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Highlights

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Top Ten Issues Identified by the IRS in Retirement Plan Audits

The IRS has released a list of the top ten errors found during its audits of qualified retirement plans under the Employee Plans Team Audit (EPTA) Program. These issues are:

- 1. Termination or Partial Termination.** If the plan administrator fails to properly identify a termination or partial termination of a retirement plan, there are potential vesting and distribution issues. The termination or partial termination of a plan can be identified by:
 - a. When comparing multiple years, there is a large drop in plan participants.
 - b. There is a large decrease in plan participants from the beginning of the plan year to the end of the plan year.
 - c. There appears to be a large number of separated participants during the plan year.
 - d. There appears to be a low percentage of participants compared to the total number of employees relative to other plan years.
 - e. The corporation appears to be “downsizing.”
 - f. The employer uses plan assets to provide incentives for termination, such as enhanced early retirement benefits or severance pay not specified in the plan document. Note: This is a problem even when all the affected participants are fully vested as is often the case.
 - g. Not all of the plan participants from an acquired plan continue to participate after that plan has been merged with an ongoing plan.



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2. **Acquisitions.** Corporate transactions that involve the acquisition of another company present the following issues with respect the retirement plans:
 - a. With respect to the employer allocations made each pay period, the acquiring employer's profit sharing allocation may not be made to the trust timely for the employees of the newly acquired companies because the employees may not yet be part of the centralized payroll system.
 - b. The acquiring employer may exclude the matching contribution for employees of the newly acquired company.
 - c. The acquiring employer might fail to offer all optional benefits on distributions of transferred assets from merged plans.
 - d. The acquiring employer might use incorrect compensation amounts when computing the matching contribution for business units of the newly acquired company.
 - e. Incorrect matching contributions due to inaccurate participation dates for employees of newly acquired companies.
 - f. The acquiring employer makes a plan contribution relating to an assumed liability. Such contributions are generally classified as acquisition costs that cannot be deducted by either company.

3. **Discrimination Testing.** Deferral percentage tests are performed incorrectly. Some of the issues uncovered by the IRS include:
 - a. If the plan has no limits on HCE deferrals and no matching contributions, examining how the plan meets the ADP test may uncover a process inadequacy.
 - b. ADP/ACP percentage calculations may be performed incorrectly.
 - c. ADP/ACP electronic data may be faulty.
 - d. There could be failures if testing is completed by a third party vendor and there is no oversight by the employer.
 - e. The employer's ADP test could fail if a benefit is provided to a "special" group of participants and not to all participants.
 - f. Newly acquired employees may not have been offered an option to make elective deferrals or may not have been considered for testing purposes.

4. **Compensation.** Many issues revolve around the correct definition of compensation. Using the incorrect definition of compensation can impact not only contributions made to the plan but also the discrimination testing that needs to be completed for the plans. Errors found by the EPTA group include:
 - a. Equity compensation plans typically generate Form W-2 income on exercise of stock options or early sales of stock purchased through a section 423 employee stock purchase plan. A plan, which permits



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employees to make section 401(k) deferrals from such income, may not have any means to collect the deferred income and, therefore would be applying the deferral percentages incorrectly.

- b. If the maximum compensation limit contained in Code section 401(a)(17) is exceeded, the result could be excess employer contributions.

5. Plan document.

- a. Qualification issues exist where plans have not timely adopted amendments (including GUST amendments), leading to automatic disqualification. These issues are resolved through closing agreements.
- b. The merger of plans into other plans. If the plan documents have not been amended timely to comply with all applicable prior laws prior to the time the plans are merged, the tax qualified status of the merged plan is in jeopardy.

6. Vesting. Failure to properly account for an employee's years of service results in vesting issues which also impact the plan's tax qualified status. Areas where the EPTA group has found issues include:

- a. Forfeitures of accounts where the participants are age 65 or over. If a participant is age 65 or over, the participant's account should be 100% vested and there should be no forfeitures.
- b. Failure to properly account for a participant's years of service. If an employer does not have solid procedures for identifying rehires, the participant's years of service for vesting purposes may be calculated incorrectly. This is also an issue in situations where a company has made acquisitions and has granted past service credit for time with an acquired company. Many employers do not have the appropriate procedures in place to identify rehires from an acquired company.
- c. Use of incorrect vesting schedules.
- d. Improper calculation of a participant's vesting percentage.
- e. Improper application of the plan's vesting schedule as stated in the plan documents by the third party administrator.

7. Distributions and loans.

- a. Large distributions on the income statement relative to plan assets or to a prior or subsequent plan year.
- b. Large distributions payable relative to plan assets or to distributions actually paid out during the plan year. This may indicate that the plan terms are not being followed in the timing of distributions from the plan.



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- c. Plan may fail to suspend “salary deferrals” of participants receiving hardship distributions from their accounts as required by Treas. Regs. section 1.401(k)-1(d)(2)(iv)(b).
- d. Plan participants, receiving premature distributions or defaulting on plan loans, fail to report the distributions and/or pay the 10% excise tax on their individual tax returns.
- e. Return indicates that the plan terminated a long time ago, but distributions did not take place.
- f. If the employer uses an automated system for participants to secure plan loans, in-service distributions, or hardship distributions, significant compliance issues may occur if required documentation or spousal consents are not secured and maintained.
- g. Distributions may be understated due to a plan’s failure to properly value employer real property or employer securities in a closely held corporation.
- h. Distribution codes on Form 1099 may be in error resulting in improper tax treatment of distributions and/of failure to report the 10% excise tax.

8. Assets.

- a. Large percentage of plan assets classified as other assets on the balance sheet.
- b. Large percentage of plan assets in one single investment.
- c. Large amounts of administrative expenses.
- d. Significant misclassifications of assets and liabilities.
- e. Significant changes in types of investments from one year to the next based on a comparative analysis of three or more plan years.
- f. Existence of relatively large liabilities (other than in a leveraged ESOP).
- g. Large percentage of plan assets invested in employer real property or employer securities (other than in an ESOP).

9. Limits.

- a. Excess distributions taken as a result of the “accrual” of a pension expense with no corresponding Schedule M-1 adjustment.
- b. Plan(s) may exceed the Code section 415 limits when plan participants are participating in more than one plan of the employer and employer is making contributions to all plans.
- c. Employees may also exceed the Code section 402(g) limit when participants are participating in more than one plan that permits elective deferrals.



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10. Miscellaneous.

- a. Lack of sufficient internal controls to ensure that data provided to the third party recordkeeper/plan administrator is accurate. Often the audit reveals that reports and testing prepared by third parties have inaccurate data, such as dates of hire or termination, ages of employees, amount of compensation, etc. Thus the plan administrator is improperly calculating such things as vesting or employer matching contributions.
- b. Large corporations with decentralized payroll systems may have problems administering the plan if there are no internal controls to ensure plan provisions are properly applied. For example, if each subsidiary determines eligibility for plan participation, who is an HCE, or what constitutes “plan compensation”, significant compliance issues may occur in coverage and allocations.
- c. Plan data used to prepare Form 5500 returns does not match the actual records, e.g., payroll. In addition, inconsistencies between the plan administrator’s records and the company’s employee listing. For example, an employee may be reported on the plan administrator’s records but not have a hire date on the employer’s employee listing.

How Cafeteria Plan Grace Period Impacts W-2 Dependent Care Reporting

The IRS issued Notice 2005-61 to clarify Form W-2 reporting requirements when the employer has amended its cafeteria plan to provide for a grace period for qualified dependent care assistance immediately following the end of the cafeteria plan year. The grace period cannot exceed 2 ½ months after the close of the cafeteria plan year.

In 1989, the IRS issued Notice 89-111 which provided that the employer was required to report on the W-2 issued to its employees the total amount of cash reimbursement furnished to the employee during the calendar year for qualified dependent care expenses. This notice further provided that for a salary reduction arrangement under a cafeteria plan, the amount electively contributed by an employee for the year for dependent care assistance (plus any matching contributions) is considered a reasonable estimate. The content of Notice 89-111 was made applicable to post '89 years by Notice 90-66. The IRS has stated in Notice 2005-61 that an employer who amends its cafeteria plan to provide for a grace period may rely on Notice 89-111 by reporting in Box 10 of Form W-2 the salary reduction amount elected by the employee for the year for dependent care assistance (plus any employer matching contributions).



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Katrina Emergency Tax Relief Act of 2005 (KETRA)

KETRA contains several provisions that relate to retirement plans. These provisions relate to tax-favored withdrawals, recontribution of withdrawals for home purchases cancelled due to hurricane Katrina, loans from retirement plans for relief relating to Hurricane Katrina, and provisions relating to plan amendments in connection with Hurricane Katrina. Each of these provisions is discussed below:

- 1. Tax-Favored Withdrawals from Retirement Plans.** This provision contains an exception to the 10% early withdrawal excise tax for distributions made to participants who are not age 59 ½, retired or disabled. The distribution must be made on or after August 25, 2005, and before January 1, 2007 to an individual whose principal place of residence on August 28, 2005 was in the Hurricane Katrina disaster area. In addition, the amount of the distribution can be included in an individual's income ratably over 3 years and the amount of the distribution can be recontributed to the retirement plan within 3 years beginning with the year of distribution. Any amount recontributed within the 3-year period is treated as a rollover and is not includible in the individual's income. The total amount that an individual can receive from all plans, annuities, or IRAs is \$100,000. It should also be noted that any qualified Hurricane Katrina distributions are not considered eligible rollover distributions and, therefore, are not subject to the mandatory 20% income tax withholding.
- 2. Recontribution of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina.** Any hardship distributions from a 401(k) plan, 401(b) annuity, or a first time homeowner distribution from an IRA that were received after February 28, 2005 and before August 29, 2005 and that were to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area but the residence is not purchased or constructed on account of Hurricane Katrina may be recontributed to such plan. The recontributed amount is classified as a rollover contribution and must be made during the period beginning on August 25, 2005 and ending on February 28, 2006.
- 3. Loans from Qualified Plans.** The income exclusion applicable to participant loans from tax qualified retirement plans for affected individuals is changed to be the lesser of (a) \$100,000 (with applicable reductions for outstanding loans) or (b) the greater of \$10,000 or the participant's accrued benefit. In addition, a qualified individual with an outstanding loan on or after August 25, 2005 who has a due date for loan repayment during the period beginning on August 25, 2005 and ending on December 31, 2006 such due date is delayed for one year. The



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extension is disregarded in complying with the requirements that the loan be repaid within a 5-year period and that level amortization payments be made.

- 4. Provisions Relating to Plan Amendments.** Any plan amendments that are required to be made as a result of the Hurricane Katrina changes will be treated as effective retroactively as long as the plan amendment is made on or before the last day of the first plan year beginning on or after January 1, 2007.

Proposed Reliance Regulations Explain Comparability for Employer's Contributions to HSAs

The proposed regulations that were issued generally follow guidance that was issued by the IRS in Notice 2004-2, 2004-2 IRB 269, and Notice 2004-50, 2004-33 IRB 196. However, the proposed regulations do provide additional clarification on some issues that were not addressed in either notice.

Background

Under Code section 223, an eligible individual may set up a health savings account (HSA) if they are covered under a high deductible health plan (HDHP) and are not covered under any other non-HDHPs (except for certain permitted insurance or coverage). Eligible individuals may, subject to statutory limits, contribute to HSAs, and so may employers as well as other persons on behalf of eligible individuals. Contributions made by an employer to an HSA are excludable from an employee's income and distributions for qualifying medical expenses are tax-free.

Comparability Requirement

HSAs are not subject to nondiscrimination rules that restrict the amount of benefits provided to highly compensated employees. Instead the employer must make "comparable" contributions to all comparable participating employees' HSAs. Generally, this means that all employer contributions to employee HSAs must be the same dollar amount or the same percentage of the HDHP deductible for all employees with the same category of HDHP coverage. The same category of HDHP coverage would be self-only or family. If the employer does not make comparable contributions then the employer is subject to an excise tax of 35% on the aggregate amount contributed by the employer to HSAs of its employees.



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General rules

If the employer decides to contribute to the HSAs of its employees, the employer must make comparable contributions to the HSAs of all comparable participating employees. Comparable participating employees are those who are eligible individuals who have the same category of HDHP coverage. Contributions are considered comparable if they are either the same dollar amount or the same percentage of the deductible for employees who are eligible individuals with the same category of coverage.

The two categories of HDHP coverage are treated separately. For example, an employer does not need to contribute the same dollar amount or the same percentage of the deductible for employees who are eligible individuals with self-only HDHP coverage that it contributes for those who have family HDHP coverage.

In addition, the comparability rules apply separately to each of three categories of employees:

1. Current full-time are those working 30 or more hours per week;
2. Current part-time are those working fewer than 30 hours per week; and
3. Former employees except for those former employees with coverage under the employer's HDHP because of COBRA continuation coverage.

These three categories of employees are the exclusive categories for comparability testing. Thus, the comparability rules do not apply separately to groups of collective bargained employees. An employer must make comparable contributions to the HSAs of all comparable participating employees, whether or not they are covered under a collective bargaining agreement.

An employer has the ability to limit HSA contributions to employees who are eligible individuals with HDHP coverage through the employer and doesn't have to make comparable contributions to the HSAs of employees covered under other HDHPs. However, if the employer decides to make contributions to the HSAs of employees who are eligible individuals with coverage under any HDHP, it must make comparable contributions to HSAs of all comparable participating employees, whether or not they are covered under the employer's HDHP.

Timing of Contributions. In determining whether the comparability rules are satisfied, an employer must take into account all full-time and part-time employees who were eligible individuals for any month during the calendar year. This requirement highlights



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the issue of what happens when an employee does not work for the employer for the entire year. There are two methods to solve this issue:

1. *Pay as you go.* The employer makes the contributions to the HSA at one or more times during the calendar year, e.g., every payroll period. The contributions must be the same amount or the same percentage of the HDHP deductible for employees who are eligible individuals as of the first day of the month with the same category of coverage and must be made at the same time. Contributions that are made at the usual payroll interval for different groups of employees are treated as made at the same time.
2. *Look back.* Comparable contributions for the calendar year are determined at the end of the calendar year, taking into account all employees who were eligible individuals for any month during the calendar year. The employer must contribute the correct amount to employees' HSAs by April 15th of the following year.

The employer can also pre-fund the contributions at the beginning of the calendar year by making contributions to the HSAs of eligible individuals at the beginning of the calendar year. If the employee leaves before the end of the calendar year, the comparability rules will not be violated because the terminated employee has received more HSA contributions on a monthly basis than employees who worked the entire calendar year.

Noncompliance. The monies contributed to the employees' HSAs accounts are nonforfeitable. Therefore, an employer cannot recoup from an employee's HSA any amounts that have been contributed. However, the employer can correct any violations of the comparability requirements by making additional HSA contributions to satisfy the comparability requirements by April 15th of the following year.

Final IRS Regulations Attack Springing Value Life Insurance Policies Transferred to Employees

IRS issued final regulations that shut down "abusive" transactions that involve life insurance policies designed to have a low cash surrender value when transferred from a Code section 412(i) retirement plan to an employee. This scheme was designed to have the employee taxed on the insurance policy's low cash surrender value. The final regulations provide that the employee is taxed at the full fair market value of the insurance contract transferred to him/her.



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Background

If an employer established a Code section 412(i) plan, the plan was not subject to the minimum funding requirements if the following six requirements are met:

1. The plan must be funded exclusively with individual annuity or individual life insurance contracts or a combination of such contracts that are purchased from a licensed life insurance company. The purchase of the contracts may be made directly by the employer through the use of a custodial account or trust.
2. The contracts must provide for level annual or more frequent premium payments.
3. Benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by a licensed insurance carrier to the extent premiums have been paid.
4. Premiums payable for the plan year, and all earlier plan years under the contracts have been paid before lapse or there is reinstatement of the policy. If the lapse has occurred during the plan year, this requirement is met if the reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse and before distribution is made, or benefits commence to any participant whose benefits are reduced because of the lapse.
5. No rights under the contracts have been subject to a security interest at any time during the plan year. This rule does not apply to contracts that have been distributed to participants if the security interest is created after the date of distribution.
6. No policy loans are outstanding at any time during the plan year. This does not apply to contracts that have been distributed to participants if the loan is made after the date of distribution.

As long as the above rules are met, the employer claims a tax deduction for contributions made to the plan that are used by the plan to pay premiums on the insurance contract covering an employee. The plan may hold the contract until the employee dies, or it may distribute or sell the contract to the employee at a specific time, e.g. when the employee retires.

Why are the new regulations important?

Some pension advisors have promoted a tax avoidance arrangement whereby an employer establishes a 412(i) plan under which the contributions to the plan are used to purchase a specially designed life insurance contract. The employer takes a tax deduction for the contributions that have been made to the plan and used to pay insurance premiums on the life insurance contract. The insurance contract used to fund these arrangements



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provided for a cash surrender value is temporarily depressed to a level significantly below the premiums paid. The contract is distributed or sold to the employee for the amount of the temporarily depressed cash surrender value.

After the policy is transferred to the employee, the cash surrender value increases significantly. The springing value of the insurance contract results in a mismatch between the employer's deduction and the employee's recognition of income. The employer has taken a deduction for the full value of the contributions that have been made to the plan and used to pay the insurance premiums. However, the employee has paid taxes only on the depressed value of the contract.

What the final regulations provide.

Under the final regulations, the employee is taxed on the fair market value of the life insurance, retirement income, endowment, or other contract providing life insurance protection. The fair market value of the contract includes the value of all rights under the contract, including any supplemental agreements thereto and whether or not guaranteed and not merely the entire cash value of the contracts. In addition, the final regulations provide that if a qualified plan transfers property to a plan participant or beneficiary for consideration that is less than the FMV of the property, the transfer will be treated as a distribution by the plan to the participant or beneficiary to the extent of the fair market value of the distributed property exceeds the value of the consideration paid.

Safe Harbors.

IRS previously issued Revenue Procedure 2005-25 to provide safe harbor formulas for determining the fair market value of a life insurance contract, retirement income contract, endowment contract or other contract providing life insurance protection for purposes of applying the rules in the final regulations.

PBGC Releases 2005 Model Participant Notice

PBGC released its annual guidance for plan administrators on providing notices to participants and beneficiaries in underfunded pension plans. The model notice includes fields for the plan's funding status, and sets forth the applicable limits on PBGC's benefit guaranty.

PBGC Technical Update 05-1 contains a worksheet and examples to assist plan administrators in determining whether they must provide participant notices for the 2005 plan year. The Technical Update also explains how the interest rate changes enacted by



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the Job Creation and Worker Assistance Act of 2002 and the Pension Funding Act of 2004 can affect (a) the requirement to issue a 2005 participant notice, and (b) the plan funding information required to be disclosed in a 2005 notice.

A plan administrator is required to issue a 2005 participant notice *unless*:

1. no variable rate premium (VRP) is payable for the 2005 year;
2. the plan meets the deficit reduction contribution (DRC) exception test for the 2005 plan year; or
3. the plan meets the DRC exception test for the 2004 plan year.

However, a plan administrator is not required to issue a 2005 participant notice if a VRP is not payable for that plan year, either because (1) the plan has no unfunded vested benefits (determined on a premium basis), or (2) the plan qualifies for at least one of five exemptions from the VRP found in PBGC Regs. section 4006.5(a).

The participant notice must be provided no later than two months after the due date (including extensions) for filing the previous year's Form 5500. For a calendar year plan for which the Form 5500 was due on August 1, 2005 (July 31, 2005 was a weekend), the due date for providing the notice would be Monday, October 3, 2005. Other common due dates for providing the 2005 participant notice are: November 15, 2005 (Form 5500 due on September 15, 2005 based on corporate extension) and December 19, 2005 (Form 5500 due on October 17, 2005 based on extension granted on Form 5558).