stage for regulatory relief for the "one bad apple" problem. Our February 1 *Legislate* includes additional information about congressional efforts related to open MEPs.

Portability. The budget proposal calls for $100 million in mandatory funding to encourage and facilitate greater portability of retirement plan assets. Specifically, these funds would be available to permit "states and nonprofits to design, implement, and evaluate new approaches to expand retirement and other employer-provided benefit coverage, with a focus on developing models that are portable across employers and can accommodate contributions from multiple employers for an individual worker."

Automatic Enrollment. For many employees without access to an employer-sponsored retirement plan, the proposal calls for mandatory automatic enrollment in an Individual Retirement Account (IRA). Specifically, it would require those employers with more than 10 employees and that have been in business for at least two years to facilitate payroll-deduction transfers to private-sector IRA trustees. Employers would not have to select investments or face any fiduciary responsibility for the program. Importantly, this proposal would not require automatic enrollment into an IRA for employees excluded from participating in an employer-sponsored retirement plan due to certain age and service requirements, or because they are union employees or nonresident aliens. The proposal would affect those employees who are excluded from an employer-sponsored retirement plan if the exclusion is based on class of employees, such as employees of a subsidiary or division.

Part-Time Employees. The budget proposal supports extending 401(k) plans to part-time workers. Specifically, it would require access to making elective deferrals for employees who work at least 500 hours per year for three years. It would not require these employees to be included in nondiscrimination tests and would not create an obligation to provide top-heavy minimum contributions. This proposal is similar to provisions included in the Women's Pension Protection Act of 2015 (S. 2110 and H.R. 4235) as described in our January 11 *Legislate*.

Tax Credits. Under current law, employers with 100 or fewer employees that adopt a new qualified retirement plan are eligible for tax credits (up to $500 a year for three years) for start-up costs. The president's proposal would increase the cap to $1,500 a year for four years. Furthermore, the proposal would be expanded to provide additional tax credits for small employers that add an auto-enrollment feature to a plan that they already sponsor.

Retirement Provisions — Distributions

The president's budget proposal includes other retirement provisions that focus on use of retirement assets.

Minimum Required Distributions. Current tax rules generally require participants in tax-favored retirement plans to begin receiving minimum required distributions (MRDs) soon after attaining age 70½. The budget proposal seeks a variety of changes to these rules, including an exemption for certain individuals who have not accumulated more than $100,000 (subject to indexing) in the aggregate under their IRAs and tax-favored retirement plans. The proposal would also mandate commencement for funds in Roth IRAs. It would also add the "stretch IRA" rule that would require many non-spouse beneficiaries to take inherited distributions over no more than five years. The rule would apply to qualified plans as well as IRAs and would exempt minor children and certain disabled or chronically ill individuals. Previous renditions of this proposal would have curtailed death benefits under pension plan "period certain and continuous" options. Details on this proposal are unknown.

Long-Term Unemployed. Current law permits certain exceptions from the 10% penalty tax applied to premature distributions from tax qualified plans and IRAs. The proposal would expand the exceptions to include distributions from defined contribution plans and IRAs to certain individuals unemployed for more than 26 weeks due to a separation from employment. The exception would be limited to distributions made in the year unemployment compensation is received and the following year, to a maximum of $50,000 per year. Some new reporting obligations would be created for plan administrators of defined contribution plans.

Retirement Provisions — Limiting Tax Benefits

Several provisions in the president's budget proposal would have the effect of reducing the value to employees of tax favored retirement plans.

Caps on Benefit Accruals. The law currently provides caps and limits on the amounts that qualify for tax-preferred treatment. For example, the maximum amount an employee can contribute on a pre-tax basis to a 401(k) plan in 2017 is $18,000, if under age 50, and $24,000, if age 50 or older. The president's proposal again calls for another limitation. In general, the budget proposal would prohibit an individual from making additional contributions or receiving additional accruals under any tax-favored retirement arrangement if the individual has accumulated enough to provide the maximum annuity permitted under a tax-qualified defined benefit plan. Based on current maximums and rates, the maximum permitted accumulation for an individual age 62 would be approximately $3.4 million.

ESOPs and Dividends. The president's proposal seeks to repeal the deduction for dividends paid on employer stock held by an ESOP sponsored by a publicly traded corporation.

NUA. Under current law, if employer stock is distributed in a lump sum from a tax-qualified retirement plan, the amount of net unrealized appreciation in the employer stock is excludable from gross income in the year of the distribution. The proposal would repeal the exclusion of net unrealized appreciation (NUA) in employer stock in the year of a distribution for tax-qualified retirement plan participants who have not yet attained age 50 as of December 31, 2016. The administration proposal is designed to limit the concentration of employees' retirement savings in the stock of their employer.

W-2 Reporting. Under current law, employers must include information on an employee's IRS Form W-2 to reflect the amount deferred from an employee's pay to a 401(k) plan or other cash or deferred arrangement. The budget proposal would add a new reporting mandate. Beginning in 2017, employers would be required to report the amount of employer contributions to the employee's defined contribution plan account.

> **Comment.** This reporting requirement would help employees better understand their overall retirement savings and compensation. Moreover, it would facilitate compliance with the proposal to cap overall benefit accruals.

Other Benefits and Employment-Related Provisions

The president's proposal seeks other changes unrelated to health and retirement that would affect employers and employees. Notably, the proposed budget calls for $277 million to enforce various employment-related laws, including those that establish the minimum standards for wages and working conditions and to ensure that workers are properly classified. Highlights of many of these provisions are described below.

Minimum Wage. In the budget proposal, the president makes clear that he is "ready to work with the Congress" to pass legislation to raise the minimum wage. The proposal does not provide any details.

Worker Classification. Workers today are classified as either an employee or an independent contractor, albeit not always correctly. The president's budget proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law, and would increase the penalties for misclassification. The Department of the Treasury and IRS would also be permitted to issue generally applicable guidance on the proper classification of workers under common law standards.

> **Comment.** In addition to the implications of this for FICA tax purposes, reclassification can have a significant impact on retirement and health plans. If workers are reclassified, employers would need to review whether each plan is operated in compliance with its rules and applicable law. For example, a failure to count certain workers as employees, whether or not eligible for plan coverage, could put the plan at risk for disqualification and the company at risk for penalties.

FUTA. The Federal Unemployment Tax Act (FUTA) currently imposes on employers a federal payroll tax equal to 6% of the first $7,000 paid annually to each employee. Before July 1, 2011, there was a temporary surtax of 0.2% added to the permanent FUTA tax rate. The president's budget proposes to reinstate the 0.2% surtax and make it permanent, effective for wages paid beginning in 2017. In addition, the budget proposal would raise the FUTA wage base in 2018 from $7,000 to $40,000 per worker (indexed to wage growth for subsequent years). These proposals would be coordinated with a reduction in the net federal unemployment insurance tax. The proposal would also impose a minimum requirement on state employer tax rates and change the FUTA credit reduction rules.

Unemployment Insurance Benefits. The president's proposal includes a variety of changes to the Unemployment Insurance (UI) program. Expansion to certain part-time workers and workers who are re-employed at a lower paying job that pays less than $50,000 a year is a key component of the proposal.

Paid Leave. To support workers' efforts to balance work and family, the president's proposal provides funding to encourage states and localities to offer paid family leave. Specifically, the budget includes more than $2 billion to assist up to five states to establish, and pay certain benefits under, paid leave programs, as well as to fund grants for analysis for the development of paid family and medical leave programs.

Dependent Care. Many employers provide employees with the opportunity to contribute to a dependent care flexible spending account (FSAs). Typically, higher-paid workers utilize such accounts whereas lower-paid workers rely on the child and dependent care credit. The president's proposal would repeal dependent care FSAs, increase the child and dependent care credit, and create a larger credit for taxpayers with children under age five.

Employment Tax Credits. The president's proposal seeks to create new employment tax credits and to modify and make others permanent. Specifically, the proposal calls for a new $5,000 tax credit for each full-time permanent employee who is a graduate from a community or technical college. It also would expand and make permanent the work opportunity tax credit (WOTC) and the Indian employment tax credit, both of which have been extended periodically, including most recently as part of the permanent tax extenders package in the Consolidated Appropriations Act, 2016. With regard to the Indian employment tax credit, the calculation of the credit would be modified to so that the base year is the two years immediately prior to the hire date. (For more information about the WOTC and the Indian employment tax credit, as well other employee benefits changes included in the Consolidated Appropriations Act, 2016, see our December 21, 2015 *Legislate*.)

Tax Expenditures Reform

Under current law, an individual's taxable income may be reduced by excluding from the calculation certain income, such as premiums for employer-sponsored health coverage, contributions to health savings accounts (HSAs) and deferrals and contributions to employer-sponsored retirement plans. The president's budget proposes to limit the tax rate at which high income earners can use itemized deductions and other tax preferences (including tax exclusions for contributions to defined contribution plans, HSAs and employer-sponsored health insurance) to a maximum of 28%. The individual's tax basis in an account would be adjusted to reflect the additional tax imposed by this change.

What are Tax Expenditures?

Tax expenditures are revenue losses attributable to provisions of the federal tax laws that allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Comment. According to OMB, the tax preferences and exclusions for employer-sponsored plans, including medical insurance premiums, 401(k) plan deferrals, pension contributions, and earnings have an enormous and significant impact on revenue. Collectively, they represent an income tax expenditure of nearly $5 trillion over a 10 year period. As such, it is not a surprise that a key component of a comprehensive tax reform proposal includes modifications to the tax treatment of these benefits. For additional details on employer-sponsored plans and tax expenditures, see OMB's Analytical Perspectives supplement to the budget proposal.

In Closing

Congress will vet the president's proposed budget during the upcoming weeks and months. Some of the ideas will be reflected in legislation that could be enacted during the current Congress or, more likely, the next one that begins in 2017. Importantly, the president's $4.15 trillion proposal sends a strong message to employers to operate their businesses in compliance with employment and employee benefits laws and regulations. Indeed, his budget includes $1.9 billion to support the DOL's worker protection agencies in their efforts to "defend the health, safety, wages, working conditions, and retirement security of American workers."

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