

Fiscal Cliff Legislation - Employee Benefits and Compensation Provisions of Interest

Earlier this month we notified you that that under the American Taxpayer Relief Act of 2012—*i.e.*, the “fiscal cliff legislation”—Congress extended the ability of employers to pay or reimburse an employee on a tax-free basis for up to \$5,250 in educational assistance (which does not have to be job-related) under a written plan of the employer. [Please click here for a link to that Alert.](#) We now summarize below some other notable employee benefits and compensation-related provisions contained in the fiscal cliff legislation.

- **Expansion of In-Plan Roth Conversion Opportunity for Defined Contribution Plans.** The fiscal cliff legislation offers a new opportunity for defined contribution plans (such as 401(k) and 403(b) plans) to enable participants to make an in-plan conversion to a Roth account. Prior to the new law, defined contribution plans could only offer plan participants the opportunity to convert to a Roth account within the plan if the participant experienced a distribution event in which the amounts to be converted were an eligible rollover distribution. Under the fiscal cliff legislation, a defined contribution plan may now permit *any* vested amounts in the plan to be converted to a Roth account within the plan, regardless of whether the amounts are currently distributable. To take advantage of this new rule, a defined contribution plan must permit (or be amended to permit) Roth contributions to the plan generally and be amended to provide for this broad in-plan Roth conversion.

While questions remain about how this provision of the fiscal cliff legislation will apply, prior IRS guidance indicates that amounts converted under this provision would be includable in a participant’s gross income in the year of the conversion, but exempt from the 10 percent additional tax on early distributions (regardless of whether the participant is under age 59 ½). We also anticipate that such conversions would not be subject to the mandatory 20 percent withholding that applies to certain plan distributions.

- **Mass Transit Expenses Increased through 2013.** The monthly allowance for employees’ qualified mass transit expenses that can be excluded from employees’ taxable income (whether funded via employee pre-tax contributions and/or employer contributions) has been increased for 2013 to the same monthly amount as is available for parking expenses—*i.e.*, \$245 per month.¹
- **Employer Adoption Assistance Programs Exclusion Extended.** The employer adoption assistance programs exclusion for which employers may exclude up to a maximum amount from an employee’s taxable income for substantiated qualified adoption expenses (*e.g.*, adoption fees, court costs, attorney fees, etc.) whether funded through direct payment or reimbursement by the employer or by the employee through pre-tax contributions (*i.e.*, through the employer’s cafeteria plan), was permanently extended for taxable years beginning after December 31, 2012. *The maximum amount that can be excluded from an employee’s income for 2013 is \$12,970 (for employees with modified adjusted gross income over \$194,580, this maximum available amount is*

¹ The legislation also retroactively increased *for 2012* the monthly allowance for employees’ qualified mass transit expenses that can be excluded from employees’ taxable income to \$240 per month (rather than the \$125 monthly allowance previously relied on for 2012). The IRS has released guidance addressing the retroactive application of the increased monthly allowance for 2012 with respect to adjusting and reporting employees’ 2012 taxable income and payroll taxes for employers who provided transit benefits to employees in 2012 in excess of the \$125 former maximum monthly excludable amount.

reduced proportionately, and for some highly compensated employees, the favorable tax treatment will not be available at all).

- **2% Payroll Tax Increase on all Employees.** In 2011 and 2012, employees experienced a “payroll tax holiday” whereby the Social Security portion of the FICA payroll tax (which is composed of the Social Security and Medicare tax), was reduced by 2% for all employees. The fiscal cliff legislation does not extend this payroll tax holiday, and so effective January 1, 2013 employers will be required to withhold on employees’ taxable income to take into account the additional 2% FICA tax for all employees.²

While subsequent guidance from the IRS would be welcomed with respect to certain aspects of the new legislation, most of the above-mentioned provisions are straightforward and can be implemented immediately at the option of the employer.

Please contact one of the Patterson Belknap attorneys listed below if you would like more information on the impact of the fiscal cliff legislation on employee benefits.

² This 2% increase in FICA tax for employees is in addition to the .9% increase in the Medicare tax rate that applies to employees’ earnings over \$200,000 beginning as of January 1, 2013 pursuant to the Patient Protection and Affordable Care Act of 2010.

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