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Management Alert

Fiscal Cliff NO. 5: Top Ten Steps Employers Should Consider to Prepare for the Fiscal Cliff and Beyond

Uncertainties abound as the clock ticks and the nation approaches the "fiscal cliff" – a series of automatic spending cuts and tax hikes slated to commence if a budget agreement is not reached in the next few days. Below are steps that employers should consider in preparing for the fiscal cliff and its potential (for some, probable) consequences. Some involve financial and workplace communication planning above and beyond legal compliance. **Importantly, many of these steps make sense *even if a budget agreement is reached***, since (i) the Budget Control Act ("BCA") requires that any agreement include at least $1.2 trillion in federal spending cuts; and (ii) tax increases in some form, both for businesses and certain individuals, appear inevitable if a fiscal crisis is to be averted.

We, of course, do not know whether or how this saga will end. From listening to and working on behalf of our clients, however, we believe:

1. **Employers Need To Audit and Understand Their Reliance on Government Funds.** Employers of all types should conduct a revenue risk analysis, to determine the extent and details of their dependence on federal, state, and local funds. (Those latter budgets will inevitably be impacted by federal cutbacks.) Many employers now receiving federal contract and grant monies can expect less in the future, even if a budget deal comes to pass. Other employers not directly dependent on federal spending should analyze and understand how budget cuts (compounded by tax increases) may impact revenue in 2013.

2. **Payroll Taxes are Virtually Certain to Change Effective January 1, 2013.** As things stand now, the 2% payroll tax cut (which reduced Social Security taxes in 2010 and 2011) will expire January 1, 2013. This means Social Security taxes will revert from 4.2% to 6.2%, which affects employer withholding obligations, as does the Affordable Care Act's additional withholding amount for any employee whose annual wages exceed $200,000. Many expect a payroll tax hike as part of any budget deal. Thus, employer Payroll and Employee Relations functions have to be ready to implement these changes and help explain them to employees, with or without a budget agreement.

3. **Other Payroll Changes Are in The Offing.** Unless the current fiscal situation gets resolved, all federal income tax rates will revert to those in 2001. That means the 10% rate would expire, and the following rate changes would take effect January 1:

Old Rate	New Rate
25%	28%
31%	33%
33%	36%
35%	39.6%

Payroll functions must be prepared to implement withholding changes in the event of the above or other withholding changes if Congress and the Administration strike a deal regarding income taxes.

4. **Some Employers Have No Choice But to Prepare for Layoffs.** For defense contractors and others at risk of a major drop in federal revenue, layoff preparations have begun (and are in some instances well underway). Several large defense contractors have announced that reductions will take place even if the current budget crisis gets resolved. Others are awaiting the outcome of current negotiations, hoping that discretionary defense spending will be spared the axe. If there is no deal, however, the BCA's 10% discretionary defense cuts will eventually necessitate reductions. Contractors would then be faced with WARN risks discussed in our *first Fiscal Cliff Alert*. As reported therein, the DOL's guidance may mitigate federal WARN exposure. However, employers in California and elsewhere face state WARN risks as well.

5. **Prudent WARN Preparations at This Time Include:**

- Identifying locations at which 50 full-time employees could lose employment over a rolling 90-day period. (Some states including California and Illinois have lower employment loss thresholds.)

- Determining at which of those locations a department, operating unit, or functions may be shut down (WARN treats these actions as a covered "plant closing"). Alternatively, at which locations do 50 covered employees at risk constitute 1/3 of the workforce (a "mass layoff" under federal WARN)?

- Assessing whether employees at impacted facilities have or will be provided bumping rights. These must be specified in any WARN notice, and need to be understood (by both the employer and employees) well before any separations.

6. **Reducing Hours of Work or Pay Rates or Both May Avoid (or at Least Minimize) Separations.** Employers needing to reduce payroll costs should consider these options instead of or on top of a reduction in force. However, alternatives to RIFs come with potential risks if not implemented properly. Details in these regards are contained in our *second Fiscal Cliff Alert*. Alternatives to workforce reductions include:

- Reducing hourly wages, subject to federal and state minimum wage laws.

- Reducing salaried employees' pay (but beware short-term reductions that may jeopardize an employee's exempt status).

- Reducing hours worked by hourly employees (i.e., furloughs), but be mindful that having employees "on call" or working at home during non-work hours may trigger wage and/or overtime claims.

- Furloughing exempt employees, but remember that furloughs lasting less than a week may jeopardize an employee's exempt/salary basis status.

7. **Health Care Employers Are Uniquely at Risk.** Hospitals and other health care providers face an across-the-board 2% decrease in Medicare reimbursement under sequestration cuts scheduled to take effect in January. This is on top of the 27% Medicare cut otherwise due to take effect in 2013. That marginal difference may seem slight. Some hospitals, however, count on Medicare for nearly 50% of revenue. According to the Office of Management and Budget, sequestration would reduce payments to hospitals by about $5.8 billion. Many health care employers are making contingency plans right now to deal with these prospects.

8. **Certain Employee Benefits Will Likely Be Impacted.** Adoption assistance for employees is presently scheduled to cease effective January 1, 2013. Currently, employers benefit from a tax exclusion on amounts up to $12,650/employee. An employer can reimburse employees on a tax-free basis for reasonable expenses related to actual or attempted adoption. That assistance will end upon sequestration, and could also disappear as part of any compromise. How will your company respond to this gap?

   Educational assistance for employees may also end soon. Federal tax subsidies for certain employer-provided educational assistance are slated to end on January 1st. Currently, Section 127 of the Internal Revenue Code allows employers to reimburse employees on a tax-free basis up to $5,250 for certain educational expenses. As with adoption assistance, federal support for this benefit would end automatically in the event of sequestration, and could also be eliminated under a negotiated solution. Employers should consider how this impacts current (continuing) and future support for employee tuition and other support.

9. **Employers and Employees Alike Are in Financial Planning Overdrive.** With the current rate on dividends at 15%, companies are rushing to pay special dividends like never before. Companies ranging from Las Vegas Sands to Tyson, Dillard's to Brown-Forman, have recently paid special dividends to help reassure shareholders before the fiscal cliff. Historically, tax rates have not driven dividend payments (nor have they tended to drive shareholder behavior). As we continue towards the fiscal cliff, however, the past provides little precedent. Come January 1, the tax rate on dividends could more than double for high income taxpayers. That also means executives and others with vested options are feeling pressure to sell, both to avoid a potentially higher capital gains tax (in the event of a gain) and in any event to earn income this year instead of next.

10. **Most Employers, Like the Rest Of the Country, Remain In Wait-and-See Mode.** There is widespread agreement that a total breakdown in budget talks would plunge the U.S. back into recession. Conversely, at least in the short-term, a conclusive agreement to cut spending and raise revenue could ignite the U.S. economy, leading business to invest in new products, equipment and services, which could at last cause hiring to rebound unequivocally. Fiscal uncertainty has for some time tethered U.S. employers, slowing economic recovery both here and abroad. Other uncertainties will remain – in China and Europe especially – no matter what happens in Washington over the next few weeks. One thing is certain: a lasting solution to our fiscal crisis may not suffice to ensure continued U.S. recovery, but it becomes more necessary as each day passes.

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