Excerpts from January ’09 Notes –

New Stimulus Bill Becomes Law

The American Recovery and Reinvestment Act of 2009 (ARRA), the cornerstone of President Obama’s new economic stimulus efforts, is now law. Several provisions of the new law are of particular interest to governmental plans, dealing with refundable tax credits for public sector retirees; the new “Making Work Pay” tax credit and associated withholding requirements; COBRA premium assistance; and non-wage withholding.

On February 17, 2009, President Obama signed H.R. 1 into law (PL 111-5). The new measure provides $212 billion in tax reductions, $267 billion in direct assistance (i.e., unemployment benefits and food stamps), and $308 billion in spending projects.

There are also several provisions in the massive legislation of particular interest to public plans:

Economic Recovery Payments to Retirees. Recipients of Social Security, SSI, Railroad Retirement and Veterans Disability Compensation Benefits will receive a one-time payment of $250, which will not be considered as gross income for Federal tax purposes. Generally, to be eligible for this payment, an individual must have been entitled to payments from such programs in November or December of 2008 or January of 2009. The payments will be automatic, so people receiving benefits do not need to take any action, and they should receive the payment by late May 2009, according to the Social Security Administration (SSA). In April, Social Security will send an advance notice with further information to each person who is eligible for the one-time payment. So that they can issue the payments as quickly as possible, the SSA asks that beneficiaries not contact Social Security unless they do not receive their payment by June 4th.

Initially, this benefit would not have been available to public employees who were not covered by Social Security. However, during the conference on the legislation, Senator John Kerry (D-MA) and others succeeded in adding a section providing a one-time refundable tax credit of $250 in 2009 for such non-covered government retirees ($500 in the case of a joint return where both spouses are eligible individuals). Any such credit must be deducted from any allowable “Making Work Pay” credit (see below).

“Making Work Pay” Credit and Tax Withholding. One of the key provisions of the stimulus package is the new “Making Work Pay” tax credit, which provides a refundable tax credit of up to $400 for working individuals and $800 for working families for 2009 and 2010. This tax credit would be calculated at a rate of 6.2% of earned income, and would phase out for taxpayers with adjusted gross income in excess of $75,000 ($150,000 for married couples filing jointly). Taxpayers can receive this benefit through a reduction in the amount of income tax that is withheld from their paychecks, or through claiming the credit on their tax returns.

Pension plan distributions are not considered to be “earned income” for purposes of qualifying for this new credit. Nevertheless, when the IRS issued “Early Release Copies of New Wage Withholding and Advance Earned Income Credit Payment Tables” that incorporate the credit in its Notice 1036 in February, it indicated that the withholding tables in Publication 15-T are to replace the tables in Publication 15. Read literally, this would suggest that pension plans should use these new tables for withholding on pension distributions, and indeed, some IRS field representatives have been so advising plans. However, in response to an inquiry from the National Council on Teacher Retirement (NCTR) concerning the confusion surrounding the issue, Treasury officials confirmed that, since pension income is not subject to the new credit, such withholding could increase the likelihood that pension recipients will owe taxes and possibly penalties at the end of the year, and that “it would probably not be a good idea to switch to the new tables just yet.”

Subsequently, following discussions with the IRS, the Treasury officials effectively reversed themselves, saying that pension plans are supposed to use the new tables; the new Publication 15-T released on

March 3rd makes it clear: “For the calculation of income tax withholding on pensions, the new withholding tables also apply.” Reportedly, the IRS believes that providing multiple withholding tables would be “confusing,” and apparently this outweighs any potential adverse consequences for retirees.

Clearly, there has certainly been some “confusion” over this issue at the Treasury Department. It may well be that a decision was made at some level within the Administration to use the tables regardless of the lack of eligibility because they will result in an immediate boost in retiree income that will help add to the economic stimulus effect that is being sought. (Of course, such under-withholding could produce the opposite effect in 2010 if taxes are owed as a consequence of such action.)

There are reports that some in the private sector are concerned with the potential impact of the IRS approach, and there may be some push-back as a result.

Premium Assistance for COBRA Continuation Coverage. The new law provides a 65% subsidy for COBRA continuation premiums for up to 9 months for workers who have been involuntarily terminated, and for their families, so long as the worker’s same year income is not expected to exceed $125,000 ($250,000 for families). The new premium assistance subsidy program applies to all private and public sector group health plans currently subject to COBRA, and to continuation coverage under similar Federal and state laws, and is effective almost immediately, beginning with the first period of coverage after February 17, 2009. (Under the Consolidated Omnibus Budget Reconciliation Act of 1985, commonly referred to as “COBRA,” employers with at least 20 employees must allow those employees and their dependents to continue coverage under the employer’s health plan if the employee is discharged, an employee’s hours are reduced, or there is a change in family status. Typically, COBRA enrollees are required to pay up to 100 percent of their premiums and an additional two percent fee to cover administrative costs,)

To qualify for the new premium assistance, a worker must be involuntarily terminated between September 1, 2008 and December 31, 2009, and the subsidy would end if the individual became eligible for any new employer-sponsored health care coverage or for Medicare. For individuals who had been involuntarily terminated between September 1, 2008 and enactment, but failed to initially elect COBRA, they would be given an additional 60 days to elect COBRA and receive the subsidy.

Thus, an individual eligible for this subsidy would only have to pay 35% of the COBRA continuation premium. The cost for the rest of the premium would be the responsibility of the Federal government, and would be paid to whoever an eligible individual would normally pay his or her COBRA premiums. This Federal “payment” would essentially be a reimbursement in the form of a credit against the payroll taxes that the entity who continued to pay the health insurance premium would otherwise pay to the Treasury Department.
Initially, there was some concern that this would only apply to FICA taxes, which could once again create problems in cases of non-Social Security coverage. However, the legislation clearly includes wage withholding as also eligible for the offsetting credit.

This new benefit has substantial notice requirements that must be met in a very short period of time, and the reimbursement provisions could create administrative issues. Therefore, for plans affected by this new provision, it should be quickly reviewed for compliance purposes so that there are no problems when reimbursement is sought from the Federal government. For example, the group health plan will have the responsibility for determining who is eligible for the premium, and not the individual. Furthermore, since individuals who may otherwise be eligible for COBRA due to a reduction in hours, retirement or voluntary separation from service are not eligible for the subsidy, a new identification process may therefore need to be implemented. Also, the subsidy is available to those who were involuntarily terminated after August 31, 2008, including those who did not elect COBRA, and they will therefore need to be notified about the new election and subsidy options.

3% Non-Wage Withholding. Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA,” P.L. 109-222), as originally enacted, would require Federal and State governments, including any agencies thereof, to withhold three percent on payments made for most goods and services

beginning in 2011, regardless of the amount spent. Local governments and subdivisions that spend more than $100 billion annually on goods and services will also be subject to this withholding. (This provision was included in TIPRA at the last minute, in conference, without any hearings or initial review by the House and Senate, in order to raise $7 billion.)

Section 511 has the potential to impose substantial administrative costs on pension plans covered by such a mandate in connection with consultant contracts, fees paid to money managers and other payments to providers. Furthermore, private sector vendors are likely to simply add three percent to their bids or products for their government clients to deal with this requirement, creating even more problems. NCTR has therefore been working with a coalition of other concerned public sector organizations to obtain the repeal of this measure, and succeeded in getting such a full repeal included in the House-passed version of the stimulus bill.

However, the Senate bill only included a one-year delay in the application of Section 511. Despite strong efforts to keep the House approach in the final compromise, including letters from public sector groups to the conferees, and a direct plea to Senate Finance Committee Chairman Max Baucus (D-MT) from both Montana retirement systems, only the one-year extension is in the final law. Senior Hill staff reported that there was very strong support for full repeal, but it was too costly to include in the final deal due to serious pressure to keep the overall cost under $800 billion.

Nevertheless, there is a commitment from many fronts in Congress to make repeal happen. The score (how much it will cost the Federal government in lost revenue if the provision is repealed) has always been the big obstacle. However, proposed IRS regulations dealing with the implementation of the withholding requirement contain an exemption for any payment that is less than $10,000. The Treasury Department and IRS say they are proposing this payment threshold “because the burden of withholding on smaller transactions is likely to be substantial and outweigh the benefits of increased withholding.” This threshold corresponds to a minimum withholding of $300. (For once, the IRS seems to have actually gotten it right!)

Congressional supporters believe that if the proposed IRS regulations are finalized with this $10,000 threshold included, then the repeal legislation could be re-scored, and the cost will drop dramatically. This could vastly improve the chances for repeal.

Excerpts from Spring ’09 Notes –

Feds Reverse Themselves on Withholding Tables, but Create Even More Problems with Proposed Solution

The Internal Revenue Service (IRS) has now decided that pension plans’ use of new withholding tables reflecting the “Making Work Pay” tax credit could indeed create under-withholding problems for many retirees. However, instead of simply permitting plans to revert to the use of the old withholding tables, the IRS has provided new withholding adjustment procedures that pension plans, at their option, can choose to implement in an effort to try to “put the toothpaste back in the tube.” The new procedures will be costly and time-consuming for many plans to implement, and trying to explain this latest twist will also be expensive and even more confusing to retirees who flooded call centers when the first changes in withholding were made. As a result, some plans are considering doing nothing more in connection with this mess and relying instead on IRS promises to conduct a “wider outreach campaign to educate pensioners and other taxpayers about the withholding tables.”

Following complaints from employee groups, including AFSCME, and retiree organizations such as the NRTA: *AARP’s Educator Community* -- as well as inquiries from Capitol Hill and increasing press coverage of the potential impact of under-withholding on retirees -- the Internal Revenue Service (IRS) announced on May 14th that it had decided pension plans could choose a new procedure to address the potential under-withholding problems created by Publication 15-Tt.

The problem was that the new withholding tables, which took effect April 1st, incorporated the new

“Making Work Pay Tax Credit,” one of the key provisions of the massive American Recovery and Reinvestment Act that became law early in 2009. The idea was to provide an immediate economic stimulus by increasing taxpayers’ take-home pay. However, pension payments are not considered “earned income” and thus do not qualify for the credit. Therefore, for some retirees, public and private, who only received such income, the new withholding tables would likely result in under-withholding. This in turn could mean these retirees might unexpectedly owe taxes next year, or even possibly penalties.

The Treasury Department was notified in February about this problem, and officials there agreed that “Because pension income is not subject to the new credit, using the new tables will increase the likelihood that pension recipients will owe taxes (and possibly penalties) at the end of the year.” However, the IRS decided that permitting pension plans to use the old withholding tables in Publication 15 would be confusing and ignored these expressions of concern.

Consequently, many public plans spent thousands of dollars revising their systems to accommodate the new tables, and then even more monies in connection with notices to retirees advising them of the reason for the withholding change and the possible need to make changes in their W-4P withholding forms. Plan call centers were then swamped with inquiries from confused retirees.

The IRS itself also began to hear from plan participant and retiree organizations, who also contacted Capitol Hill to alert them to the impending problem. The media began to run stories on the potential impact on retirees as well. For example, in early April, the Columbus Dispatch ran a piece that noted that while Americans are getting more money in their paychecks and pension payments thanks to a new tax change in the Federal stimulus package, “but retirees beware: A little-publicized quirk could lead to a nasty surprise at tax time next year.” CNN also picked up the story.

However, when the IRS decided to make the change, it did not consult with pension plans. Also, it refused to advise plan representatives about any details concerning a possible change in this policy despite repeated calls to the agency. As a result, the new “cure” is in many ways worse than the original problem itself. Instead of permitting plans to simply revert to the old withholding tables in Publication 15 that were replaced by the new withholding tables in Publication 15-T -- which would have been a relatively easy switch for most plans – the IRS produced new withholding tables which are “to be used only in conjunction with the withholding tables found in Publication 15-T.” These new tables provide additional withholding amounts which, according to the IRS, provide “an approximate offset for the withholding reduction” that was included in the new tables that jiust went into effect. Clear as mud?

Unfortunately, given that some under-withholding has already probably occurred, a simple reversion to the old tables would likely not completely offset the damage. In order to return an individual retiree to the position he/she would have been in prior to the original change, some over-withholding may now be necessary. Hence, the apparent need for yet a new withholding table.

As noted, the use of the new tables is optional. Based on the additional time, cost and confusion it would entail, some plans are already deciding not to make the change. Here is how one system director of a relatively small plan explained it: “The change to the new tax tables in March caused considerable concern among our retired members, which resulted in hundreds of calls and numerous new tax withholding filings. We are now preparing to send another targeted mailing to our retirees to provide further updates, which will likely generate more calls. A rough estimate of the additional cost incurred, including the upcoming mailing, is around $20,000. This includes staff time, postage and miscellaneous items such as paper stock for the mailings, etc. Frankly, if we included compensation for the ‘pain and suffering’ of our retired members as they struggle to understand what this means to them, the cost would be significantly higher. It is not an overstatement to state that the confusion surrounding this issue had had a negative impact on our most vulnerable population.”

The IRS claims that it is committed to helping address the confusion that their original decision has created. For example, the IRS says that they are “gearing up for a wider outreach campaign to educate pensioners and other taxpayers about the withholding tables and Recovery payments.” The IRS has also promised that it “will work with partner groups to provide taxpayers information to make sure they have

the appropriate withholding for their situation," and will also "work on developing a variety of information products, including brochures, video and audio material to help educate taxpayers."

Regardless how your plan decides to deal with this latest turn, there will likely still be problems next year at tax time.