

RETIREMENT FUNDS AND CREDITOR PROTECTION **Bob Brant and Steve Kisling**



In April, 2005, the Bankruptcy Abuse and Consumer Protection Act of 2005 (the "Act") was enacted

to establish new rules, including those regarding retirement plans and creditor protection.

Prior to the Act, an individual's benefits under a qualified retirement plan such as a profit sharing or 401(k) plan were protected from creditors under federal law (ERISA). However, this federal protection did not extend to (1) a retirement plan which has no participants other than the business owner (and his or her spouse) or (2) IRAs. Rather, individuals having or maintaining these types of retirement arrangements had to rely upon other applicable state and federal law to determine whether these arrangements were exempt from the claims of creditors.

The following is a summary of the applicable provisions of the Act:

*Under the Act, the exemption from creditors under federal law (ERISA) is generally extended to IRAs and certain other retirement arrangements.*

1. The exemption from creditors continues to apply to qualified retirement plans and has been extended to include retirement plans under which the business owner (and his or her spouse) is the only participant. The exemption from creditors has also generally been extended to other retirement arrangements such as traditional IRAs, Roth IRAs, Section 457 plans and Section 403(b) plans.

2. There is a special rule for Roth and traditional IRAs which generally provides that only the first \$1,000,000 is exempt from creditors. However, this \$1,000,000 limitation does not apply to any IRA (or portion thereof) which is attributable to amounts rolled over from a qualified plan, 403(b) plan or 457 plan. (Because of the relatively small annual limit imposed on non-rollover IRA contributions since their inception in 1975, it is unlikely that an individual has accumulated more than \$1,000,000 in a non-rollover IRA at this time.) It is not clear whether amounts in excess of \$1,000,000 could be protected under applicable state law.

For instance, Ohio, Kentucky and Florida laws generally provide full creditor protection with respect to IRAs.

3. As a result of the distinction between non-rollover and rollover IRAs, it is advisable to separate non-rollover and rollover IRAs. If an IRA consists of both traditional contributions and rollover contributions, the individual will have to trace the source of the contributions in order to separate the rollover from the non-rollover portion of the IRA.
4. The Act is generally effective for bankruptcies filed on or after October 17, 2005.

CAFETERIA PLANS – CHANGE IN "USE OR LOSE" RULES **Steve Kisling**

The IRS has issued guidance which permits an employer to amend its cafeteria plan to allow a 2½ month grace period following the end of the plan year during which participants may incur expenses for reimbursement from their flexible spending account (medical and dependent care). Prior to this change, all such expenses had to be incurred by the end of the plan year and any unspent funds were forfeited.

Under the new rule, for example, if an employer with a

calendar year cafeteria plan amends the document for the December 31, 2005 plan year to adopt this grace period, all participants will be permitted to apply unused funds in their accounts as of December 31, 2005 to pay for medical and/or dependent care expenses incurred for the period January 1, 2006 through March 15, 2006.

Employers who want to adopt the 2½ month grace period for a plan year must amend their cafeteria plans before the end of such plan year.

**NEW RULES ON DEFERRED COMPENSATION ARRANGEMENTS** Steve Kisling and Bob Brant

**R**ecent Federal legislation makes significant changes to the rules concerning the design and taxation of nonqualified deferred compensation arrangements (“DCAs”). This article summarizes these changes.

**PLANS SUBJECT TO THE NEW RULES**

The new rules generally apply to any plan, agreement or arrangement that provides for the deferral of compensation of employees and independent contractors (e.g., outside directors). The new rules can even apply to a one person DCA such as deferred compensation provisions in an employment agreement. Notable exceptions are:

- A tax-qualified plan (such as a qualified profit sharing/401(k) plan).
- A bona fide vacation leave, sick leave, disability pay or death benefit plan.
- 457(b) plan of a tax-exempt or governmental employer.
- A plan that pays a bonus within 2½ months after the close of the year in which the bonus becomes vested.

**NEW DCA RULES***1. Employee Elections*

- a. **Elections to Defer.** If the DCA permits a participant to elect to defer compensation, the participant’s election generally must be made no later than the end of the tax year preceding the year in which the compensation is earned.
- b. **Elections as to the Time and Form of Distributions.** If the DCA allows the participant to elect the timing and form of distributions, such election must be made at the same time as the participant’s initial deferral election. There are restrictions on changing these elections.

*2. Distributions*

Distributions from a DCA may be made only in the following events:

- a. Separation from service (for key employees of public companies, distributions may not be made earlier than six months after separation from service or death, if earlier)
- b. Disability
- c. Death

- d. A specified time (or pursuant to a fixed schedule)
- e. A “change in control” of the employer
- f. Unforeseeable emergency

**EQUITY-BASED DEFERRED COMPENSATION**

The new rules will not apply to a stock option as long as the option cannot be exercised at less than the fair market value of the underlying stock on the date of the grant and does not permit the deferral of the gain on the exercise of the option. The new rules generally apply to stock appreciation rights.

**Tax Consequences of Failing to Comply with the New Rules**

If the DCA fails to comply with the new rules and amounts are required to be included in income of the participant, then in addition to the income tax imposed, the participant will be charged interest and is subject to a penalty equal to 20% of the amount required to be included in gross income.

**Reporting Requirements**

The new rules require that an individual’s Form W-2 or 1099 include the total amount of deferrals under a DCA in the year in which the amounts are deferred (even if the amount is not currently includable in income for that tax year).

**Effective Date**

Subject to certain transition rules, the new rules are effective for amounts deferred in taxable years beginning after December 31, 2004. An existing DCA must be amended to comply with the new rules by no later than December 31, 2005.

**WHAT TO DO NOW**

1. Identify all arrangements which could be subject to the new DCA rules.
2. Before making any changes to the design or operation of the DCA, make sure such changes comply with the new rules.
3. To the extent necessary, make sure your DCA is amended by no later than December 31, 2005.■

**ROTH 401(k) CONTRIBUTIONS** Bob Brant and Steve Kisling

**A** change in the pension laws is scheduled to take effect January 1, 2006 to permit (but not require) a 401(k) plan to provide participants an opportunity to designate all or a portion of their 401(k) contributions as Roth 401(k) contributions. A Roth 401(k) contribution is made on an after-tax basis unlike regular 401(k) contributions. However, in general, all distributions from a Roth 401(k) contribution account (including investment earnings) are tax-free.

This can be a huge tax benefit. All participants will be eligible to make Roth 401(k) contributions, if the Plan so permits and without regard to the participant’s level of income. Here are some of the issues to consider:

- A 401(k) plan will need to be amended if Roth 401(k) contributions are to be allowed.

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- There are a number of recordkeeping changes that will need to be made including separate accounting for Roth contributions.
- Roth 401(k) contributions will need to be explained to employees so they can make an informed decision whether to designate their elective deferrals as Roth or traditional 401(k) contributions.
- A Roth 401(k) contribution will almost always be more valuable tax-wise than the traditional pre-tax 401(k) contribution as long as (1) the participant can afford to make the same level of 401(k) contributions even though the contributions are on an after-tax basis and (2) tax rates for the participant remain the same or are higher when the participant receives distributions from the 401(k) plan.

- The Roth tax benefits become magnified the higher the rate of return on investments inside the Plan without taxes when compared to the rate of return earned on investments outside the Plan after taxes.
- The distribution of Roth 401(k) contributions is tax-free only if the distribution is made (1) after the end of the 5 year period beginning with the first year in which the participant makes a Roth 401(k) contribution and (2) on account of attaining age 59 1/2, death or disability. If these requirements are not met, the earnings in the Roth 401(k) account will be taxable upon distribution and may also be subject to a 10% penalty tax.
- Roth 401(k) accounts can be rolled over to Roth IRAs. If this is done prior to age 70 1/2, there are no minimum distributions required during the lifetimes of the participant and the participant's spouse which will also magnify the Roth tax benefits.

**IDENTITY THEFT – EMPLOYERS BEWARE** Cynthia Gibson



An employer's records are a gold mine for identity thieves. According to the Federal Trade Commission, nearly 10 million people fall victim to identity theft each year, costing consumers \$5 billion in out-of-pocket losses and businesses \$48 billion.

Prompted by mounting concerns about identity theft, a new law went into effect on June 1, 2005 imposing strict requirements for the disposal of certain employee records. When discarding information about its employees, an employer is required to "burn, pulverize or shred" paper and to "destroy or erase" electronic media. An employer is also required to implement and monitor policies and procedures relating to its disposal practices.

Moreover, simply hiring "Joe's Shredding and Erasing Service" is not enough. Before contracting out these disposal services, the employer must conduct proper due diligence to make sure that the service complies with the new law.

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Although most human resources personnel are sensitive to maintaining the confidentiality of information in the ordinary course, this new law creates a new potential landmine for employers. According to the U.S. Department of

Justice, to obtain employer information, identity thieves often bribe employees, hack into employer computers or simply sift through an employer's trash. Therefore, employers would be well advised to review their practices regarding employee data.

**NEW IRS CIRCULAR 230 REGULATIONS** Jody Brant



You may have noticed a new disclaimer at the end of e-mails or correspondence you receive from various professionals such as law firms and CPA firms which reads something like: "Any tax advice contained in this correspondence cannot be

relied upon to avoid IRS penalties." This disclaimer represents some firms' response to the revised Circular 230 Regulations recently implemented by the IRS. The revised Regulations govern the conduct of individuals and firms providing tax advice in certain instances.

but allow tax professionals to avoid compliance with those requirements by including the disclaimer regarding penalty protection in the correspondence. Some firms have chosen to include the disclaimer on all correspondence and e-mails.

*The revised Regulations impose more stringent requirements with respect to certain written tax advice by tax professionals but allow tax professionals to avoid compliance with those requirements by including the disclaimer regarding penalty protection in the correspondence.*

We have carefully reviewed the revised Circular 230 Regulations and have determined that including the disclaimer in all correspondence and e-mails would be confusing and unwarranted. The disclaimer is not required on correspondence that does not address tax issues and is not even necessary on many forms of written tax advice. However, you may see the disclaimer on some specific correspondence

The revised Regulations impose more stringent requirements with respect to certain written tax advice by tax professionals

you receive from us regarding certain tax issues.

We have been selected as legal counsel for Cincinnati USA Regional Chamber of Commerce. **Mark Jahnke** has been elected to the Chamber's Board of Directors and Executive Committee.

**Cynthia Gibson** was the recipient of the Woman of Distinction Award in 2005 from the Great Rivers Girl Scout Council in recognition of her contributions to the community. In July Cynthia was also identified as one of the Top 10 Women Attorneys by readers of *Women's Business Cincinnati*.

**Andy Berger** has been installed as President of Isaac M. Wise Temple, Cincinnati's largest Jewish congregation with over 1400 families. He previously served on its Executive committee and chaired its Strategic Planning Committee.

**Bob Pitcairn** and **Mark Jahnke** have been included in the distinguished publication *Chambers USA – America's Leading Lawyers for Business*. Bob was listed in Litigation and Mark in Mergers and Acquisitions.

**Jim McCarthy** has been named to the Potter Stewart Inn of Court executive board. The Inn of Court brings judges, lawyers, law professors and students together to learn, interact and enhance the professional and ethical quality of litigation practice in Cincinnati.

**Bill Russo** has been admitted to the Bar in both Florida and Kentucky.

Kare To Be Helpful (KARE) recently adopted Lighthouse New Beginnings, a community-based residential treatment program for adolescent victims of childhood abuse and domestic violence. KARE is currently filling tote bags containing personal care items and basic necessities for girls entering New Beginnings. Future plans for the next few months include gardening and general yard work at the New Beginnings home, as well as a holiday gift program. KARE is a volunteer committee of staff members who work on a number of philanthropic projects each year.

**Bob Brant** and **Steve Kisling** participated in a presentation at the June 2005 Cincinnati Employee Benefits Conference sponsored by the Cincinnati Bar Association, Internal Revenue Service and U.S. Department of Labor. Their topic was "Design of Retirement Plans for Smaller Employers"

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