

New Proposed IRS Regulations on Cafeteria Plans



The IRS has issued new Regulations for Cafeteria plans that can cause the expected tax benefits for both the Employer and the Employee to **blow-up!**

The IRS has cleaned up some issues that, from a practical standpoint, the industry has used as a norm (i.e. we now have regulatory authority to process claims for health insurance premiums paid in the last month of a year for the first month of the next year). For the most part, this is all good news.

However, the IRS has added specific language that will cause the plan's benefits to become non-qualified (and, therefore, taxable to participants) if the plan's provisions are not strictly adhered to. An example of this would be allowing a group of employees to participate before the plan allows participation, or the plan is designed to discriminate in favor of the highly compensated employees.

There are also new tests that will have to be run on the Cafeteria Plans. The new "objective utilization test" is a percentage of the cumulative election of the highly compensated employees to their cumulative salaries - the resulting percentage cannot exceed the total of the non-highly compensated employees' percentage. The Premium Only Plans (that don't include HSA contributions) will be exempt from this test. The HSA contributions will throw the plan out of the "POP" arena.

One exception to the annual election is that HSA contributions will need to be allowed to be adjusted monthly, on a prospective basis. There is also a new provision that allows employees to elect, within 30 days of their hire date, and have their Plan participation date retro-active to their date of hire. Individual health insurance is an eligible expense under the Plan, however a specific needs to be elected. We can no longer put it in the Plan—whatever the employee's portion of the cost of the individual policy is the amount of the election.

Our 20th Anniversary Year !!



CAUTION HSA Tax Code Language Vetoed in Minnesota

At the present time, Minnesota HSA Tax Code language does not conform to the new federal HSA rules relating to maximum deductible contribution. The maximum 2007 HSA contribution amount (for MN state tax purposes) is at the 2006 level, which is not in line with the Federal 2007 maximum contribution levels.

There is nothing on Minnesota's individual income tax form that would account for excess funding in an HSA. Minnesota's individual income tax return begins the income tax calculation with Line 1, which asks for the individual's federal taxable income amount. The remaining lines apply principles of Minnesota tax law, none of which apply to the excess funding in an HSA. At the Federal level, the contributions to an HSA are included on the 1040 individual income tax return above the federal taxable income line.

There appears to be no penalty for excess contributions to an HSA under Minnesota state law, but that the excess amounts reported as other income on the federal tax return would be included in the total federal taxable income amount, and would then carry over into the calculation of Minnesota individual income tax.

REMINDER—Reimbursement Policies—

Prescription drugs used for cosmetic purposes are not allowed to be reimbursed through Cafeteria Plans. Regulations are requiring additional documentation for reimbursement of prescription drugs.

Retirement Plan Updates - FORM 8905 You probably have recently seen a Form 8905 from our office in regard to your Retirement Plan. This Form is a Certification that states that you plan to adopt a restated plan that complies with the new Regulations that have recently been put into place —Final 401(k) Regulations, EGTRRA, etc. There is a cycle, dependent upon the last digits of your Employer Identification Number, that determines what year you MUST update. Further information will follow concerning this amendment and restatement cycle. After this "initial amendment period" - plans must be updated every five years. Please contact our office if you have any questions.

Evaluating Your 401(k) Plan's Features

Studies show that a 401(k) plan's design can have a significant influence on both participation and contributions. One way you can evaluate the effectiveness of your plan design is to compare the plan's features to a benchmark, such as the Profit Sharing/401(k) Council of America's (PSCA) Annual Survey of Profit Sharing and 401(k) Plans. The most recent survey published reflects 2005 plan year experience.*

The first things an employer should consider are the plan's participation and participant deferral rates. The PSCA survey's average participation rate for all 401(k) plans is 77.7%. Participation is greatest in plans that offer both a fixed and discretionary match (89% average participation rate) and — not surprisingly — lowest in plans with no employer match (66.1%). The average deferral of lower paid participants, as the ADP tests define them, is 5.4% of pretax pay, while higher paid participants defer 6.9%.

Company 401(k) contributions average 2.8% of pay (5.8% in combination profit sharing/401(k) plans). The most common matching formula is a fixed match (31.9% of plans). Among plans with company matches, 19.1% offer a graded match based on the percentage of pay deferred. The most common fixed-match contribution (33.6%) is 50 cents per dollar of the first 6% of pay deferred. A dollar-for-dollar match of up to 4% of pay is the choice for 8.6% of plans, and 8.4% offer a 50-cents-per-dollar match of the first 4% deferred.

Should you find that your participation and participant deferral rates vary significantly from other similarly sized 401(k) plans, you may want to investigate why. A good place to start is by looking at the rates and plan features offered by similarly sized plans (see table below).

How Does Your 401(k) Plan Compare?

Plan Rates and Features Offered	Plan Size by Number of Participants			
	1-49	50-199	200-999	All Plans*
Average employee participation rate	84.6%	81.1%	76.6%	77.7%
Average pretax deferral for nondiscrimination testing				
Higher paid employees	7.3%	7.1%	6.8%	6.9%
Lower paid employees	6.1%	5.9%	5.2%	5.4%
Type of match (where offered)				
Fixed	76.9%	87.8%	84.5%	79.3%
Graded	22.2%	12.2%	14.4%	19.1%
Plans permitting catch-up contributions for participants age 50 and older	97.5%	98.5%	98.4%	98.0%
Plans matching catch-up contributions (when permitted)	38.7%	31.3%	29.6%	27.9%
Participants making catch-up contributions	39.7%	24.7%	15.3%	23.3%
Plans permitting loans	73.3%	71.6%	91.1%	85.2%
Plans allowing multiple loans	25.0%	40.8%	43.4%	45.8%

* Includes larger sized plans

We will be happy to discuss alternative plan designs. Call us for information on different designs.



New IRS LIMITS On Benefits and Compensation



	<u>2008</u>	<u>2007</u>	<u>2006</u>
Qualified Plan Compensation Limit	\$ 230,000	\$225,000	\$220,000
401(k) Plan/403(b) Plan Maximum Elective Deferral	\$ 15,500	\$ 15,500	\$ 15,000
SIMPLE Plan Maximum Elective Deferral	\$ 10,500	\$ 10,500	\$ 10,000
457 Plan Dollar Limitation	\$ 15,500	\$ 15,500	\$ 15,000
Catch-Up Contribution Limit 401(k)/403(b)/457 Simple	\$ 5,000	\$ 5,000	\$ 5,000
Highly Compensated Definition Compensation Test	\$ 2,500	\$ 2,500	\$ 2,500
Social Security Taxable Wage Base	\$105,000	\$100,000	\$100,000
Defined Contribution Annual Additions Limit			

REMINDER - 2008 Safe Harbor 401(k)s need to have notice to employees by December 1, 2007.

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