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Newsletter – Volume 1, No. 11 – November 4, 2005

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### Highlights

1. IRS and Social Security Issue Limits for 2006
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### IRS and Social Security Issue Limits for 2006

On October 14, 2005 the IRS issued the new limits that applicable to pension plans. The limits are as follows:

<b>Limitations on Compensation and Benefits</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
401(k), 403(b) and 457(b) plan maximum salary reduction	\$15,000	\$ 14,000	\$ 13,000
Age 50 catch-up salary reduction contributions	5,000	4,000	3,000
SIMPLE maximum salary reduction	10,000	10,000	9,000
SIMPLE age 50 –catch-up salary reduction	2,500	2,000	1,500
Defined Benefit Maximum Annual Pension	175,000	170,000	165,000
Defined Contribution Maximum Annual Addition	44,000	42,000	41,000
Maximum Compensation Limit	220,000	210,000	205,000
Highly Compensated Employees dollar limit	100,000	95,000	90,000
Definition of Key Employee Earnings Limit for Top-Heavy Plans	140,000	135,000	130,000
SEP Minimum Compensation	450	450	450



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In addition, the Social Security Administration has also announced the limits that are applicable for 2006.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Taxable Wage Base</b>			
Social Security	\$94,200	\$ 90,000	\$ 87,900
Medicare	Unlimited	Unlimited	Unlimited
<b>Employer/Employee Payroll Tax Rates</b>			
Social Security	6.2%	6.2%	6.2%
Medicare	1.45%	1.45%	1.45%
<b>Maximum monthly social security benefit</b>	\$2,053	\$1,939	\$1,825
<b>Maximum income without reducing Social Security retirement benefits</b>			
Over age 65	Unlimited	Unlimited	Unlimited
Year attaining age 65	\$33,240	\$31,080	\$31,080
Under age 65	\$12,480	\$12,000	\$11,640
<b>Medicare Part A</b>			
Medicare tax rate	1.45%	1.45%	1.45%
60-day deductible	\$952	\$912	\$876
<b>Medicare Part B</b>			
Monthly premium	\$88.50	\$78.20	\$66.60
Deductible	\$124	\$110	\$100

### IRS Releases 2006 Limits for Health Savings Accounts (HSAs)

On October 28, 2005 IRS released the limits for contributions, deductibles, and out-of-pocket expenses for HSA High Deductible Health Plans (HDHPs).

	<u>2006</u>	<u>2005</u>
<b>Maximum Contribution for Individuals</b>	\$ 2,700	\$ 2,650
<b>Maximum Contribution for Families</b>	5,450	5,250
<b>Catch-up Contributions for age 55 and over</b>	700	600
<b>Maximum Out-of-Pocket for HDHPs for Individuals</b>	5,250	5,100
<b>Maximum Out-of-Pocket for HDHPs for Families</b>	10,500	10,200
<b>Minimum Deductible for HSA HDHPs for Individuals</b>	1,050	1,000
<b>Minimum Deductible for HSA HDHPs for Families</b>	2,100	2,000



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## **IRS Settlement Initiative for Benefit Plan Transactions Considered Abusive**

On October 27, 2005 the IRS announced a settlement initiative for certain abusive transactions. The announcement listed twenty one transactions eight of which involved employee benefit plans/programs. Taxpayers who undertook one of the covered transactions will have until January 23, 2006 to submit their settlement papers to the IRS.

The nine employee benefit plan transactions listed are:

1. **Reimbursements for Employee Parking.** Reimbursements for parking expenses previously paid by an employer or previously paid by an employee through salary reduction. This transaction was described in Revenue Ruling 2004-98, 2004-42, I.R.B. 664. The revenue ruling held that the amounts considered reimbursements under the parking program described in the ruling were wages for purposes of the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and federal income tax withholding.
2. **412(i) Pension Arrangements.** IRS has issued two revenue rulings that deal with abusive transactions involving pension plans under Internal Revenue Code (“Code”) Section 412(i). The first revenue ruling (Revenue Ruling 2004-20, 2004-1, C.B. 546) describes two situations that do not meet the requirements of Code Section 412(i). The first situation involved a pension plan that fails to satisfy the requirements of 412(i) because the amounts accumulated under the insurance contracts and annuities held by the plan exceed the benefits payable under the plan terms. The second situation involved insurance contracts providing for life insurance on a participant’s life in excess of the participant’s death benefit under the terms of the plan. With respect to the second situation, the IRS held that the employer contributions to the pension plan were not currently deductible.

The second revenue ruling (Revenue Ruling 2004-21, 2004-1 C.B. 544) describes a situation where the pension plan fails to satisfy the nondiscrimination provisions due to differences in the value of participant’s rights to purchase life insurance contracts from the plan.

3. **Medical Reimbursement Arrangements.** The employer excluded from gross income the reimbursements to its employees for salary reduction amounts that were used to pay for health insurance. This transaction was described in Revenue Ruling 2002-3, 2002-1 C.B. 316. Under this transaction, the employer



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excluded from employees' gross income reimbursements for health insurance premiums under Code section 106. In addition, the employer permitted the employees to elect to pay the same premiums with pre-tax dollars under a cafeteria plan/Code section 125 plan.

4. **Abusive Roth IRA Transactions.** These transactions involve (1) an individual who owns a pre-existing business such as a corporation or sole proprietorship, (2) a Roth IRA and (3) a corporation, substantially all the shares of which are owned or acquired by the Roth IRA. The business and the Roth IRA enter into transactions which have the effect of shifting value into the Roth IRA. The value that is shifted to the Roth IRA greatly exceeds the permissible contribution limit to Roth IRAs.
5. **Abusive S Corp ESOP Transaction.** These transactions involved segregating the business profits of an ESOP-owned S Corp in a qualified subchapter S subsidiary of the S Corp so that the rank-and-file employees did not benefit from participation in the ESOP.
6. **Welfare Benefit Funds incorrectly classified as Collectively Bargained.** Contributions to welfare benefit funds are deductible when paid but only if they qualify as ordinary and necessary business expenses and only to the extent they do not exceed the limits under Code section 419A. Some of the restrictions, e.g., the limit on reserves, do not impact collectively bargained funds. Under these arrangements, businesses were taking a current tax deduction for all contributions to a welfare benefit fund. However, these businesses typically had not been involved with unions or other aspects of the collective bargaining process prior to the establishment of the welfare benefit fund. These arrangements normally required large employer contributions relative to the amount actually needed to provide the current coverage for welfare benefits under the arrangement.
7. **10 or More Employer Exception to Code section 419A Limitations.** Promoters have sold trust arrangements in which at least 10 or more unrelated employers participate. These trusts provide welfare benefits such as life insurance, disability, and severance pay benefits. The promoters for the trust arrangements represented to the employers that all contributions to the trust were fully deductible on the company's tax return when made. Typically the trusts were funded with variable life or universal life insurance contracts on the lives of the employees covered under the trust. The trust arrangement generally required large employer contributions relative to the cost of the amount of term insurance provided to the employees. The trust was the beneficiary of the insurance



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policies. Generally, the trusts had separate accounting for each subscribing employer. This type of arrangement does not meet the requirements for the 10 or more employer exception to the funding limitations of welfare benefit funds.

8. ***Delayed Effective Date of S Corp ESOP Prohibited Allocations.*** Transactions where the taxpayer has claimed that it is entitled to exclude income of an operating business by asserting, incorrectly, that the taxpayer had established on or before March 14, 2001, an ESOP entitled to exemption from unrelated business income and an S Corp that is a management corporation.

IRS Announcement 2005-80 lists the actions that must be taken in order to correct the abusive transactions under the settlement initiative and the maximum penalty amounts that will apply under the initiative.

### **IRS Extends Deadline for Compliance of Section 403(b) Plans with New Regulations**

In the Fall Edition of the Employee Plans News, the IRS made it official that entities that sponsor 403(b) arrangements will not have to comply with the new rules including the proposed regulations until plan years beginning after 2006. The stated reason for the delayed effective date is to provide sponsors of 403(b) arrangements with a reasonable period of time to comply with the regulations before their effective date.

At this time the IRS is still evaluating the comments and recommendations that it has received from the public on the proposed regulations before issuing final regulations. IRS expects to have the final regulations issued in early 2006 so that the 403(b) sponsors will have sufficient time in calendar year 2006 to comply with the final regulations for all plan years beginning after December 31, 2006.

### **Wrap-Around 401(k) Plans**

The newly issued Code section 409A regulations provide guidelines whereby an employer can combine a tax qualified 401(k) plan with a nonqualified plan without violating the new nonqualified deferred compensation rules.

Prior to the passage of Code section 409A, the IRS had issued several private letter rulings that permitted wrapping a nonqualified plan around a tax qualified 401(k) plan. The primary reason to link the plans was to permit a highly compensated employee to avoid the necessity of receiving corrective distributions of his/her elective deferrals when the 401(k) plan failed the ADP/ACP tests. The wrap-around plan also permitted the



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employee to make a single deferral election that applied to both the nonqualified and tax qualified 401(k) plan.

Under the old arrangement, the employee would make a deferral election under the nonqualified plan and an election under the 401(k) plan for the maximum amount allowable under Code section 402(g) which would not cause the plan to fail the ADP/ACP tests for the year. After the close of the plan year, the ADP/ACP test would be completed and the permissible deferral and matching contribution amounts would be determined. As soon as the permissible amounts were determined, the nonqualified plan would transfer the elective deferrals and matching contributions to the 401(k) plan.

Under the Code section 409A proposed regulations, an employer may link a nonqualified plan with a 401(k) plan without violating any of the Code section 409A restrictions. In order for the arrangement to be in compliance with the proposed regulations, the following conditions must be met:

1. The eligible employee must make the deferral election before the beginning of his/her taxable year.
2. The eligible employee also needs to make a corresponding election under the 401(k) plan to defer the maximum permissible amount under the ADP and ACP tests.
3. Perform the ADP and ACP tests after the close of the plan year.
4. Transfer the elective deferrals and matching contributions to the 401(k) plan as soon as practicable after the close of the plan year. The transfers cannot exceed the Code section 402(g) limit, i.e., \$14,000 for 2005 and \$15,000 for 2006. The 402(g) limit also applies to the matching contributions which should not pose a problem for the employer as long as the matching contribution rate is 100% or less.

### **IRS to Hold Hearings on Proposed ESOP Regulations**

IRS is holding hearings on the proposed ESOP Regulations dealing with the deduction for dividends paid for stock held by an ESOP. The hearing is scheduled for January 18, 2006 at 10:00 AM at the IRS Auditorium, 1111 Constitution Avenue NW, Washington, DC. The proposed ESOP regulations provide that: (1) the payor corporation is entitled to the deduction for dividends paid with respect to the stock held in the ESOP and (2) a corporation is not entitled to a dividend deduction for redemption of stock held by an ESOP. See our newsletter dated September 7, 2005 for a description of the proposed ESOP regulations.