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Legislative Update - Budget Control Act of 2011: How the Debt Limit and Budget Negotiations Could Impact Health and Retirement Plans

After a prolonged and partisan battle, the federal debt limit was increased by $900 billion with the enactment of the Budget Control Act of 2011 on August 2, 2011. Among other things, the Budget Control Act provides for over $900 billion in federal spending cuts over 10 years by establishing immediate spending caps as well as a process to cut federal spending by at least another $1.2 trillion over 10 years. The deficit reductions will be tied to additional increases in the debt limit, as necessary. This process may result in changes to spending under the last year's health care reform law, the Patient Protection and Affordable Care Act, and, if tax reform is addressed as part of this process, changes in the tax treatment of retirement plans and employer-sponsored health care plans could also occur.

This update will outline the deficit reduction process provided for in the Budget Control Act and discuss how that process could potentially impact health and retirement plans.

Joint Select Congressional Committee

The Budget Control Act creates a special Congressional committee called the Joint Select Committee on Deficit Reduction ("Select Committee") that is charged with developing legislation to reduce the federal deficit by approximately $1.5 trillion over a ten year period starting in 2013. This Select Committee is made up of twelve members – six from the Senate and six from the House of Representatives – with an equal number of members from each party.[1] Legislation to reduce the deficit must be reported out of the committee by November 23, 2011. For the Select Committee to approve legislation to reduce the deficit, it must be supported by a majority of the committee. This means that at least one Republican or Democrat would have to join with the six Committee members from the other party to support the legislation. If the Select Committee reports out the legislation, the House of Representative and the Senate would each vote on it in a straight up or down vote, without amendments or any Senate filibuster. If both the House and Senate approve this legislation, it is sent to the President for final approval.

The deficit reduction plan can include a combination of spending cuts, including entitlement program reforms, and tax increases; however, there is no requirement in the law that tax increases must be included in the legislation reported out of the committee. The standing

[1] The members chosen by Senate Majority Leader Harry Reid (D-NV) are Senators Patty Murray (D-WA), John Kerry (D-MA) and Max Baucus (D-MT). The members chosen by Senate Minority Leader Mitch McConnell (R-KY) are Senators Rob Portman (R-OH), Jon Kyl (R-AZ) and Pat Toomey (R-PA). Speaker of the House John Boehner (R-OH) chose Representatives Dave Camp (R-MI), Jeb Hensarling (R-TX) and Fred Upton (R-MI). House Minority Leader Nancy Pelosi (D-CA) appointed Representatives Chris Van Hollen (D-MD), James Clyburn (D-SC) and Xavier Becerra (D-CA). The co-chairs of the Select Committee are Sen. Murray and Rep. Hensarling.

committees in the House and Senate will be able to provide recommendations to the Select Committee no later than October 14, 2011. For example, the House Ways and Means Committee and Senate Finance Committee could provide tax reform recommendations to the Select Committee.

Consequences of Failure – Sequestration Process

If the Select Committee cannot agree on legislation to reduce the deficit by at least $1.2 trillion, or if the legislation is not enacted because either the House or Senate does not approve it by December 23, 2011 or the President vetoes it, then automatic spending cuts will automatically be made through a process known as "sequestration" starting in 2013. Under the sequestration process outlined in the Budget Control Act, across-the-board reductions of $1.2 trillion would be made to certain discretionary and mandatory spending programs over the nine-year period beginning January 1, 2013. Reductions would be split evenly between defense and non-defense spending programs. Spending cuts to the Medicare program would be limited to two percent and could only include cuts in payments to providers (not benefit reductions). Certain entitlement programs would be exempt from sequestration, including Social Security, Medicaid, most welfare programs, veterans' benefits, and civilian and military retirement benefits. The $1.2 trillion sequestration amount would be reduced by any deficit reduction amounts that are enacted into law. Any reduction in the deficit attributable to the expiration of the "Bush tax cuts" at the end of 2012 will not be counted as part of the Select Committee's legislation or in determining the amount of the sequestration.[2]

Many in Washington believe that it is unlikely the Select Committee will be able to successfully report out deficit reduction legislation because of large policy differences between the parties on increasing taxes and making cuts in entitlement programs to lower the deficit. The Republican members of the Committee have made it clear that they do not believe that tax increases should be included as part of deficit reduction; Democrats have expressed concerns about cutting entitlement programs, particularly if the cuts are not coupled with increases in taxes on higher income taxpayers. It is important to note, however, that continuing weakness in the economy and financial markets could increase pressure on the Committee members and House and Senate leadership to compromise and "cut a deal." In addition, the large cuts in defense programs that would occur under the sequestration process are intended to help spur lawmakers to reach a deal.

Potential Impact on Retirement Plans

If the Select Committee decides to address tax issues, then there is the possibility that retirement plan tax incentives, which are scored by the Joint Committee on Taxation as one of the largest tax expenditures in the Federal budget, could be impacted. Previous commissions that have made recommendations to reduce the deficit have focused on tax reform, including recommended changes in defined contribution plan contribution limits. Most notably, the National Commission on Fiscal Responsibility and Reform – headed by Erskine Bowles, former chief of staff for President Clinton, and Alan Simpson, a former Republican Senator from Wyoming – issued a report in December 2010 that addressed tax reform in the context of deficit reduction. In general, the Bowles-Simpson Commission recommended lowering marginal tax rates and broadening the taxable income base while eliminating or greatly reducing "tax expenditures" (e.g., deductions and credits already in the Internal Revenue Code) and directing some

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[2] Since the "Bush tax cuts" will expire at the end of 2012 under *current law*, the extra revenue raised by their expiration would not count as deficit reduction under the Budget Control Act. Please note, however, that increases in the retirement plan contribution limits that were enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were made permanent by the Pension Protection Act of 2006, and thus reductions to those limits would count as revenue under the Budget Control Act.

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of the revenue from reducing tax expenditures to deficit reduction. The Bowles-Simpson Commission recommended that the maximum tax deductible contribution to various types of defined contribution plans be reduced to the lesser of $20,000 or twenty percent of income. It is unclear exactly what types of plans would be affected and whether or to what extent the consolidated limit would apply to traditional or Roth IRA contributions. In any event, if the Select Committee tackles tax reform, it is likely that retirement plan tax incentives will be in play.

The Select Committee could also look at a potential revenue raiser dealing with PBGC premiums that the Obama Administration proposed in its FY 2012 budget proposal. Currently, premiums paid to the PBGC are set by Congress and adjusted for cost-of-living increases and additional variable rate premiums are paid by underfunded plans under a formula set out in the statute. The Administration's proposal would give the PBGC's Board (the Secretaries of Labor, Treasury and Commerce) the ability to adjust the insurance premiums paid by companies with defined benefit plans, depending on the level of risk plans pose to the PBGC. The proposal is estimated to raise $16 billion over ten years and could be considered by the Select Committee as a way to raise revenue without increasing taxes. Businesses have been opposed to these types of proposals in the past and they will likely strongly oppose this proposal.

Sen. Rob Portman is a member of the Select Committee and has a strong history of supporting retirement plans. Many of the provisions in EGTRRA that increased the contribution limits for retirement plans were initially championed by then Rep. Portman and then Rep. and current Sen. Ben Cardin (D-MD). It is possible that Sen. Portman will act as an advocate for the current retirement system if the Select Committee considers changes to retirement plan tax incentives as part of tax reform.

There will be little impact on the tax status of retirement plans if the Select Committee cannot agree on a deficit reduction plan and sequestration is required. Sequestration only will impact government spending; the tax rules will not change as a result of sequestration.

Impact on Health Plans and Health Reform

Because the Select Committee could include tax reform as part of its efforts to craft deficit reduction legislation, changes to the tax treatment of employer-sponsored health plans also could be explored. The tax exclusion for employer-provided health coverage is one of the largest tax expenditures and changes to limit the exclusion have been examined by other groups seeking to address the deficit situation. For example, the Bowles-Simpson Commission recommended that the current exclusion for employer-provided health insurance be capped at 75 percentile of the premium levels in 2014, frozen for cost of living increases, and eventually phased out (with accompanying changes to reduce the Affordable Care Act 40-percent "Cadillac tax"). The Select Committee could also look at cutting spending provisions enacted as part of health care reform under the Affordable Care Act. For example, the Bowles-Simpson Commission suggested the elimination of the government program providing for long term care under the CLASS Act as a means of reducing the long-term deficit. Any cuts to the Affordable Care Act will be hotly debated by Republicans and Democrats on the Committee.

The imposition of a sequester could have a significant impact on the federal health care spending provisions under the Affordable Care Act since most federal discretionary spending will be reduced on a pro-rata basis. For example, the Affordable Care Act added tax credits and cost-sharing subsidies for low income individuals purchasing health insurance through an exchange. While the tax credit will not be affected by the sequester, the amount that the federal government spends for the cost-sharing subsidies would be reduced by the sequester. Similarly, federal

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assistance to states for establishing the state insurance exchanges would be reduced under a sequester, as would other funding for programs established under the Affordable Care Act. Medicare spending would be reduced under a sequester in the form of cuts in reimbursements to providers. This could have a significant impact on those providers and may have repercussions for health care outside of Medicare.

Conclusion

Although the Budget Control Act solved the immediate problem of raising the debt ceiling limit, its establishment of a Select Committee and the process for requiring future deficit reduction means that cuts in government spending and tax reform will continue to be discussed in the legislative arena. While it is too early to predict the result of this process, it is likely that health care and retirement issues will be part of these discussions.

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