

## CAFETERIA PLANS MAY NOW ADD GRACE PERIODS

Under the Rules relating to Section 125 Plans, participants make an election prior to the start of a Plan Year of the dollar amount of qualifying benefits that they will put into and be reimbursed for out of the 125 Plan.

According to the traditional rules for a 125 Plan, a participant forfeited any balance left in that account if eligible expenses were not incurred by the last day of the Plan Year. The dollar amounts that were forfeited went back into the Plan as a general asset. This rule was known as the “use it or lose it” rule.

Pursuant to an unexpected IRS Notice, the IRS has declared that the “use or lose it” rule was too harsh. As a result, their new ruling replaces it with the “spend it within 2 1/2 months later” grace rule. According to the IRS Notice 2005-42, the use it or lose it rule was required under Section 125 of the Internal Revenue Code so that the Cafeteria Plan did not permit deferred compensation. However, the IRS said that the use it or lose it rule created practical problems. Since other areas of the Internal Revenue Code permit mistakes to be remedied for short periods following the year in which the services that are being compensated were performed, the IRS concluded a similar rule should be applied to Section 125 Plans.

As a result, the IRS Ruling states that a Cafeteria Plan Document may be amended to provide for a grace period immediately following the end of each Plan Year. The grace period must apply to all participants

in the Cafeteria Plan.

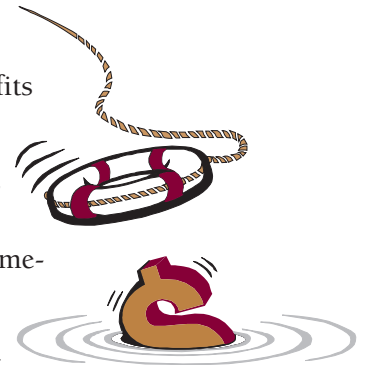
Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding Plan year.

The grace period must not extend beyond the 15th day of the third month (2 1/2 months) after the end of the immediately preceding Plan Year to which it relates.

If a Cafeteria Plan Document is amended to include a grace period, a participant who has unused contributions relating to a particular qualified benefit from the immediately preceding Plan Year and who incurs expenses for that same qualified benefit during the grace period may be paid or reimbursed for those expenses from the unused benefit contributions as if the expenses had been incurred in the immediately preceding Plan year. According to the IRS, the effect of the grace period is that a participant may have as long as 14 months and 15 days to spend the elected benefits before they are lost under the use it or lose it rule.

Not surprisingly, the Plan may still not permit any unused benefits to be cashed out or converted into any other taxable or nontaxable benefit during the grace period. In addition, the unused benefits for any particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to that particular qualified benefit in the 2 1/2 months following the end of the Plan Year.

For example, unused amounts to pay or reimburse medical expenses in a health flexible spending account may not be used to pay or reimburse dependent care expenses incurred during the grace period. As with current practice, Plans can still continue to provide a claims run-out period after the end of the grace period, during which the expenses for qualified



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## PLAN WINS STARE DOWN WITH UNHAPPY PARENTS

As joyful as a birth can be, not every employee knows or remembers that a bouncing baby has to be added to the Plan to participate as a dependent in a medical insurance Plan. This is particularly true when the medical benefits Plan requires that the participating parents advise them within a specific number of days after a child was born or adopted before the child will be covered by the Plan.

Giving cigars and banners to co-workers is not enough. Most Plans have a requirement that a participant give written notification to the Plan that a child is born or adopted within 30 days of the birth or adoption. Assuming that notice is given, the child is covered from the date of birth. If the notice is not given, most Plans with which we work have a provision which says that the child cannot be covered until the next open enrollment period. This usually is the start of the next Plan Year.

This becomes a particular problem when the participating employee has left the company that provided the insurance and forgets to give the notice of the new dependent to the former employer and its medical insurance Plan. If that happens, you can forget about receiving reimbursement from the insurance coverage for the birth expenses.

In the case of *Martin v. North Texas Health Care Network*, an attorney who was employed by a county was covered by a self-insured medical plan provided by the county. Martin left his employment after 4 years and elected to continue medical coverage under COBRA through December 2000. On October 1, 2000, Martin's wife gave birth to twins. Martin alleges that he called the insurance company and gave notice of the birth of his twins, but had no written or oral proof of giving this notice.

Unfortunately, Martin said that a representative of the insurance company told him that no additional documents were required to add the twins to the insurance. Under the terms of that Plan, Martin was required to provide written notification of the birth of his children within 31 days after the birth. Assuming that notice was filed, coverage begins on the date of birth. Otherwise, the children in the Plan cannot be added until the next annual enrollment period.

Martin never proved at trial that he filed the requisite notice with the insurer. As a result, the Plan denied the \$31,000 worth of medical bills that Martin eventually submitted to the insurer.



Martin sued his former employer on the grounds that denying coverage was:

1. A violation of his due process
2. A breach of his contract with his former employer
3. Violated a variety of tort claims – promissory estoppel, negligent misrepresentation, breach of good faith and fair dealing
4. A deceptive insurance practice

Martin lost on all claims. As sympathetic as Martin's situation was, the Court held that the medical Plan required that notice be given within 31 days after birth for the child in order to be covered from the date of birth. Having failed to prove that he gave that notice, Martin lost.

This simple if painful lesson is that any time a participant is adding a child or other dependent, the participant must read the Plan and follow the notice provisions if they expect medical claims for the child or dependent to be covered. If a participant fails to do that, you can expect to kiss that insurance reimbursement goodbye.

If you have any questions, contact Terry Cullen or Ruth Marcott of our Minneapolis Office.

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# IS THERE A REAL CHOICE IN CHOICE-OF-ENTITY? S CORPORATION VERSUS LLC

Despite the flexibility and versatility that limited liability companies (LLCs) offer, use of S corporations continues to grow. A recent study conducted by the IRS indicated that there were more than 3,000,000 S corporations operating in the United States, accounting for 59% of all corporate tax returns filed.

When it comes to choice-of-entity decisions, one may wonder whether there is any meaningful difference between an LLC and S corporation. In fact, there is. The purpose of this article is to highlight the major differences between these entities, and provide a framework for effective analysis of the choices involved.

## A. Taxable versus Tax Free Distributions

One major difference between an LLC and S corporation is the tax implications of distributing appreciated property to its owners. When appreciated property is distributed out of an S corporation, gain is recognized by the corporation, regardless of whether it is a liquidating or non-liquidating distribution. The gain passes through to its shareholders, who pay tax on that gain. The gain increases their basis in their stock, which ordinarily eliminates gain recognition at the shareholder level. If the value of the property distributed exceeds the shareholders' basis in their stock, however, the shareholders again pay a capital gain tax on the excess amount.

Distributions of appreciated property by an LLC generally trigger no gain recognition by the company or its members. Certain exceptions exist if the distribution consists of appreciated marketable securities, appreciated inventory or unrealized accounts receivables. No such exception exists for real property, however. Consequently, tax practitioners generally recommend using an LLC rather than an S corporation for holding real property investments.

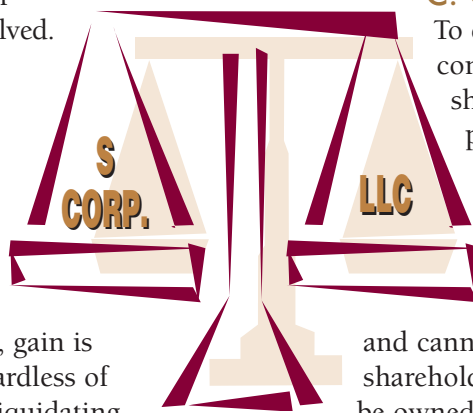
## B. Basis Calculation

Another major difference between the entities is how they treat debt when calculating the owners' bases in their partnership or S corporation interests. Basis is critical for both entities because it determines the

amount of tax-free distributions, and the losses that are passed through to the owners. For LLCs, all partnership debt is added to the partners' basis in their partnership interest (outside basis), which gives them greater ability to use their losses in the current year and also take more tax-free distributions. The only type of debt that is added to the basis of S corporation shareholders' interest is a direct loan by the shareholder to the corporation. Thus, S corporation shareholders are more susceptible to having suspended losses than LLC members.

## C. Other Differences

To qualify for tax free capital contributions, the contributing shareholders in an S corporation must possess at least 80% ownership of the S corporation, by vote and value, following the contribution. Furthermore, S corporations cannot be owned by other entities except certain eligible trusts and estates, and cannot have non-resident aliens as shareholders. LLCs, on the other hand, can be owned by any person or entity, and there is no 80% control requirement to qualify for a tax free capital contribution. Unlike S corporations, the flow-through nature of LLCs is not susceptible to inadvertent termination due to the transfer of ownership interest to an ineligible person or entity.



With respect to operations, LLCs can provide more flexibility in terms of how income, gains and losses are allocated among the partners while S corporation allocations are based strictly on the number of shares owned by each shareholder.

Unlike S corporations, LLCs can be subsidiaries, including subsidiaries of S corporations. In fact, LLCs provide more flexibility than even the Congressionally-sanctioned S corporation subsidiaries - Qualified Subchapter S Subsidiaries (QSSS). Although both wholly owned LLCs and QSSSs are disregarded entities, only the LLC retains its flow-through structure when there is more than

## BUSINESS SECTION ATTORNEYS

one owner. The QSSS is available only when the S corporation is its only owner. If there is more than one owner, the LLC converts into a partnership while the QSSS becomes a C corporation.

### D. Employment Tax

The one area where S corporations may have an advantage over LLCs is employment taxes. S corporation shareholders are subject to the self-employment tax on income derived from the entity to the extent that they are paid to them as wages. On the other hand, the distributive shares of the members of an LLC are subject to the self-employment tax, with the exception of certain items such as interest, dividends and rental income. Hence, S corporations provide an opportunity to reduce the self-employment tax burden. Note, however, that the IRS may assess additional self-employment tax in situations where a substantial portion of the S corporation's income is derived from personal services provided by its shareholders. This situation is still evolving and we will keep you updated in future newsletters.

### E. Conclusion

In light of the discussion above, the continued growth of S corporations is surprising. In most situations, the LLC is the optimal entity for conducting a closely held business. Of course, if the business is already conducted in a C corporation form, an S corporation election may be the only viable means of attaining pass-through taxation. In the end, the most important consideration is being aware of what each entity has to offer and selecting the entity that works best for the situation involved.

If you have any questions, contact Pomy Ketema of our St. Paul Office.

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## 2005 FELHABER SEMINARS

Please attend one of our upcoming seminars, with discussions on a variety of timely legal topics. The seminar presenters include our firm attorneys who have expertise in the seminar subject matter. Recent seminars we have hosted include the following topics: estate planning, business, real estate, and multi-employer benefits. Seminars include a complimentary continental breakfast and/or luncheon.



### SEMINAR SCHEDULE

<u>Topic</u>	<u>Date</u>	<u>Location</u>
Builder/Developer	Wednesday, October 26	Town & Country Club, St. Paul
Labor & Employment	Friday, November 4	Mall of America Marriott, Bloomington

If you are interested in receiving a seminar invitation, e-mail [kdyck@felhaber.com](mailto:kdyck@felhaber.com). State your name and address with the name of the seminar(s) you wish to attend. You may also log on to [www.felhaber.com](http://www.felhaber.com), to access online seminar registration approximately three weeks prior to the seminar date.



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## RICHARD J. SAVELKOUL JOINS THE FIRM

The law firm of Felhaber, Larson, Fenlon and Vogt, P.A. is pleased to announce that Richard J. Savelkoul has joined the firm's St. Paul office. Mr. Savelkoul practices in the areas of business law, energy law, real estate, and estate planning.

Mr. Savelkoul graduated with a B.A. from St. John's University in 1994. He received his J.D. from William Mitchell College of Law in 1999. Mr. Savelkoul also has a certified public accountant's license and practiced as a CPA from 1994-1998.



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benefits incurred during the Cafeteria Plan Year and the grace period may be submitted to be paid.

In order to take advantage of this change, your Cafeteria Plan will need to be amended to add the 2 1/2 month grace period during the following Plan Year to soak up benefits that the Plan participants would otherwise lose. In the event that the participant does not incur sufficient expenses in the grace period to cover all of the elected expenses, the use it or lose it rule still applies. Although the ruling does not specifically say so, it appears that this ruling will only be effective for the current Plan Year moving forward. Since most of the Cafeteria Plans with which we work are calendar year Plans, and the elections for the year 2005 have already been made, you should consider amending your Cafeteria Plan to add the 2 1/2 month catch-up period effective January 1, 2006 through March 15, 2006.

For questions contact either Terry Cullen & Tom Hughes of our Minneapolis Office.



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## Business Report

*The Business Report is an update on legal developments. It is not intended to be legal advice and should not be relied upon without consulting counsel.*

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