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2005 UPDATE IN THE PENSION/EMPLOYEE BENEFIT AREA

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I. Post-2005 COLA Increases

The following limits change after 2005:

Defined Benefit Annual Benefit Limit (for Plan Years <u>ending</u> in 2006) means bigger contribution for straddles (see later discussion)	\$175,000 (was \$170,000)
Defined Contribution Limit (for Plan Years beginning in 2006)	\$44,000 (was \$42,000)
Compensation Limit (for Plan Years beginning in 2006)	\$220,000 (was \$210,000)
Key Employee Compensation (for top heavy)	\$140,000 (was \$135,000)
Highly Compensated Employee (applies to 2007-\$95,000 in 2005 makes one an HCE in 2006 – unless top paid election overrides)	\$100,000 (was \$95,000)

Statutory Increases are:

401(k)/403(b) deferrals	\$14,000 to \$15,000
Post-50+ catch-up	\$ 4,000 to \$5,000 (\$2,500 for Simple IRA)
Simple IRA deferral	\$10,000 unchanged
Social Security Taxable Wage Base	\$94,200 (\$90,000 for 2004)
Maximum Annual IRA contribution	\$4,000 (unchanged)
Maximum IRA post 50+ catch up	\$1,000 (\$500 for 2005)

Example for 2006

The maximum 2006 401(k) allocation for 50+ participants is \$49,000-subject to deduction limits for non-deferrals of 25% of salary (or 20% of net self-employment income minus 50% of FICA/Medicare).

II. EP Abusive Tax Transactions – Listed Transaction Refresher

Comment - We have been discovering companies with 419A, Welfare Plans or 412(i) defined benefit Plans who have committed “listed transactions but whose CPAs did not disclose them. Many CPAs, we find, are not fully aware of the rules in this area or are not being given the info from their clients to identify them. Query? What duty do

you have to identify them – and to probe your client for the information? Unfortunately litigation will explore that duty in some situations.

The IRS finalized regulations in 2004 on abusive tax shelters. The regulations provide that a taxpayer must disclose certain transactions known as “listed transactions” by filing a disclosure statement (Form 8886) with its tax return. A “listed transaction” is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance. The parties who participate in listed transactions may be required to disclose the transaction as required by the regulations, register the transaction with the IRS, or maintain lists of investors in the transactions and provide the list to the IRS on request.

Listed Transactions

The IRS had identified the following transactions involving employee benefit plans as listed transactions:

- 401(k) Accelerated Deductions
- S Corporation ESOP Abuse of Delayed Effective Date for Section 409(a)
- Collectively Bargained Welfare Benefit Funds under Section 419A(f)(5)
- Certain Trust Arrangements Seeking to Qualify for Exemption from Section 419
- Abusive Roth IRA Transactions
- S Corporation ESOP Abuses; Certain Business Structures Held to Violate Code Section 409(p)
- Deductions for Excess Life Insurance in a Section 412(i) or Other Defined Benefit Plan

SEE DISCUSSION BELOW ON THE IRS SETTLEMENT INITIATIVE, ANNOUNCEMENT 2005-80

III. Massive IRS Settlement Initiative

The settlement program, described in Announcement 2005-80, provides a onetime opportunity for taxpayers voluntarily to come forward and resolve their civil tax disputes over sixteen listed and five other potentially abusive transactions. Under the initiative, taxpayers would concede improper tax benefits and be provided some tax relief for transaction costs and civil penalties.

This initiative is available for taxpayers both known and unknown to the IRS.

A. Program Fundamentals. The twenty-one transactions are divided into three groups:

1. Group 1 – Six Listed Transactions (no benefit ones).

2. Group 2 – Ten Listed Transactions.
3. Group 3 – Five Other Transactions.

Group 2 includes abusive transactions listed by the IRS. The only difference between the listed groups, are the penalty level required to participate.

Group 3 covers five transactions that the IRS is concerned about but have not been formally listed.

B. Settlement Initiative Terms. Participation in the Settlement Initiative requires:

1. Transaction Merits. The taxpayer must concede 100% of the transaction's tax benefits. All tax deductions are disallowed.
2. Transaction Costs. The taxpayer will be allowed to treat as an ordinary loss the full transaction costs claimed on the tax return, including promoter and professional fees.
3. Penalties. A penalty of a quarter of the maximum applicable penalty (which in most cases would be 20% of the tax, but in certain cases would be 40%) will be paid on Group 2 and 3 transactions. For Group 1 transactions, the penalty will be half of the maximum.

No penalty is due if the taxpayer:

(a) Got a written tax opinion before filing the tax return that:

- Was not a opinion that was part of the package sold by the promoter, but was given by a tax adviser meeting certain tests, **and**
- Was a “more likely than not” opinion, that is, it concluded at a confidence level greater than 50% that the significant tax issues would be resolved in the taxpayer's favor.

C. Settlement Procedures. The taxpayer must file an Election Form with the IRS indicating an intent to participate, which would include required information necessary to determine eligibility and calculate the taxes, interest and applicable penalties. Full payment (or payment plan acceptable to the Service) of all taxes, interest and penalties will be required as a condition to settling and executing a closing agreement with the IRS.

D. Other Dispute Resolution Procedures. The settlement initiative will not affect conventional IRS resolution procedures available to taxpayers, either with Compliance (exam), Appeals Fast Track or the traditional Appeals review process. For eligible taxpayers that forgo the settlement initiative and take their issues to Appeals, the IRS indicates the taxpayer should not expect to receive a

better offer in Appeals than that offered by the settlement initiative and may in fact have a less favorable outcome.

Eligible Transactions

Group 2 – Listed Benefit Transactions (Penalty = ¼ of the Maximum)

Rev. Rul. 2004-20, 2004-1 C.B. 546, Situation 2 (5%) (and including the non-listed Situation 1 and Rev. Rul. 2004-21, 2004-1 C.B. 544); (412(i) Plans);

Rev. Rul. 2004-4, 2004-1 C.B. 414, ESOP - owned S corporation (5%);

Notice 2004-8, 2004-1 C.B. 333, Abusive Roth IRA Transactions (5%);

Notice 2003-24, 2003-7 C.B. 853, Welfare Benefit Funds under § 419A(f)(5)(5%);

Rev. Rul. 2003-6, 2003-7 C.B. 286, ESOPs holding stock in an S corporation (5%);

Notice 95-34, 1995-1 C.B. 309, Certain Trust Arrangements Seeking Exemption from Section § 419 (5%).

Group 3- Other Benefit Transactions (Penalty = ¼ of the Maximum)

Rev. Rul. 2004-98, 2004-42 I.R.B. 664, Reimbursements for Employee Parking (5%);

Rev. Rul. 2002-3, 2002-1 C.B. 316; Rev. Rul. 2002-80, 2002-2 C.B. 925, Reimbursements of employees' medical expenses (5%); and Management S Corporation/ESOP Transactions (5%).

As to 412(i) Plans –

- Entity loses all tax deductions for open years (6 year statute applies? 3 years?)
- 412(i) Plan must be terminated and the plan assets (including policies) distributed. The taxable value of the policies is deemed to be cumulative premiums!
- Distribution is deemed to be from a non-qualified plan (No rollover to IRA, etc.)

Example:

To settle, Company deducts \$200,000 in 2002 to abusive 412(i) Plan and all went into life/annuity policies having a current cash surrender value of \$90,000.

- \$200,000 deduction disallowed. ¼ of the maximum applicable penalty is assessed for 2002 – and taxes and interest assessed accordingly.
- Policy distributed to owner. Tax value is \$200,000 (even though annuity and life insurance policies are worth \$90,000!)

- Income to owner in year of distribution. Deductible by business entity in same year.
- Deadline to submit settlement proposal is January 23, 2006.

Issues:

- Deadline to pay Plan benefits out to get 3 year NOL to cover 2002 is 12/31/05 – This can become more crucial in a C corporation context – as CPAs know better than tax attorneys do. Even an S corporation 2006 loss may be less useful than a 2005 loss in obviating effects of the 2002 deduction disallowance.

Do you take the deal? And if so, do you scramble to distribute by 12/31/05? Every situation is different. Some taxpayers will balk at paying tax on \$200,000 while receiving a life insurance policy that is likely to lapse for non-payment of premiums. Under the example, there was \$110,000 of “hot air” much of which is gone forever - even assuming life insurance policy premiums continue to be paid, the policy usually is a poor excuse for a life insurance policy. Proper evaluation of such a policy is a job for a competent trusted life insurance professional (usually someone different than the original sales agent). Or do you freeze the Plan, these situations are complex – too much so to cover here), terminate it and rollover to another qualified plan (and caution before injecting bad rollover \$s over to a good plan) – we’ve advised creation of frozen 0% Money Purchase Plans for the rollovers if a rollover is called for – there is no easy solution). An IRA incurs a 6% annual excess contribution excise tax if the rollover is invalidated, plus, no life insurance policy is allowed in an IRA. What do you do if you paid tax on \$110,000 of value when it lapses at zero value? Most likely a non-deductible personal loss? (not likely) theft loss? Who knows. All unanswered questions. Plus, California has not yet indicated whether it will go along with this IRS initiative.

The New York Times reported last week the IRS has identified more than 4,000 wealthy investors and businesses who used listed tax shelters and is conducting audits to locate more.

Some taxpayers may take their chances on the deduction disallowance to avert paying taxes on a lousy life insurance policy and annuity contract, but watch out! Seek help if in doubt.

IV. Creditor Protection Update

The new Amended Bankruptcy Act went into effect October 17, 2005! 11 U.S.C § 522.

Thus, now under United States Bankruptcy law the following is in effect:

1. Pension Plans subject to ERISA – Exempt under ERISA, Exempt in Bankruptcy under Bankruptcy law.

2. Corporate Plans – Exempt under CA law (and Federal if ERISA covers), Exempt in Bankruptcy context, too.
3. Sole Proprietor Plans with no employees, SEPs, SIMPLE IRAs – not exempt under CA except to extent judge allows under a financial needs test – Not Exempt under ERISA, Exempt in Bankruptcy under recent Bankruptcy law.
4. IRAs (see below)
 - Not exempt under ERISA
 - Not exempt under California law except to extent a judge allows under a financial needs test.
 - Exempt in Bankruptcy context if from a rollover of qualified plan funds, or from SIMPLE or SEP contributions and exempt up to \$1,000,000 for other IRA funds.

Comment : The new Bankruptcy protection applies only in Bankruptcy. If one prefers not to file for Bankruptcy, or does not qualify for Bankruptcy under the new “earnings” test, the old regime still applies! Thus, IRAs, SEPs, SIMPLE IRAs and owner only “Keogh” Plans still have less protection than a corporate or ERISA qualified plan in California!!

V. Flex Plan Reimbursement Extension

Notice 2005-42 (May 18, 2005), as clarified by Notice 2005-61 (September 7, 2005) permits a “grace” period following a Plan Year of a Cafeteria Plan (IRC § 125) of 2½ months during which unused qualified cafeteria plan benefits can be paid or reimbursed without being treated as “deferred compensation”. This modifies the “use it or lose it” rule.

This is permissive. Employers need not adopt this!

Example: Calendar Year Flex (125) Plan

- Employee converts pre-tax \$100 per month to her health reimbursement account for 2005.
- \$300 remains unused on 12/31/05.
- Old rule – forfeited!
- New permissive rule – She has until March 15, 2006 to “spend” the \$300. This is different than the “run- off” periods most plans have of allowing 30 days to submit bills for December 2005 services.

Notice 2005-61 clarifies the W-2 reporting rules to indicate the reporting of dependent care assistance amount on a W-2 is to use a “reasonable estimate” when a child care account surplus exists on 12-31-05.

Comment – The advent of IRC § 409A means it is highly unlikely any further regulatory extension of this will occur beyond 2½ months. IRC § 409A would treat a longer period as “deferred compensation”.

VI. Small Plan Start-up Costs

Do not forget IRC § 45E. The U.S. Treasury gives a \$500 per year (for 3 years) credit up to 50% of the start-up costs (set-up fees and administration fees) of a qualified plan that covers at least one non-highly compensated employee. No deduction is allowed for the same costs – and you can only do this once every 3 years. No credit is allowed if a plan covering substantially the same people existed during the 3 year period preceding the first allowable credit year.

VII. Roth Conversion Strategy Debunked

The IRS issued rules on August 19, 2005 to curtail “springing value” annuity contracts in the conversion of an IRA to a Roth IRA. Treasury Decision 9220.

Comment: Apparently creative minds decided to develop annuity contracts with temporary high surrender charges – so as to attempt to minimize the tax value upon conversion. The regs specify the tax value is the “Fair Market Value” not the cash surrender value.

VIII. Automatic Rollover Regs In Effect

EGTRRA added IRC § 401(a)(31)(B) mandating direct rollovers of distributions of lump sum taxable benefits between \$1,000-5,000 to IRAs (if the participant does not elect a taxable distribution). The only way “out” of this is to reduce the Plan’s mandatory payout rule to \$1,000. The provision was effective only after U.S. Department of Labor issued final regulations for a “safe harbor” on fiduciary liability. The regulation was published in the Federal Register on September 28, 2004 and was final March 28, 2005 (29CFR § 2550. 404a-2). All Plans have/had to be amended before the first Plan Year ending after March 31, 2005!

The regulation requires:

1. The Plan must enter a written agreement with an authorized IRA provider (most but not all IRA custodians will qualify under DOL regs – see regs for more detail).
2. The “funds must be placed in a investment product designed to preserve principal and provide a reasonable rate of return – whether or not such return is guaranteed, consistent with liquidity.”

3. Participants must be given a notice or Summary Plan Description describing the automatic rollover provision and giving the participant information about the selected IRA provider and the IRA's fees.

The Qualified Plan must also be amended to provide for the automatic rollover procedure. The IRS provided a Model Amendment and a Model Participant Notice.

Groan – all plans need(ed) amending for this requirement and double groan – few IRA custodians want this type of business. Setting up an IRA for someone without his/her signature, or investment direction is not as easy as you'd think. The DOL wants no principal risk, but a reasonable rate of return? The product is limited to FDIC insured products, credit unions, mutual funds or insurance company products subject to state guaranty.

IX. EGTRRA Remedial Amendment Period Coming Up!

Believe it or not, all qualified plans will need further amendments for EGTRRA. Plan sponsors have until the end of a specified remedial amendment period to fix disqualifying provisions, assuming EGTRRA "good faith" amendments were previously timely adopted.

Revenue Procedure 2005-66 (August 26, 2005) sets forth the program. The IRS established a staggered 5 year remedial amendment period for individually designed plans and 6 year amendment/approval cycle for pre-approved plans (prototypes/volume submitters).

Note – Anyone who handles 5500 forms, does plan administration, audits qualified plans or drafts qualified plans should review Revenue Procedure 2005-66.

- Individually Designed Plans

The 5-year cycle for individually designed plans is determined as follows: (special rules apply to plans in controlled groups, multi-employer plans, mergers, etc.)

If the TIN of the Employer ends in -	The plan's cycle is -	EGTRRA remedial amendment period (i.e., the first cycle) is -
1 or 6	Cycle A	January 31, 2007
2 or 7	Cycle B	January 31, 2008
3 or 8	Cycle C	January 31, 2009
4 or 9	Cycle D	January 31, 2010
5 or 0	Cycle E	January 31, 2011

Termination of a plan ends the remedial amendment cycle.

Note – this might make IRS submissions for favorable determination letters more important with plan terminations. Difficulty is that – with long "cycles" on amendments – plans terminating in the 2005 - mid - 2007 period might not yet have IRS approved language available – meaning relying on already approved language is perhaps not

possible. The IRS's determination letter program for EGTRRA on individually designed plans will not open until February 1, 2006!

- Volume Submitter/Prototypes

The "sponsor" of a volume submitter and prototype plan must submit every 6 years as follows:

- Defined Contribution Plans

Sponsors: February 17, 2005 through January 31, 2006

Mass Submitters: February 17, 2005 through January 31, 2006

- Defined Benefit Plans

Sponsors: February 1, 2007 through January 31, 2008

Mass Submitters: February 1, 2007 through October 31, 2007

IRS indicated it may take up to 2 years to review and approve a submitted "pre-approved" document. Once approved the IRS will publish an announcement that will most likely provide a two year window for employers to adopt the plan.

Example – Existing 401(k) Plan by Acme Roofing. Assume the "sponsor law firm" submits plan for ruling on January 2, 2006. Assume IRS ruling on the form occurs March 1, 2007. An "eligible adopting employer" (see below) has until February 28, 2009 to adopt an approved plan amendment.

Note – An "adopting employer" must either adopt the plan within the time frames described earlier for an "individually designed plan," or sign a "Certification of Intent to Adopt Pre-Approved Plan" within that period. Thus, under the Example above, assume Acme's TIN ends with a "6." It need not amend the Plan before January 31, 2007 but will not have the extension I indicated could go until February 28, 2009 unless it signs the "Certification of Intent to Adopt Pre-Approved Plan" by January 31, 2007.

X. Internal Revenue Code Section 412(i)

IRC § 412(i) provides an exception to "minimum funding" rules for fully insured defined benefit plans. Some insurance agents/benefit advisors/accountants have, over the last 3-4 years, been advising 412(i) plans as the answer to a (lack of) deduction problem.

Watch out! The chickens are coming home to roost. Our practice has devoted considerable time lately to representing taxpayers who lost significant money in poorly designed insurance policies and programs that clearly violated IRC rules on life insurance limits in a qualified Plan. Lawsuits seeking recovery against their lawyers, accountants and insurance companies are beginning to flood in.

Claims.

1. Deductions are significantly higher than a noninsured defined benefit plan.
2. The investment is secure.
3. Distributions when receiving benefits are based solely on cash surrender value, allowing statements such as "you can fund \$200,000 per year for 5 years-then terminate plan and take it out with only \$80,000 of taxable income because that is the cash value."
4. You can deduct based on a 3% or 4% assumed interest rate instead of 5% or more.

Reality. I represented more than 1 taxpayer in the late 1980's and early 1990's in IRS attacks on 412(i) plans. They "resurfaced" during 2002, 2003, 2004 and 2005 big time, perhaps due more to an audit lottery mentality than reality:

1. Distributions of a "springing cash value" policy (see below) is not based on cash surrender value and 2004 Regs emphasize this with tough rules.
2. IRC § 415 limits are based on a 5% rate (5.5% as indicated elsewhere for 2005) -not 3% or 4%.
3. Employees' cost can be significant-and the "top-heavy" minimum benefit must continue to be provided-costing a lot if you are using artificially depressed cash value policies.
4. Most of the policies pitched under this approach are less than stellar-high loads, low cash value for many years. Thus, higher deduction offset by lesser performance over the years-not to mention a horrible result if you need to cash in an artificially low cash value policy before it "springs" back to life.

Note - Treasury and IRS issued final regulations on August 9, 2005 intended to shut down abusive 412(i) plans. The rules are 4 prong:

1. IRS Regulations provide that life insurance contracts distributed must be taxed at full fair market value. No more distributions at an artificially depressed cash value (Prior Notice 89-25 so said, but without the force of Regulations. Some insurance agents have tried to ignore 89-25). The final regulations indicate the value of all rights under the contract go toward computation of the fair market value of the policy, not merely the cash value of the contract.
2. Rev. Procedure 2005-25 (Effective February 13, 2004) Supersedes Revenue Procedure 2004-14 for purposes of determining the fair market value of life

insurance contracts. The Revenue Procedure provides two “safe harbor” formulas for determining the fair market value of an insurance contract.

3. Rev. Rule 2004-20 412(i) plan cannot hold life insurance and annuity contracts for benefit of a participant that provides for benefits at normal retirement age in excess of the participant’s benefits at normal retirement age under the Plan’s terms. Note - This limits amounts payable under the policy if it grows in excess of the retirement benefit! Means it is a must to terminate a 412(i) plan before policy exceeds benefits! Also IRS indicated such “excess arrangements” are Listed Transactions. Regulations also state life insurance death benefits on a participant in excess of a participant’s plan death benefit is OK if the excess reverts to the Plan but the cost of the excess coverage is not currently deductible. Use of this technique to boost deductions also is a “listed transaction.”

4. Rev. Rule 2004-21 412(i) plan not allowed to provide highly compensated employees with better rights to purchase policies from the Plan than others.

So where are we now with 412(i)?

Even more of a niche product than before. Fully insured/annuitized Plan can produce contributions greater than a traditional Defined Benefit Plan, but the use of low cash value policies to artificially depress taxable payouts, different policies for owners vs. others, different policy purchase rights, and ignoring the underlying values of policies in determining IRC § 415 limits, is out! Watch out for your explosive! Do not advise a 412(i) without extreme caution. And make sure to disclose any listed transactions.

All existing 412(i) plans need to be reviewed for compliance. Plan amendments and policy restructuring may be necessary.

XI. New 401(k) Rules-

The IRS issued new regulations re 401(k) Plans during 2005 (26 CFR 1.401(k)-1 through 1-401(k)-6 and 26 CFR 1.401(m)-1 through 1.401(m)-5). By and large they are highly technical and just codify prior practice. Here are some highlights:

- “Qualified Nonelective Contributions” are used to help an employer meet the ADP test (in a non “safe harbor” setting). The new regulations apply new tests post 2005 to limit the current ability to give more to the lowest paid participants to meet the tests. QNECs are likely to be more expensive post 2005. Refunds to HCEs might be more preferable. A “safe harbor” election might be more suitable than a QNEC in some scenarios. A safe harbor amendment for a 2006 calendar year 401(k) must be adopted by 1-1-2006 and a notice given out at least 30 days prior.
- Technical changes were made to rules valuing “gap” income on refunds to HCEs. Effective in 2007 for 2006 calendar year refunds.

- New safe harbor hardship exceptions (Plans may need amending):
 - Burial or funeral expenses for the employee's deceased parent, spouse, child or dependent.
 - Repair expenses to damage to the participant's principal residence that otherwise qualify as casualty expense (without regard to 10% floor).

XII. California State Taxation

In Re Cower (No. 294394 October 2005 State Board of Equalization). Nonqualified stock options exercised by non California residents was taxable to California as the options compensated them for services provided in California.

Comment - the rules allowing taxpayers to move out of California and avoid California IRA and qualified plan funds that were contributed while working in California do not apply to nonqualified plan/non IRA funds.

XIII. Microsoft Settles!

In the "bigger they are the harder they fall category" is Microsoft. Microsoft recently settled a case filed in 1992 under which "permeating" employees claimed Microsoft improperly hired them through "temp" agencies to avoid paying them pensions, 401(k) matches, health insurance and stock options.

8,000-12,000 class members (and their lawyers) will split \$96.9 Million.

Comment - I have used this case as an example: "If Microsoft lost, then what chance do you – small employer – have if you try the same – albeit on a smaller scale." Remember all of the aggregation rules under IRC § 414?

Rules under IRC § 414 - plus – the "common law" tests.

- "One would think Microsoft had the best attorneys, the best accountants and the best pension advisors. Yet the pre - 1992, advice appears to have cost Microsoft close to a \$100 million, not to mention its costs of defense and all the associated bad press/bad will." "If this is what the "best" did, be careful when talking to your local attorney accountant and other advisor if they counsel schemes to exclude from benefit plans people who clearly have an employment relationship."
- "Be cautious and take defensive measures when classifying people as independent contractors or excluding people from plans by category. If you rely on IRC §410(b) coverage tests to exclude people, make sure you know what you are doing, and exclude people properly. Always consider what could happen if the affected person; IRS or EDD attempted to challenge a exclusion."

XIV. Introduction to Concept of Defined Benefit Plan Straddle

We find many CPAs who believe a Defined Benefit Plan is inflexible, a straightjacket of sorts, cannot be amended to reduce contributions and has no flexibility. Here is a possible counterpoint to that.

Small business with cyclical but significant income sets up a Defined Benefit Plan - primarily to benefit the 55 year old owner. Facts:

Calendar year S corporation
Defined Benefit Plan Year of December 1 to November 30

Year One 2005

Corporation deducts \$100,000 on a “beginning year valuation - permissible under IRC §404 regulations - for 2005-2006 Plan Year.

Year Two 2006

Same as above for 2006-2007 plan year.

Year Three 2007

Business is “bumpy” – little profit for 2007 but 2008 looks terrific. CPA requests IRS to switch to “end of year valuation” method (choices are 1. Beginning 2. End 3. Hybrid). Contribution for 2007 is zero.

Year Four - 2008

Contribution of \$110,000 (assume) is made for 2007-2008 Plan Year – due date is August 15, 2009 (assuming 2008 1120 is on extension until September 15, 2009). Why not September? 8 ½ months funding period deadline after 11-30-2008 is 8-15-2009. Employer seeks more flexibility again - thus amends DB Plan before February 2009 (so no employee has accrued a benefit to reduce benefit formula) - so that contribution for 2008-2009 Plan Year is within expected profit levels. Or freezes benefits for one year and reactivates benefits again on 12-1-2009, so as to get back to paying contributions in ADVANCE, rather than in arrears.

There are many variations on this, but the game plan is to do this: 1. Contribute in advance before benefits accrue – if at all possible, and 2. Minimize accruals from occurring before the business has identified the source of \$ to pay for them.

This “straddle” method reduces the need for Plan benefit formula amendments. (the IRS frowns on frequent amendments to a benefit formula-no frequent fixed standard – once every 3 years usually creates few issues) and even more importantly, reduces accruals of employees in situations where benefits have accrued, but funds to

pay for them are non-existent. You are usually ahead in funding with a straddle. We have found a straddle invaluable when two co-owners are in a DB Plan together. This helps reduce chance one will leave at a time when his/her accrued benefits are not fully funded-thereby creating a potential dispute as to “who pays?”

XV. Roth IRA Within Qualified Plans Coming! 2006!

Heads up! For tax years after 2005, a 401(k) plan or 403(b) plan can permit a plan participant to (under IRC § 402A) optionally treat elective deferrals as after-tax Roth IRA-type contributions.

Note – We expect significant added IRS guidance along with model language for plan amendments before 2006.

Note 2 – The annual “Roth-type” dollar deferral limit will be \$15,000 (plus \$5,000 for age 50+) with no cap on earnings.

Roth IRA eligibility current phases out from \$150,000 – 160,000 AGI for married couples and \$95,000 – 110,000 for singles.

Query – there still is little real benefit for a high bracket taxpayer to defer under a Roth – IRA.

The tax savings of a current deduction provide a “tax bonus” that carries forward and is available – if invested under “tax management” to pay the eventual tax.

Niche use of Roth 401(k): Mom/Pop have small business. Two teenager children work for it – on payroll. Couple other unrelated employees. Business adopts a safe harbor 401(k) Plan (normally NOT with a rate group – due to “testing” issues that arise with your HCE).

Example:

	<u>Compensation</u>	<u>Safe Harbor Minimum</u>	<u>Maximum Deferral</u>
Mom (less than 50)	\$30,000	\$900	\$15,000 (tax deduct)
Pop (50+)	\$100,000	\$3,000	\$20,000 (tax deduct)
Son	\$16,000	\$480	\$15,000 (Roth)
Daughter	\$16,000	\$480	\$15,000 (Roth)
Employee #1 (young)	\$30,000	\$900	Who cares?
Employee #2 (young)	\$30,000	\$900	Who cares?

XVI. 415 Regulations

Proposed regulations were issued on May 31, 2005 under IRC § 415 (Benefit Limits). Most of it is highly technical – suitable for pension seminars, but a couple of highlights:

- Regs clarify that post severance compensation paid more than 2½ months later cannot be considered for deferrals under a 401(k) Plan. See § 1.415(c)-

2. Payments made within 2½ months after termination of that are of the type that would have been paid if he/she still worked there are still subject to deferral. These rules technically apply for post 2006 plan years – although IRS policy and most practitioners have been applying similar interpretations in practice right now.

Example – Commission salesperson terminates employment on June 30, 2007. Commission accrues under her contract as of November 30, 2007 for a sale she worked on. This compensation is “post severance” and may not be subject to a 401(k) deferral election. But if the commission accrued on September 2, 2007, the 2½ rule is met and a prior deferral election can be honored.

- Compensation used for a Defined Benefit Pension Plan’s “high 3 year average” must be attributed to compensation earned during periods of active participation effective for Plan Years beginning after 2006. This is a big change!

Current Policy – 55 year old owner earns \$100,000 (assuming no employees – or reasonable employee cost) – his/her corporation set up a 2005 Defined Benefit Plan prior to June 1, 2005 and uses \$100,000 average as basis to defer all \$100,000 of 2005 profit to a DB Plan – saves income tax and FICA/Medicare. He/she can do this for 2006, too. For 2007, new rules kick in – and his/her December 31, 2006 PVAB cannot increase above that level unless it does so on the basis of a high 3 year average earned while a participant. Defined Benefit Plan set up after May 31, 2005 do not appear, under the proposed regs, to meet the rules for the Plan Years beginning after 2006. To avert post 2007 disqualification, the accrued benefits as of post 2007 Plan Year cannot exceed the amounts allowed under the new rules as of the first effective date (no grandfathering of higher amounts).

New Policy - post 2006 – New DB Plan set up after 2006 can only count compensation earned during active participation.

XVII. Nonqualified Executive Compensation

The American Jobs Creation Act of 2004 overhauled rules governing Nonqualified Deferred Compensation (NQDC) and similar executive compensation arrangements for all deferrals after 2004. It added IRC § 409A. The IRS issued 238 pages of proposed regulations recently (Proposed Reg §1.409A-1 to 1.409A-6). The regulations will update and supercede Notice 2005-1. Notice 2005-1 remains generally in effect until the regulations become final (January 1, 2007). Any plan adopted prior to October 4, 2005 should not be materially modified ever (the regs provide guidance) unless you want to comply with the new rules. Plans adopted on or after October 4, 2005 have, under transitional relief in the regs, until December 31, 2006 (formerly 2005) to amend to conform to Section 409A. The time period to change or modify certain payment elections also was extended to December 31, 2006, (but no payment due in 2006 can be postponed to later). Meanwhile, the Plan has to be operated through December 31, 2006 in good faith reliance on the provisions of Section 409A and Notice

2005-1. Thus, provisions in the Plan document that violate Section 409A must be ignored – and operated in compliance with it. Any Plan provision allowing “exercise of discretion” must not be exercised in contravention of Section 409A.

Comment- This means the Plan should be amended sooner than later to avert disputes with participants who see a plan provision, want to use it and such use violates 409A. Note - the regs do appear to provide that an exercise of a right by one participant that violates 409A will not cause the plan to violate §409A with respect to other participants. Thus, one remedy would be to allow a complaining participant to exercise – and nail him/her with the 20% excise tax.

1. All plans providing for deferral of compensation are included under §409A other than a qualified employer plan, an eligible IRC §457(b) governmental plan and any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. 409A applies the new rules to severance plans that are “disguised deferred compensation plans (consider severance pay VEBAs in this category). Severance plans providing for no more than twice annual compensation (limited to \$210,000 per year-\$220,000 in 2006) are generally considered severance plans.

2. For a participant to avoid constructive receipt (requiring immediate taxation) on deferred amounts that are not subject to a substantial risk of forfeiture:

(a) Payouts must be restricted to separation from service, disability (as defined in §409A) death, a time specified under the plan, a change in ownership or control of the company (IRC §280G will be possible reference point) or an unforeseeable emergency. Regs (§1.409A-3(d)) specify a payment is deemed made on a specified date if it is made on such date, a later date within the same calendar year, or by the 15th day of the third month following such date (post October dates desired?)

(b) For key employees of public companies (as defined in IRC § 416(i)), payout after separation from service is delayed for six months.

(c) Under no circumstances can a payout be accelerated (except as permitted by regulations) but a payment can be delayed if the election to delay is made more than 12 months before the first payment and for distributions for reasons other than death, disability, or change of control, the payment is delayed no less than five years. A plan can provide for acceleration to extent needed to prevent a “nonallocation” year under IRC § 409 (ESOP in S Corp). The ability to terminate a Plan is a violation. Owners therefore should use informal non binding neatened earnings programs at hear than deferred compensatory arrangements, for post 2004 deferrals. Important!

(d) An unforeseeable emergency is defined in § 409A much more narrowly than a hardship under the 401(k) rules (severe financial hardship from illness, accident, funeral expenses; or casualty loss to property). Reg §1.409A-3 contains guidelines. The purchase of a home and payment of college tuition are not unforeseeable.

(e) Deferral elections must be made during the preceding year (or within 30 days of initial eligibility), except performance based compensation over a period of at least 12 months (then you need to defer no later than 6 months before the period's end). Reg § 1.409A-1(e) specifies that "performance-based" compensation includes amounts that are (1) variable and contingent on satisfaction of pre-established organization or individual performance criteria relating to a performance period of at least 12 consecutive months, and (2) not readily ascertainable at time of election. Performance-based compensation has to meet requirements and performance criteria that is established no later than 90 days after beginning of the service period, but the determination need not be made by a board of directors or compensation committee.

3. NQDC accumulations cannot be funded through an offshore trust.

4. Funding of NQDC accumulations to a Rabbi Trust cannot occur due to the employer's financial health-as defined in future IRS guidance (with this restriction, a rabbi trust would be allowed under §409A-presumably if used from inception).

5. Deferred amounts must be reported on the employee's W-2 form.

6. Penalties include (a) current income inclusion with interest and (b) an added 20% tax of the amount includable in gross income.

7. A "NQDCP" can include just one person (§409A(d)(3))

Effective Date – Amounts deferred after December 31, 2004 plus, amounts deferred (plus earnings) prior to 2005 if the Plan under which deferral was made is materially modified after October 3, 2004, unless the amendment follows approved amendments allowed under IRS regulations under IRC § 409A(f).

Post 2004 "NQDCP World":

8. Existing Plans should be left alone – not amended. Regulations provide that a "material modification" does NOT include (1) exercise of a feature, (2) reduction or removal of a feature, (3) change in plan administrator. The Regs (§1.409A-6(a)(4)) provides that a "material modification" DOES include (1) addition of a new benefit, right, or feature (e.g., a haircut (penalty) provision), (elimination of a right is usually not a material modification) and (2) acceleration of vesting. The regulation would provide a limited period of time ending December 31, 2006 to allow executives to cancel previously irrevocable post 2004 deferral elections. The Regs state amending a "old" plan to allow an election to terminate participation in a plan is a material modification. The Regs allow termination of a Plan, or cessation of deferrals for all. The Regs state it is possible to amend a pre 10-4-04 plan to have a new set of rules for post 2004 deferrals, but why take a risk?

9. Consideration should have been given earlier in 2005 to adopting a new NQDCP for post 2004 deferrals. Executives would presumably want to defer under Plan II, rather than Plan I, assuming the restrictions of Plan II are acceptable to the Executive.

10. A mutual amendment by an executive and a company of a pre-October 4, 2004 NQDCP to accelerate income in a manner not allowed under new plan rules (assume done in 2006 while the Executive is still working) runs risk of subjecting the funds to the added 20% (because the pre 10-4-04 plan was materially amended). Some existing NQDCPs have built-in existing plan language to allow acceleration by Board of Directors' action, etc. Do not amend the pre 2005 Plan – or fail to follow its provisions – unless you are certain IRS guidance provides the 20% penalty does not apply.

11. A phantom stock plan, incentive compensation plans, and performance share plans, stock appreciation right plans, discounted stock option plans, supplement executive retirement plans, all would appear to fall under these new rules.

XVIII. Health Savings Accounts

IRC § 223 was added by late 2003 legislation to allow Health Savings Accounts. Archer Medical Savings Accounts are now obsolete for set-up post 2003.

IRS issued 88 Q & As in Notice 2004-50 to answer “everything you need to know” about HSAs.

HSA is a marriage of a High Deductible Health Plan (HDHP) and a Health Savings Account.

A discussion of all the ins and outs of HSAs is too lengthy for the program but here are some issues/comments relating to HSAs that relate to benefits:

1. HSA can be offered as an option under a Flexible Spending Account (IRC § 125) Q&A 58. Monthly rather than annual elections are allowed for HSAs under FSA arrangements (other FSA benefits must be elected annually unless there is a permissible “change in status”). An HSA can be added as a new benefit mid year (but this does not allow revoking other elections). Under Q&A 61 an FSA can provide for “negative elections” for HSAs. Once made, a contribution by an employer to an HSA is irrevocable (i.e. cannot get a refund if the employee quits before year end) – Q&A 82.

2. An HSA is not subject to the non-discrimination rules of IRC § 105(h). Q&A 83.

3. Deduction to HSA by self-employed individual does not reduce “net earnings from self-employment” (i.e. not deducted on Schedule C – or excluded for Schedule SE) Q&A 84.

4. C corporation's contribution to a shareholder who is not an employee is a dividend. Q&A 88.

5. May an employer fail to make comparable contributions to each employee under IRC § 4980G?

No! A 35% tax applies to HSA contributions of an offending employer, Q&A 46. IRC § 4980G applies rules of IRC § 4980E. 4980E requires coverage of all employees who are covered by a HDHP (part-time employees-under 30 hours per week-who are covered by an HDHP may get a prorated HSA contribution). Thus, a company may not implement a HDHP for all employees who work over 20 hours per week but fund the HSA only for executives. It could have a HDHP for executives and a low-deductible health plan for non-executives – and fund HSAs only for executives.

Note – Solution may be to not fund HSA at the employer level-raise salary by \$5,000 and let the executive deduct HSA contributions on Form 1040.

5. Do IRC § 4980G's comparability rules apply to HSA contributions made through a Cafeteria Plan? No! Q&A 47 and Notice 2004-2. Cafeteria Plan contributions then are subject to non-discrimination rules of IRC § 125.

6. An employer conditions contributions to an HSA on participation in wellness programs and health assessment programs. Is there an issue under IRC § 4980G. Yes! Q&A 48. If all eligible employees do not participate in HSA contributions because of "wellness program pre-conditions" the comparability test is not met. But Q&A 49 points out that placing the HSA under the Cafeteria Plan then eliminates the 4980G issue – and switches it to Section 125 rules.

7. Note – Q&As 50-54 contain added detailed rules relating to comparability of HSA benefit plans.

8. Q&A 54 highlights that after-tax contributions to an HSA paid through payroll deduction are not subject to 4980G.

9. Notice 2004-50 also indicates coverage under an employee assistance program, disease management program or wellness program does not make an individual ineligible to contribute to an HSA (as long as medical care or treatment benefits are "insignificant").

Revenue Ruling 2004-45 – IRC § 223 says individual who is covered by HDHP and a Health FSA (Flexible Savings Account) or HRA (Health Reimbursement Account) that pays or reimburses § 213(d) expenses is not eligible to contribute to an HSA. But 2004-45 allows contributions to an HSA even if the employee is participating in a "limited purpose FSA or HRA". "Limited purpose" is insurance for a specific disease, non-long term care insurance providing a fixed benefit per day, certain preventative care

benefits, and an FSA or HRA that does not reimburse participants until the HDHP deductible is reached.

- California Assembly Bill 115 (California tax conformity update) did not conform California to the federal Health Savings Account rules. Governor Schwarzenegger signed the Bill in October 2005.

IRS Releases 2006 HSA Limits

The HSA maximum contribution for individuals increases to 2,700 for 2006 from \$2,650 in 2005, while the maximum contribution for families increases to \$5,450 for 2006 from \$5,250. The catch up contribution for those aged 55 and over increases to \$700 from \$600 in 2005.

The maximum out-of-pocket for HSA HDHPs will be \$5,250 for individuals and \$10,500 for families in 2006. The minimum deductible for HSA HDHPs will increase to \$1,050 for individuals and \$2,100 for families.

XIX. Pension Funding Equity Act of 2004-Impact on 2005

A little known provision of the PFEA of 2004 increased the 5% minimum interest rate floor for GATT rates to 5.5% for calculating the present value of the maximum benefit payable from a Defined Benefit Plan. IRC § 415(b)(2)(E)(ii). Effective for Plan Years beginning in 2004 and 2005.

Impact - Reduces the maximum lump sum benefits payable from a Defined Benefit Plan by about 4% (depending on whether applicable GATT rate is under or over 5%) under calculations provided to me by Mike Milch of San Diego Actuarial Consultants.

Transitional Rule- Did not apply to distributions prior to January 1, 2005. As law applies only to 2005 Plan Year payouts (and distributions from 1-1-2005 until the beginning of a fiscal 2005 Plan Year), there is a concern about payout timing for those with maximum benefits desiring payouts in 2005. Assuming law expires after 2005, watch out for 2005 payouts - might be a trap for those with benefits at maximum levels who are expected to be paid in 2005. Waiting until 2006 can perhaps work if:

- (a) Law is not extended or
- (b) Plan assets do not grow at more than 5%.

Watch out for new lower lump sum limits if you have a lump sum distribution of a maximum 415 benefit scheduled for 2005 at a time when you anticipate Plan assets will grow at more than 5%. Increase in maximum annual benefit to \$175,000 helps counteract this.

XX. Expansions in Defined Benefit Concepts

General Testing—Actuaries can explain this in more detail, but a “general test” formula ventures outside of the Regulation established “safe harbors” – grouping non-highly compensated employees together in “rate groups” under methods that can, if properly done, reduce and help “level out” employee cost (for benefits other than the “top-heavy minimum”) where non-owner employees are in a range of ages and salaries. Few actuaries do this type of test, and be prepared for higher professional fees. Another concept possible is a “cash balance” formula (which is under legislative and Court attack recently-most advise “wait and see” for Cash Balance Plans these days).

Comment—Some law firms and other professional practices are considering the foregoing Defined Benefit Plan techniques to increase contributions over Defined Contribution limits for older partners. This is sophisticated, and expensive, planning. Employee costs must be kept in mind always. Risk of loss in investments is at the employer’s risk in a Defined Benefit Plan – and funding in advance and conservative investments (to prevent underfunding if loss in assets, or a partner leaves) is always to be kept in mind. Some, we have heard, are taking “cash balance” to a more aggressive level – using IRC §414(k) account methods to allow partners to switch their Defined Benefit account to an “earmarked account” at some artificial “early retirement age.” Proceed with caution and seek IRS rulings with these strategies!

Comment 2—A comparison of a general test Defined Benefit Plan to a traditional DB Plan formula in the form of a redacted letter to a client follows:

“The “general test” study definitely worked out great! It is the way to go! A general test plan is more costly to set up and administer due to complexity and the added work but well worth it for you. See below.

EMPLOYEE	1 Contribution Traditional DB formula	2 Contribution Special Tiered General Test
Owner	\$142,921	\$150,346
Secretary	7,400	1,658
Nurse	4,645	1,179
Nurse	1,347	396

These results are outstanding!

Example of “Carve Out” Approach

Company has employees as follows:

1. Owners of Company–Husband/Wife. Both work in business. He is 51; she is 43.
2. Desire Defined Benefit Plan contribution level (i.e. significantly more than \$40,000).
3. Company has 6 other employees who meet 2-year eligibility rule and are NHCES.

Steps:

1. We exclude Wife from Defined Benefit Plan.
2. Exclude (under a classification) 4 NHCES. 2 employees left are ages 30 and 26.

This meets 410(b) Test:

50% of HCEs covered

$50\% \times 70\% = 35\%$

$6 \times 35\% = 2$ (rounded up)

This flunks 401(a)(26) test:

$8 \times 40\% = 4$ (rounded up)

Thus, Plan needs to cover “3” NHCES.

Then we go into analysis of whether to use “Traditional” vs. “General Test.”

Options in Defined Benefit Planning

- Traditional – no “Carve Out”
- Traditional – “Carve Out”
- General Test – No “Carve Out”
- General Test / Carve Out Plan (the ULTIMATE in Plan design, we could say “the Cadillac in Plan design” too).

Combined with a 401(k) Plan deferral only option—possibly with a “safe harbor” to allow husband and wife to put in maximum deferrals (\$20,000 in 2006 for Husband and \$15,000 for Wife—it is not yet too late to do safe harbor for 2005 unless you use a non-calendar year Plan). Then your major concern is the 25% of compensation deduction

limit under IRC § 404 for combinations of DB/DC Plans (the only issue then is whether the “safe harbor” contributions can be deducted, as deferrals are not subject to the 25% limit).

Plus (to avert 401(a)(4) testing) Mom & Pop can have a separate Profit Sharing Plan with a “rate group” formula doing this:

	<u>Salary</u>	<u>Contribution*</u>
Mom	\$30,000	\$6,600 **
Pop	\$100,000	\$22,000 **
Son	\$16,000	Not eligible
Daughter	\$16,000	Not eligible
Employee #1 (young)	\$30,000	\$1,500
Employee #2 (young)	\$30,000	\$1,500

* assume 5% Gateway minimum for Non-HCEs (does not work if employees are not-on average-young enough)

** Can get even more than 25% in some scenarios.

Bottom Line: Total contribution for staff \$4,800

Total contribution for Owner family is: \$98,480 (\$30,000 of which is under a Roth 401(k) feature).

XXI. COBRA Update

- An employer did not establish a group health plan by reimbursing a single employee for health insurance costs – Cox v. Transit Group Transportation (U.S. District Court, S.D. Ohio No. C-1-03-679 9-29-05).
- A Michigan U.S. District Court ruled an oral notice sufficed for COBRA under the facts. “Joiner vs. Dreisenga & Associates W.D. Michigan, No. 1: 04-CV-437 8-29-05.” Do NOT rely on that!

XXII. Pension Legislation Stalled

Several bills are stalled in Congress (“Pension Security and Transparency Act of 2005”, and others) that would tighten funding of Defined Benefit Plans to attempt to lessen the effect on the PBGC of spectacular bankruptcies of companies whose Pension Plans meet IRC § 412 minimum funding rules yet still have significant underfunding.

XXIII. VEBA Deduction Limits (revisited)

Insurance sales people often need “sexy wrappers” to sell life insurance. One of the most aggressive over the past few years has been the Multi-Employer Welfare Plan

intended to qualify for the “more than 10 employer” exception from IRC § 419A’s strict deduction limits.

Typical Scenario: Insurance/benefit advisor indicates there is a fantastic deduction opportunity under a program that requires little or no employee coverage, but promises large deductions to the employer. Your money will go into your own life insurance policy, or account, and that policy or account is yours eventually, with the performance of that policy being yours. They explain there is some “window dressing” risk that your funds could be part of some overall “pool” of risks, but that “don’t worry”-your own policy is safe and secure-its “yours.”

Recent Developments Have Belied This!

1. IRS Final Regulations. On July 16, 2003, the IRS issued final regulations about this type of VEBA, generally following the proposed issued regulations issued in 2002. The final regs are effective with respect to contributions paid or incurred in taxable years of an employer beginning on or after July 11, 2002.

2. Insurance and Investment Risk: The policies are normally heavily loaded, and trustees and promoters of these VEBAs have been known to (a) charge high fees to the funds, (b) provide specious over inflated illustrations of future policy performance and (c) speculate with the trust funds.

3. IRS Deduction Risk: This is “audit lottery” stuff. The IRS has been disallowing deductions to VEBAs whenever they can identify an appropriate situation. Some insurance/benefit advisors play the “audit lottery game” but rarely tell the customer that is what they are doing. Do you want to practice accountancy that way? Doubt it! I have received calls from over 4 taxpayers since last year who have sought advice on how to deal with disallowance of deductions to a VEBA.

4. Sham Collectively Bargain/Welfare Plans: Internal Revenue Service Notice 2003-24 was intended to shut down tax shelters established through “sham” labor negotiations that take advantage of collectively bargained welfare benefit funds’ exception from certain deduction limits. Regulations interpreting those tax code sections require that benefits provided through the funds be the subject of such arms-length negotiations, and that the bargaining agreement evidence “good faith bargaining” between adverse parties, in order to qualify as a welfare benefit fund under a collective agreement.

5. Beware: Prospective buyers need to be aware that experience-rated 10-or-more-employer plans are listed tax shelter transactions (Notices 2000-15 and 2001-51) and that the IRS seems ready to pursue them vigorously.

XXIV. Section 79 Group Life Insurance Programs

Last year I pointed out the issues re Section 79 abuses.

Some insurance advisors were promoting the incredible scenario of large current corporate deductions for permanent coverage under a Group Life Program under IRC § 79. Recent final regulations effective August 29, 2005 are intended to deal with this topic. Let's look at that.

1. First \$50,000 of term coverage under a nondiscriminatory group life program is tax free.

2. Assume insurance is provided as permanent coverage. Some agents are claiming deductions of as high as \$40,000 - \$50,000 annually-with no tax costs to the employee from that-claiming they have a "specially designed policy" that qualifies for special treatment under Section 79. I have heard a scenario where employee contributes \$50,000, corporation pays \$50,000-and the employee gets no tax hit on the \$50,000 corporate tax deductible payment into a permanent policy owned by the employee.

Comment—The Regs specify a precise, if complicated, method to determine the amount of taxable benefit to the employee (see 29 CFR 1.79-1). Revenue Procedure 2005-25 provides rules to coordinate with the final regulations issued in August 2005 under § 1.179-1(d) to provide that the "fair market value" of a policy (as opposed to "cash surrender value") is used as part of the formula to determine the value of the permanent coverage provided to the employee. Thus, artificially depressed cash value policies with large accelerated premiums will no longer be available as a tax shelter under IRC §79 (arguably they were not before).

XXV. UNI-k Revisited

One of most striking and popular techniques originating out of EGTRRA is the "Uni-k". This is a "single person" – or "married couple" 401(k) Plan. Not useful prior to EGTRRA, the utility of this approach for 2005 is illustrated as follows:

1. Single Participant I:

\$100,000 salary (corporate employee)
\$ 25,000+ corporate profit in addition to salary

\$14,000 Deferral (\$4,000 more if 50+)
\$25,000 Contribution
\$29,000 Deduction (39% of salary)

2. Single Participant II:

\$30,000 salary (corporate employee for FICA savings)
\$14,000 Deferral (\$4,000 more if 50+)
\$ 7,500 Contribution
\$22,500 (75% of salary)

3. Married Participants:

1. \$100,000 Salary
\$ 39,000 Deduction (\$43,000 if 50+)

2. \$20,000 Salary

\$14,000* Deferral
\$ 5,000 Contribution
\$19,000

Total Deduction: \$48,000 (48.4% of salaries)

Many brokerage/financial firms have "Uni-K" products. Be careful that your clients set them up properly. Sending a customer a "do it yourself" package usually fails in implementation.

XXVI. Incentive Stock Options and Employee Stock Purchase Plan

Section 251 of the American Jobs Creation Act of 2004 excluded from FICA/Medicare/Unemployment Compensation taxes, and wage withholding, on the income attributable to the exercise of an ISO or ESPP option or, the disposition of the stock, effective for post 10-22-04 stock option exercises.

XXVII. USERRA Rights Notice

Employers must, beginning March 10, 2005, notify employees of the right to return to their jobs at the same pay, benefits, etc. If they leave for military service (Uniformed Services Employment and Reemployment Act. – as amended on December 10, 2004 by the Veterans Benefit Improvement Act).

The poster is available at <http://www.dol.gov/vets/programs/userra/poster.pdf>

XXVIII. Continuing Reminder About Small Plan Bonding/Accountant Audit Rules

U.S. Department of Labor Regulations §2520.140-46 (10-19-2000) - The "small plan" (under 100 participants) CPA audit exception is not automatic.

Prior Regs exempted all small plans from audit requirements. Regs, effective for Plan Years beginning after April 17, 2001, are not so generous. Exemption for small plans applies only if:

- (1) 95% of plan assets are "qualifying plan assets" - or
- (2) Any person handling non-qualified assets is bonded. The amount of the bond must equal the face value of non-qualifying assets."

"Qualifying Plan Assets" are:

1. Qualifying employer securities under ERISA §407(d)(5)
2. Loans to Participants that meet ERISA §408(b)(1) (adequately secured, bear interest)
3. Assets held by bank or similar institution
4. Assets held by insurance company
5. Assets held by registered broker dealer
6. Assets held by any organization authorized to act as an IRA custodian
7. Mutual funds
8. Investment and Annuity Contracts issued by an insurance company
9. Individual Directed Accounts held by a regulated financial institution.

Not QPAs (unless held in a bank trustee earmarked account) are limited partnerships, real estate, trust deeds, loans to nonparticipants, etc.

What is the problem? Bond should be in place the entire plan year to gain the exemption. All 2002 and after Plan Years are affected. We have found only one surety company willing to issue 100% bonds for a nominal fee (example \$400 or so for \$300,000 of coverage for 3 years) and the maximum bond limit is \$500,000. Bonds can - for an added fee - be retroactive to the beginning of the affected Plan Year.

Example—Profit Sharing Plan has \$3,000,000 and 20 participants. No bank trustee. Individual Earmarked Accounts have \$1,000,000 in real estate, limited partnerships and trust deeds. Plan year begins January 1, 2005. Plan must obtain at least a \$1,000,000 bond as of January 1, 2005, or secure a CPA audit for the plan year ending December 31, 2005. Source of bonds over \$500,000 is limited and expensive (we saw quotes for \$5.00 per \$1,000 of coverage).

Alternatives? If bond is unavailable or too costly - consider alternative of terminating plan (technically not available to get out of audit rule after effective date and prior to termination) and rolling offending "non-qualified assets" to single participant frozen Money Purchase Pension Plans, or perhaps an IRA (if you can find a suitable custodian and creditor protection is of less concern), or taking other appropriate (make sure you are in compliance with other qualification rules) action to sell or distribute Non-QPAs from the plan. Or arrange for a bank trustee.

XXIX. Local Strategy Debunked

One or more local attorneys promote the following strategy:

1. Client creates management or consulting firm (Company B)—apart from the operating company (Company A) with employees.
2. Company B is owned by an irrevocable trust, with the trustee and beneficiary of the trust a relative or friend of Company A owner—it really does not matter who the other owner is (i.e. a total stranger owing it does not improve the result—might make it worse).
3. Company A contracts with Company B for management marketing and/or consulting services and shifts money to Company B.
4. Company B employs Company B's owner and pays him/her salary. Company B establishes a Defined Benefit Plan. Company A employees not covered under Defined Benefit Plan.

Does it work? NO.

Local IRS audit branch is aware of this strategy and is actively seeking audit candidates. A treatise could be written on why it does not work but here are comments:

1. Substance over form. Irrevocable Trust exercises little or no control over Company B management—and derives little or no economic benefits. Company A's owner controls Company B—lock, stock and barrel! In short, the ownership is a sham.
2. Company B employee is a leased employee with respect to most, if not all, of his/her services for Company A. IRC § 414(n) aggregates “leased” employees with the recipient—and no ownership connection need be present. Also see *Kawesch* case in which a charge leveled by IRS against him was that payments to a separate marketing corporation were not fully justified as a deduction (i.e. the deduction of payments from A to B could be challenged).
3. Company B also is likely to be a “management corporation” under IRC § 414(m)(5). This again requires no ownership connection. Thus aggregation rule is intended to aggregate the “incorporated” (a corporation is not needed for the rule to apply) executive to be aggregated with the Company he/she manages or consults with—if the relationship is exclusive or over 50% of its activities (a bona fide management consultant need not fear § 414(m)(5)).
4. Company B's employee is also not likely to pass the “common law employee” tests—and be treated as employee's of Company A. See Rev. Proc. 2002-21 under which IRS rules “leased” employees are common law employees of the recipient entity.

Comment 1—This structure has been proposed to lawyers, MDs and accountants—who have been advised to shift most or all of practice income to a *non*-professional corporation—as “consulting” or “management” services. Really now, I am managing myself or consulting to myself? While simultaneously practicing? Professional regulators might be interested in these violations of professional entity rules.

Comment 2—The arrangements I have seen also have little or no structure—no visible management or consulting contracts—just a vague “funneling” of income on an “as needed,” “as wanted” basis. Certainly not conducive to a defense against IRS attack.

Comment 3—Promoters also claim to have an “IRS Determination Letter.” Do you know what an IRS letter means? A favorable letter on a Pension document refers solely to the document! The IRS is not (repeat NOT) made aware of, or ruling on, the Company A/Company B structure and the exclusion of Company A employees from Company B’s Qualified Plan (the Plan really is NOT qualified).

Comment 4—It is just a matter of time before IRS attacks this structure, possibly seeking sanctions against promoters too. BE CAREFUL! BE SMART! If it is too good to be true, then it is not true! Don’t you think if this is really worked, that everyone would be doing it? Would not we be reading about it in Forbes, the Wall Street Journal, Professional Seminars, etc.? Want to have clients under IRS investigation (possible tax fraud allegations) and face lawsuits for malpractice? If so, those of you doing this keep doing it. There are those of us who know its wrong and will continue to speak against it.

XXX. Abusive Roth IRA Transactions

Notice 2004-8 issued 12-31-03 attempts to shut down tax shelters involving value shifting relating to transactions linking entities owned by an individual and entities owned all or in part by his/her Roth IRA.