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# The Loomis Law Update

## Recent Employee Benefits Developments

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### New Roth 401(k) Plans Offer Valuable Option for Retirement Planning

On January 1, 2006, the Roth 401(k) became another option for employers to offer their employees to prepare for retirement.

In a traditional 401(k) plan, employees contribute money which is then deducted from their gross income in the year the contribution is made. When employees receive distributions from the 401(k), taxes are assessed on the distributed funds, as well as on the interest accrued during the time the funds were invested in the tax-advantaged 401(k) account.

A Roth 401(k) account reverses the timing of when an employee pays taxes. Instead of paying taxes when the account is distributed, the employee pays taxes on the amount contributed at the time of the contribution. Furthermore, when taking distributions from the Roth 401(k),

an employee pays no tax on any accrued interest at the time it is distributed.

Employers who want to offer a Roth 401(k) must still offer their employees a traditional 401(k) option. Contributions to a Roth 401(k) must be held in a separate account from an employee's traditional 401(k) monies and be accounted for separately.

Once a Roth 401(k) contribution is made, an employee cannot have it reclassified at a later date as a traditional 401(k) contribution, and vice versa. An employee may make contributions to both a traditional 401(k) account and to a Roth 401(k) account in the same year as long as both contributions do not exceed the maximum contribution limit (\$15,000 in 2006). For example, an employee could contribute

\$10,000 to a traditional 401(k) and \$5,000 to a Roth 401(k) this year.

A distribution from a Roth 401(k) will receive tax-preferred treatment as long as the distribution occurs after a five-year period of participation in the Roth 401(k) and one of the following three criteria are met: 1) the distribution is made on or after the date the employee attains age 59½, 2) the distribution is made after the employee's death, or 3) the distribution is made because the employee is disabled.

The value of a Roth 401(k) compared to a traditional 401(k) to an individual will depend on a variety of issues, such as the employee's current income tax rate, the employee's expected income tax rate during retirement, whether Congress will increase or decrease

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### Deferred Compensation Rules Revised by Section 409A

In response to recent corporate scandals involving nonqualified deferred compensation plans, Congress enacted a new section to the Internal Revenue Code: 409A. Section 409A and related regulations define what non-qualified deferred compensation is, how it may be paid out, and penalties for failure to comply with this new rule. Any plan that wanted to avoid section

409(a) had until December 31, 2005 to terminate. Existing plans that need to be altered to comply with 409A have until December 31, 2006, to make the necessary amendments.

Generally, nonqualified deferred compensation is compensation that the employee had a legally binding right to in a given year, but

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## IRS Extends Period During Which Cafeteria Plan Participants Can Use Funds

The Internal Revenue Service now allows for an extension of the period of time during which participants under a cafeteria plan may use the funds they contribute to the plan. The new rule allows for two-and-one-half more months to use those contributions.

In a cafeteria plan, participants do not include in their gross income amounts they contribute to the plan. Previously, participants were required to use all the money they contributed to the cafeteria plan during the year contributed, or

those monies would be forfeited. This was known as the “use-it-or-lose-it” rule.

The IRS now allows cafeteria plans to be amended so that participants have until two and one-half months after the end of the cafeteria plan’s year to spend the funds. As an example, if a participant elected a salary reduction of \$350 during the year for a health flexible savings account for a plan having a year ending on December 31, 2006, but had only \$300 in reimbursable medical expenses in 2006, under

the prior rules the participant would forfeit the remaining \$50. However, if a cafeteria plan allows for the extension of the use-it-or-lose-it period, the participant will have until March 15, 2007, to spend the remaining \$50 from her 2006 cafeteria plan deferrals.

The plan sponsor does not have to allow for this option in its cafeteria plan. However, for those interested in this option, please contact Catherine Jacobs regarding amending the plan to allow for the extension of the use-it-or-lose-it period.

## 409A: Stiff Penalties for Failure to Comply with Deferred Compensation Rules

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because the employer and employee agree to defer payment, the employee receives the money in later years (those years are frequently determined by when the employee leaves the employer). In order for the employee not to be taxed on the deferred compensation in the first year, the employee must not have any control or access to the amount of deferred compensation, and the deferred compensation must be subject to a substantial risk for the employee.

### Distribution Rules

Distributions of non-qualified deferred compensation under 409A may occur only on a predetermined fixed date or upon the occurrence of certain specified events, such as death or disability

of the employee, termination of the employment relationship, or a change in control of the ownership of the employer. One noteworthy exception to this rule is that an employee will not be treated as having deferred compensation if the plan requires that the employee receive all funds within two and one-half months after the end of the taxable year during which the employee had the right to receive the funds and there is no substantial risk of forfeiture.

An employee may agree to make a subsequent deferral of the compensation. For amounts which have been previously deferred, at least twelve months before that compensation is payable, the employee extends the deferral period for another

period of time lasting at least five years.

Section 409A prohibits the acceleration of distribution payments. Thus, if the plan calls for payments to be made over five years, the employer and employee cannot agree to make all payments over two years. There are certain limited circumstances when acceleration may be available such as due to a domestic relations order or termination of the nonqualified deferred compensation plan.

### Draconian Penalties

Failure to comply with section 409A has significant tax implications. The rules impose a tax on the employee for all improperly deferred compensation which should have been reported as income previously, plus a 20% tax

penalty, plus interest penalties for failing to include the deferred compensation in income in the year it no longer met the requirements of section 409A at the underpayment rate plus 1%.

It is important to remember that section 409A only applies to nonqualified plans. Thus, a qualified pension plan or a qualified profit-sharing plan is not subject to this section. Additionally, legitimate vacation leave, sick leave and disability pay plans are exempt.

All entities should review their plans to ensure that they are not subject to section 409A, or, if the plan is subject to section 409A, that it be amended before December 31, 2006. Please contact James Anderton with questions.

## 2006 Contributions/Benefits Limits

Type of Limitation	2006 Limit	2005 Limit
Elective Deferrals (401(k) and 403(b), excluding catch-up)	\$15,000	\$14,000
Catch-up Deferrals to 401(k) and 403(b)	\$5,000	\$4,000
Defined Benefit Plans	\$175,000	\$170,000
Defined Contribution Plans	\$44,000	\$42,000
Annual Compensation Limit	\$220,000	\$210,000
Highly Compensated Employee ("HCE")	\$100,000	\$95,000
Individual Retirement Accounts ("IRA"), for individual under age 50	\$4,000	\$4,000
Individual Retirement Accounts ("IRA"), for individual age 50 and above	\$5,000	\$4,500

## ROTH: An Option to Fund Retirement

*Continued from page 1*

taxes between now and the employee's death, and rates of return achieved by the funds contributed to the 401(k).

One definite advantage of a Roth 401(k) over a traditional 401(k) is that the Roth 401(k) can be rolled over to a Roth IRA, allowing the employee to avoid the mandatory distribution

rules that apply to a traditional 401(k) or traditional IRA. This means that an employee can leave money in the Roth IRA, allowing that amount to grow tax-free and eventually more money can be transferred

to heirs.

One issue the IRS cannot resolve is the permanency of the Roth 401(k) contributions. Currently, the provisions allowing for Roth 401(k) are scheduled to expire on December 31, 2010. Unless extended by congressional act, contributions to Roth 401(k) will only be allowed for the next five years.

Employers wanting to make a Roth 401(k) available to their employees will need to have their retirement plans amended to allow for this option. Contact Catherine Jacobs with any questions regarding Roth 401(k).

## HIPAA Security Rule Sets Standards for Personal Information Stored Electronically

By April 20, 2006, small health plans must comply with the HIPAA Security Rule, as it relates to the security of electronic individually identifiable health information ("E PHI"). HIPAA stands for the Health Insurance Portability and Accountability Act of 1996. A small health plan is a plan with annual receipts (either as claims against self-insured plans or premiums in insured plans) of \$5 million or less.

Individually identifiable health information is information created or received by a health care provider, health plan or employer and relates to a health condition (past, present, or future) of a person and such information that either identifies the individual or can be used to identify the person. E PHI is information stored in a hard drive, disk, CD or other device, or information

transmitted by electronic media.

The HIPAA Security Rule requires entities to assess potential risks, and then implement procedures to reduce those risks. The HIPAA Security Rule has two sets of implementation specifications: those that are required, and those that are "addressable." If an implementation specification is addressable, then the entity must determine if and when such specification is an appropriate safeguard given its circumstances.

Implementation specifications are comprised of three main categories: Administrative procedures, physical safeguards, and technical safeguards. Broadly speaking, administrative procedures are those used to control who is allowed access to E PHI, when and how internal reviews of the system are handled, and processes regarding han-

dling security breaches. Physical safeguards are generally meant to determine who is in physical control of the hardware which stores or transmits E PHI, how to backup E PHI data, and how to dispose of hardware which was used to store or transmit E PHI. Technical safeguards are those used to protect and monitor E PHI and those with access to E PHI, including passwords, PIN and other ways to gain access, recording who accesses E PHI, and ensuring the E PHI is not inappropriately altered.

Failure to comply with the HIPAA Security Rule can result in both civil and criminal penalties. If you are required to be in compliance with the Security Rule by the April 20 deadline, or are presently unsure whether you are in compliance with the Security Rule, please contact Michael Rhodes.



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