



Employee Benefits

Active Participant for IRA Deduction Purposes

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In This Issue

- Active Participant for IRA Deduction Purposes
- Pay for Unused Leave
- Changes in Cafeteria Plan Services: New Bells & Whistles for an Old Employee Benefit
- Remedial Amendment Period
- Alternatives to that Pesky 401(k) Discrimination Testing
- Pension Legislative Update

An individual is not eligible to deduct a traditional IRA contribution (or may be subject to a reduced deduction) if he or she is an “active participant” in a qualified plan, unless his adjusted gross income (AGI) is less than a specific dollar amount.

Under a defined contribution plan subject to IRC §412 such as a money purchase plan, target benefit plan, or a profit sharing plan with a fixed benefit formula, an individual is considered an active participant if they are eligible for the contribution in the calendar year even if the contribution hasn’t been made. Under a discretionary 401(k), 403(b) or profit sharing plan, SIMPLE-IRA or SEP, an individual is considered an active participant only if a contribution has been made or forfeiture allocated during the calendar year.

Under a defined benefit plan, an individual is an active participant if they satisfy the Plan’s eligibility requirements for participation even if they do not satisfy the requirements to accrue a benefit for the year.

Eligibility for a Roth IRA or an Education IRA is separately defined. The Roth IRA contribution is phased-out for single taxpayers whose modified adjusted gross income (modified AGI) is between \$95,000 and \$110,000, and for married taxpayers filing jointly whose modified AGI is between \$150,000 and \$160,000. For a married taxpayer filing separately, the phase-out occurs for modified AGI between \$0 and \$10,000.

The Roth IRA contribution is reduced by any contribution made for the same year to a traditional IRA. For 2006, the IRA limit is \$4,000 plus a \$1,000 catch-up contribution if the individual is age 50 by the end of the calendar year. The traditional IRA contribution is available for those who exceed the AGI requirements, but the deduction is only available if the individual is not an active participant in a qualified plan.

An individual is identified as an active participant to the IRS by checking “retirement plan” in box 13 of Form W-2. ▲

Employee Benefits is published by Employee Benefit Resources, LLP. The technical information it contains is necessarily brief. No final conclusions on these topics should be drawn without further review and consultation.

Pay for Unused Leave

Although state and federal labor laws do not require private sector employers to provide vacation and sick leave, most do. The eligibility requirements and rate of accrual for "paid leave" vary considerably. In addition, some employers are opting to bundle paid leave into a single category called "paid" or "personal time off" (PTO) in an effort to afford employees more flexibility with how they use their paid leave time.

What private sector employers need to keep in mind, is that according to a 1949 Montana Attorney General's Opinion, "vacation pay which has been earned and is due and owing must be considered in the same category as wages and is collectable in the same manner and under the same statutes as are wages," 23 Op. Att'y Gen. 151, 153 (1949). The Montana Supreme Court has reaffirmed this position on numerous occasions. As such, employers cannot administer earned vacation as "use or lose." When an employee terminates, they are entitled to be compensated for their earned vacation in the same manner as other "wages," in accordance with 39-3-204, Montana Code Annotated.

A recent Montana Supreme Court (Court) Decision, however, has shed new light on the concept of "payout" for unused, earned personal leave. In *McConkey v. Flathead Electric Cooperative*, the Court ruled that because the employer had a clearly stated agreement with McConkey to pay him upon termination for 95% of the dollar value of his unused "personal leave," they were not obligated to pay him for 100%. The Court held that an employer has the freedom to establish the "terms and conditions of employment and compensation," and an employee can opt whether or not to accept them. In this case, they also deemed that a 95% cash value for conversion of unused leave time to wages was reasonable.

The full ramifications of this decision are yet to be determined. Based on the 1949 Attorney General's

Opinion and subsequent Court rulings, if a company separates vacation leave from other types of leave, they are obligated to pay unused vacation at 100% upon termination. The Montana Department of Labor & Industry has declared that private sector employers are not required to pay out PTO. Based on the Court's recent ruling, however, combining leave into a single category, such as PTO, affords employers more flexibility in regard to termination payout. Should employers adopt a policy that converts unused PTO to a percentage less than 100%, they should do so with caution. Specifically, key elements employers should consider include:

- First and foremost, such a policy must be clearly written and provided to all employees – prospective and current. Ideally, current employees would sign a copy of the policy indicating they have read and understand it. This signed document would be placed in their personnel file. Newly hired employees would sign such a statement regarding all personnel policies, including those governing leave.
- What percentage is reasonable? One approach might be to assess the allocation of time between "sick and vacation" if PTO were not used, and set the percentage accordingly.

The reduction in the *McConkey* case was tied specifically to unused leave payout upon termination. Some employers afford or require a payout of unused PTO at year end, rather than allow it to be carried over into the next year. Any consideration of a reduced percentage in this regard should be approached with great caution. Employers should consider the impact on employee morale and the use of considerable leave time at year end if employees were going to forfeit a percentage of unused PTO. More importantly, however, absent a precedent set by the Courts, it might be more judicious to wait and see prior to changing paid leave policies. ▲

Changes in Cafeteria Plan Services: New Bells & Whistles for an Old Employee Benefit

A cafeteria plan or flex plan is one of the most cost effective employee benefits available to employers. The plan allows employees to cover dependent care and medical care costs using pretax dollars. Employees save state and federal income tax as well as social security taxes on the money withheld from their paycheck to pay these expenses. Employers save social security taxes on the same amounts. Frequently, the social security tax savings offset some, if not all, of the expenses incurred by the employer to provide the benefits.

Employee Benefit Resources, LLP (EBR) does more than just process claims; we provide state of the art service to support the employer and their employees. In addition to the tax-favored advantages, employers choosing EBR to administer their flex plan receive the following value-added services.

On-line Access

Participants may access their flex account information via our web site. This feature allows a review of processed claims, payments made on claims submitted, and account balances for the current plan year and prior plan year during the run-out period. Our web site also provides participants with access to claim forms and other education materials.

Grace Period

Last year the IRS relaxed the rules on the length of time employees had to use the money they redirect for medical or dependent care expenses. Historically, all expenses had to be incurred by the last day of the plan year. Now if the employer chooses to change the plan, an employee may have up to 2 1/2 months after the end of the plan year to incur expenses. Since medical expense flex accounts operate on a "use it or lose it" basis, the expanded period

for incurring expenses may help some employees prevent the loss of the amounts they have set aside.

Debit Cards

A new feature offered to employers who use EBR to administer their flex plans is the Benny™ Card, a debit card that allows employees to pay for the services at the "point of sale" with health flex account dollars. The Benny™ Card provides participants a cash flow advantage by not requiring a cash payment for the expense.

Direct Deposit

Instead of waiting for the check reimbursing a dependent care or medical care claim to arrive in the mail, employees can have the reimbursement deposited directly to their checking or savings account.

Claims Rollover for BlueCross BlueShield Insureds

Employers whose benefit package includes EBR flex plan administration and a BlueCross BlueShield of Montana group health insurance plan

may offer their employees the opportunity to use *Claims Rollover*. This feature allows automatic reimbursement from a health flexible spending account for expense amounts covered, but not fully reimbursed by the employer's BlueCross BlueShield health insurance (some limitations apply).

EBR provides consulting, plan design, employee education, and ongoing plan administration on a wide variety of employee benefit plans. If you are interested in exploring the benefits you can provide your employees through a cafeteria plan or any other tax-favored benefit plan, please contact an EBR consultant at 1-800-765-9429 or 406-449-5500. ▲

**A cafeteria plan
is one of the most
cost effective
employee benefits
available to
employers.**

Remedial Amendment Period

Employers who sponsor retirement plans are frequently frustrated by the number of times they have to pay for plan amendments to comply with changes in the laws or regulations. Many changes in the law provide extended periods from the date the law actually changes to the date the plan amendment is required. In the meantime, the plan must be operated in accordance with changes in the law. Submitting a plan to the IRS for a determination letter is the only way to assure that all of the plan language meets the requirements for the plan to remain qualified so that retirement assets will continue to grow tax deferred. If plans are submitted within a certain time frame called the Remedial Amendment Period, the plan sponsor has the opportunity to change the language so that it meets the IRS requirements without any penalties.

Revenue Procedure 2005-66, issued by the IRS in September 2005, implements a formal system of cyclical Remedial Amendment Periods (RAPs) for the IRS determination letter program. Under the program, there is a 5-year cycle for individually designed plans and a 6-year cycle for pre-approved plans. The yearly cycles are based on a twelve month period that begins February 1 and ends the following January 31.

In general, the cycle for individually designed plans is as follows:

Tax Identification Number of Employer Ends in	Last Day of Cycle	Last Day of Initial Cycle	Next Five-Year Cycle
1 or 6	A	January 31, 2007	January 31, 2012
2 or 7	B	January 31, 2008	January 31, 2013
3 or 8	C	January 31, 2009	January 31, 2014
4 or 9	D	January 31, 2010	January 31, 2015
5 or 0	E	January 31, 2011	January 31, 2016

And the cycle for pre-approved plans (prototypes and volume submitter documents) is:

Plan Type	Last Day of Initial Cycle	Last Day of Next Six-Year Cycle
Defined Contribution	January 31, 2011	January 31, 2017
Defined Benefit	January 31, 2013	January 31, 2019

There are special rules for determining the cycle for multiple employer plans and plans maintained by a controlled group; when there is a merger, spin-off, or change in entity that results in a new employer identification number; the type of plan the employer currently maintains; and the type of plan the employer intends to adopt.

Employers who apply for a determination letter prior to the twelve month period ending on the last day of their cycle will need to file again for a determination letter within the appropriate twelve month period to rely on the determination letter previously issued. Unless there is a specific concern regarding a provision of your plan, we do not recommend you submit off-cycle.

The IRS determination letters will take into account plan amendments adopted since the adoption of the plan or prior determination letter, including the requirements of the Economic Growth and Tax Relief Reconciliation Act of 2001 and other items that will be identified on the most recently issued IRS Cumulative List of Changes in Plan Qualification Requirements.

Employers need to adopt model amendments periodically to keep their plans in compliance with legislative changes during their filing cycles. These amendments will be similar to the mandatory rollover amendments you may have adopted between March 28, 2005 and December 31, 2005.

EBR will send you confirmation of your filing deadline in the first few months of your applicable cycle. If you have specific questions regarding your plan, contact your EBR representative. ▲

Alternatives to that Pesky 401(k) Discrimination Testing

One of the dilemmas for companies sponsoring 401(k) plans is deciding the best way to operate the plan to maximize contribution levels for employees who are able and willing to take advantage of the opportunity to make their own personal retirement contributions.

401(k) plans allow plan participants to save for retirement on a tax deferred basis as long as the plan passes certain nondiscrimination tests each year. The nondiscrimination tests compare the level of contributions made by highly compensated employees to those who are not highly compensated. A highly compensated employee for the 2006 calendar year is anyone who owns more than 5% of the company or who made more than \$95,000 in 2005. If the plan fails the nondiscrimination testing, highly compensated employees may get a taxable distribution as part of their retirement contributions plus earnings.

There are several ways a plan can deal with the nondiscrimination testing issues in advance. The first suggestion is to encourage more participation by employees who are not highly compensated, by making employer matching contributions or using automatic enrollment. Second, a company can also use the prior year nondiscrimination testing method to predict the maximum amount the highly compensated employees can contribute. As a third option, a company can add Safe Harbor contributions to the plan to eliminate the need for testing altogether.

Automatic Enrollment

Automatic enrollment is a 401(k) plan feature that allows the employer to begin withholding contributions as soon as the employee becomes eligible for the plan. The employer must notify employees that they will automatically be enrolled in the plan and allow them to opt out if they choose. Unless they opt out, newly eligible employees are enrolled in the plan and a specified default percentage of their pay (commonly 3%) is deducted from their paycheck, contributed to the plan, and invested in a default investment (usually a stable value fund). To opt out, the employee must submit a request to be excluded from participation in the 401(k) feature of the plan. Studies by the Profit Sharing/401(k) Council of America indicate automatic enrollment does increase participation in the plan.

Prior Year Testing

Prior year testing will not increase the contribution levels for highly compensated employees, but it will give them advance notice of the maximum amount they can contribute in any year to avoid subsequent distributions to

satisfy the testing requirements. The maximum contributions for the highly compensated employees are determined using the average contributions made by nonhighly compensated employees in the prior year. For example, the maximum percentage of compensation the highly compensated group of employees could contribute for 2006 would be based on the average contributions of the nonhighly compensated employees in 2005.

Safe Harbor Contributions

Safe Harbor 401(k) plans automatically meet nondiscrimination requirements by providing certain fully vested contributions to plan participants. The contributions can be in the form of matching contributions of 100% of the first 3% of pay an employee contributes, plus 50% of the next 2% of pay up to a maximum of 4% of pay for any participant who is contributing at least 5%. The other form of Safe Harbor contributions is a 3% contribution for all employees eligible to participate in the plan. The 3% contribution is made to each participant regardless of whether they make their own contributions. Safe Harbor contributions are fully vested and have the same distribution restrictions as 401(k) employee contributions.

Employers who sponsor Safe Harbor 401(k) plans must provide written notice of Safe Harbor provisions to all eligible employees at least 30 days (and no more than 90 days) before the beginning of each plan year.

Safe Harbor plans effectively eliminate the nondiscrimination testing for 401(k) plans and allow highly compensated employees to contribute the maximum dollar amount each year. For 2006, the maximum is \$15,000 for employees under 50, and \$20,000 for employees age 50 or older.

There is a cost to the company for the fully vested matching or 3% employer contributions. Many companies already make a regular matching or profit sharing contribution which can be used to meet Safe Harbor requirements by amending the plan to use Safe Harbor, fully vesting the contributions and providing timely notices.

The never-simple 401(k) has a variety of options for increasing the contribution levels for highly compensated employees. Contact an EBR 401(k) consultant to decide on an approach that gives you the most return on your retirement plan investment. ▲

Pension Legislative Update

Pension reform legislation is currently in conference and is expected to be enacted in the next few weeks. While the House version of pension reform makes the EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) retirement savings provisions permanent, the Senate version does not. These provisions, which expire at the end of 2010 or earlier unless Congress acts, are critical to the future retirement security of millions of Americans.

Some examples of the EGTRRA provisions that benefit plan sponsors as well as the plan participants are:

- Catch-up contributions targeting older workers.
- A Saver's Credit to encourage lower-income savings.
- Increased dollar limits on deferrals to 401(k) plans.
- Larger total annual contribution limits for individual participants.
- Increased deduction limits for employers.
- Earlier vesting for matching contributions.
- Enhanced portability for retirement benefits.

You can help make these important retirement benefit provisions permanent by contacting your Senators and Representative.

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Senator Conrad Burns
187 Dirksen Senate Office Bldg.
Washington, DC 20510
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Representative Dennis Rehberg
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