



The 3 Prongs of a Reasonable Rate of Interest

Under the Special Timing Rule, amounts deferred under a nonqualified deferred compensation plan are taken into account as FICA wages at the later of: (a) the date on which services are performed; or (b) the date on which the amount deferred vests. Generally, once an amount deferred has been taken into account as FICA wages, then neither the amount deferred nor the income on that amount is subject to FICA tax thereafter. For account balance plans, this exclusion assumes that interest credited under the plan reflects a “reasonable rate of interest”.

The IRS does not define a “reasonable rate of interest,” but rather sets forth guidelines for establishing a reasonable rate through the use of a three-prong test. Income credited under a plan that satisfies the test will be treated as reasonable for purposes of FICA tax. The three prongs of the test are as follows:

1. Predetermined Investment

A predetermined actual investment is generally the most acceptable benchmark for crediting earnings to an account balance plan. The rate of return on a predetermined actual investment is the rate that would apply if the account balance was actually invested in the investment(s) identified under the plan. The employer does not need to invest in anything and the investment does not need to be available to the general public, but the benchmark must be an actual investment or index that is subject to increase and decrease in value without limitation. Earnings based on the greater rate of return of two or more actual investments, or the greater of the rate of return on an actual investment and a rate of interest would not meet the definition of a predetermined actual investment because decreases in the value of the investment have been limited.

2. Permissible Fixed Rate

If an account balance plan provides for a fixed rate of interest, a plan must provide for the rate to be reset no later than the end of the fifth calendar year. Assuming the interest rate set at the beginning of the year is reasonable and the rate is not changed before the reset date, the rate will be treated as reasonable in all future periods before the reset date.

3. Other “Reasonable” Rate

If income is credited to an account balance plan on a basis other than the rate of return on a predetermined actual investment or a permissible fixed rate, then the employer must determine whether the income credited for the period is reasonable. Assuming income credited under the plan is reasonable at the time the amount deferred is taken into account and annually thereafter, the income will be treated as reasonable.

Unreasonable Rates

An account balance plan that disregards the three-prong test, or otherwise fails to assume a reasonable rate of interest as determined by the IRS, will be treated as a plan with an “unreasonable rate of return”. It is completely acceptable for an account balance plan to provide for an unreasonable rate of return; however, plans that do not adhere to IRS guidelines are subject to an “excess earnings” calculation.

If an employer chooses to provide for an “above market” or otherwise unreasonable rate of return, the employer must calculate the excess of the amount credited under the plan over the amount that would have been credited under the plan assuming a reasonable rate of interest. Excess earnings, if any, are taken into account as an additional deferral in the year the income is credited.

In the event the employer fails to calculate and recognize excess earnings or fails to take the full amount deferred into account, the employer will be required to calculate excess earnings using the midterm applicable federal rate (AFR) as a reasonable rate of interest. Earnings credited over and above earnings calculated under the midterm AFR as of January 1 of the calendar year will be classified as an additional deferral in the period the income was credited. Additionally, if AFR is used to determine excess earnings, both the excess and the income on excesses are taken into account as FICA wages under the General Timing Rule, which is at the time benefits are paid to the participant.

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Last Chance to Cash In on Federal Tax Breaks

Generous tax breaks signed into law by President George W. Bush are currently set to expire on December 31, 2010. As a result, many U.S. taxpayers will recognize an increase in their federal income tax starting next year.

To minimize future tax obligations, taxpayers should be aware of the various provisions that are set to expire and take advantage of what is available. Some of the more popular tax breaks among company owners, executives and highly compensated individuals are as follows:

- **Reduced capital gain rates for individuals.** The maximum long term capital gains rate is capped at 15%, instead of the usual 20%.
- **Reduced dividend rate for individuals.** Dividends are currently taxed at capital gains rates (15% max), instead of ordinary income tax rates.
- **Reduced individual income tax rates.** The 15% tax bracket is reduced to 10%; 28% bracket is reduced to 25%; 31% bracket is reduced to 28%; 36% bracket is reduced to 33%; and 36.9% bracket is reduced to 35%.
- **Increased dependent care credit.** The dollar limit for creditable expenses is increased from \$2,400 to \$3,000 (\$4,800 to \$6,000 for two or more children); applicable credit percentage is increased from 30%-35%; and the beginning point of the phase-out range is increased from \$10,000 to \$15,000.
- **Increased child credit.** The child credit is increased from \$500 to \$1,000 and includes expanded eligibility.
- **Increased standard deduction.** Standard deduction for married filers is changed to double that of unmarried filers.
- **Increased personal exemption.** The personal exemption phase-out for high income taxpayers is repealed.
- **Education IRAs** (Coverdell education savings accounts) Maximum contribution is increased from \$500 to \$2,000; definition of qualified education expenses is expanded; size of the phase-out range is increased to double that of unmarried filers.
- **Estate Tax Exemption.** The temporary repeal of the estate tax and generation-skipping transfer tax will end in 2010. The tax will reappear in 2011 with an estate tax exemption of \$1,000,000.
- **Reduced gift tax rate.** The maximum gift tax rate is reduced to 35%.
- **New making work pay tax credit.** This tax credit is available to married taxpayers earning less than \$190,000, (\$95,000 single). A credit of up to \$800 is set to expire at the end of 2010.
- **Mortgage insurance deduction.** Premiums for mortgage insurance are currently deductible as interest on a qualified residence.
- **Increased Section 179 deduction.** Dollar limitations for Section 179 expenses are increased to \$250,000/\$500,000 (indexed)

<u>INTERESTING TRENDS</u>	<u>Jan 2010</u>	<u>Feb 2010</u>	<u>Mar 2010</u>	<u>Apr 2010</u>	<u>May 2010</u>
Moody's Aa corporate bond (20 yr)	5.50%	5.51%	5.62%	5.39%	5.28%
Moody's Aaa corporate bond (20 yr)	5.26%	5.35%	5.27%	5.29%	4.96%
Citigroup Pension Discount Curve*	5.98%	6.00%	6.14%	5.92%	5.83%
20 year treasury	4.50%	4.48%	4.49%	4.53%	4.11%
10 year treasury	3.73%	3.69%	3.73%	3.85%	3.42%
Federal funds	0.11%	0.13%	0.16%	0.20%	0.20%

* Citigroup Pension Discount Curve is a discount rate benchmark commonly used by actuaries to measure pensions and other post-retirement obligations.

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