February 7, 2006

Administration Releases Its Latest Budget Proposal

On February 6, 2006, The Administration released its budget proposals for fiscal year 2007 (FY 2007). As expected, the Administration shied away from embracing wholesale tax reform as proposed by the Tax Reform Panel. The Administration did advance a number of benefits-related tax proposals, some of which we have seen in prior budget releases and some which support a primary goal of the Administration this year: containment of heath care costs and increased tax equality in the purchase of health insurance. The following are some highlights of the employment and employee benefit-related tax provisions in the Administration's FY2007 budget.

Permanence of Previously Enacted Tax Relief. The President wants Congress to make permanent all the tax relief that was enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA). This is one of the Administration's most important tax priorities this year and will be a major point of contention between the two political parties. EGTRRA contained the most extensive changes in the tax laws dealing with employee benefits since the enactment of ERISA, including increases in contribution limits and the addition of "catch-up" contributions and the Roth 401(k). These changes will expire in 2010 if the provisions are not made

permanent, which would cause significant problems in plan administration for plan sponsors and administrators and result in the cutting back of contribution and benefit limit increases for plan participants. Permanence of the retirement plan provisions in EGTRRA is being considered as part of the pension funding reform bill, so there is the possibility that relief may be forthcoming this year.

Simplified Savings Vehicles. The Administration again proposed three new simplified retirement and savings vehicles: the Life-Time Savings Account (LSA), the Retirement Savings Account (RSA) and the Employer Retirement Savings Account (ERSA) in the same format that they proposed last year. Significantly, the Administration's FY 2007 LSA/RSA/ERSA proposal does not contain some of the simplification ideas that the Tax Reform Panel suggested, including the elimination of other account-based tax favored savings vehicles like health savings accounts, flexible spending arrangements, and education savings accounts. There did not appear to be widespread Congressional interest in moving forward with this element of the Tax Reform Panel's proposal last year, and we do not anticipate much activity on it in the coming year.

Expansion of Health Savings Account Incentives. Another important priority of the Administration is health care and, in furtherance of that goal, the FY 2007 budget includes several proposals to expand health savings accounts (HSAs). The Administration wants to eliminate the tax bias toward employer-provided health plans by providing similar tax breaks to individuals purchasing health insurance on their own account. The proposals include providing

an above-the-line deduction for the purchase of HSA-eligible non-group coverage and a refundable tax credit that would approximate the FICA taxes imposed on amounts used to pay for health insurance premiums. Those individuals making contributions to an HSA on their own account (i.e., not through a cafeteria plan) would also be eligible for a refundable tax credit which would approximate the FICA taxes on that contribution. A refundable tax credit for lower income individuals would be provided to assist in the purchase of HSA-eligible high deductible health plans.

The Administration also wants to make HSAs more consumer-friendly by increasing the amounts that can be contributed to an individual's HSA and making certain other changes:

- The maximum contribution to an HSA would be increased to the out-of-pocket limit for and HSA-eligible high deductible health plan (HDHP) (with a 2006 statutory maximum of $5,250 for individual coverage and $10,500 for family coverage) rather than the deductible amount for the individual's HDHP (with a 2006 statutory maximum on contributions of $2,700 for individual coverage and $5,450 for family coverage).
- Expenses that can be paid for tax-free from an HSA would be those incurred after the individual is covered under an HSA-eligible HDHP rather than when the HSA is established, as long as the HSA is established by the end of the filing date for the individual's income tax return (generally April 15 of the following year).

- Premiums for non-group, HSA-eligible high deductible health insurance could be paid for tax-free from the HSA under the Administration's proposal (as compared to current law, where the purchase of health insurance before age 65 generally is subject to tax and the 10 percent additional tax).
- Employers would be able to contribute to an HSA the amounts allocated to participants under a health reimbursement arrangement (HRA) without running afoul of the contribution limits or the requirements that all employer contributions to employees' HSAs be comparable. This proposal would only apply to HRAs in existence on the date of enactment.
- The comparable contribution rules will also be revised under the Administration's proposal to allow employers to contribute a higher amount to an HSA on behalf of chronically ill individuals. This will address a concern that many employers had with HSAs – how can the chronically ill population be convinced that HSAs are appropriate for them when all the funds contributed to the HSA are used annually for their chronic health care expenses.

Defined Benefit Plans. Last year's proposals regarding pension funding reform, cash balance and other hybrid plans and the calculation of lump sum benefits have been proposed again this year. These issues are currently being addressed in the pending conference on pension funding reform legislation.

Employee Leasing Companies. As employee leasing has become more commonplace, especially in the small business market, questions have been raised as to the extent to which the leasing company is liable for employment taxes on the employees it "leases" to other organization. The IRS realizes that leasing companies, as a whole, are more likely to properly comply with the employment tax withholding rules than small businesses; however, there needs to be legal clarification as to the extent that the leasing company can assume the employment tax liability of the company that the employees are "leased" to. While the budget proposal does not get into specifics about what this proposal will entail, there are a number of legislative proposals that have been advanced which set out requirements for professional leasing organizations that, if met, will result in the leasing organization becoming solely liable for employment and withholding tax obligations for the leased employees.

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We will continue to monitor the legislation proposed by Congress over the coming year and provide updates on important legislative activity as needed. In the meantime, if you have any questions regarding the Administration's tax proposals as part of the FY 2007 budget, please feel free to contact Bill Sweetnam at (202) 861-5427 or Brigen Winters at (202) 861-6618.