



# BENEFIT *Advisor*

## In This Issue

*In this first issue of the McGraw Wentworth Benefit Advisor for 2008, we discuss the changes in the proposed Section 125 regulations for non-discrimination tests. Section 125 plans enable employees to save tax dollars on certain health plan premiums as well as health and dependent care expenses. However, these plans cannot favor highly compensated or key employees. This Advisor discusses the non-discrimination requirements and the new regulations to help employers understand these complicated requirements.*

*We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGraw Wentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “Clarifications of Non-Discrimination Requirements for Section 125 Plans”

Section 125 cafeteria plans allow employees to pay for certain benefits with pre-tax dollars. Employers may also allow employees to set aside pre-tax dollars in flexible spending accounts governed by Section 125 to cover certain medical and dependent care expenses.

However, Section 125 does not allow plans to favor certain highly compensated employees and key employees.

If a plan does discriminate in favor of these employees, they will be assessed tax penalties under the plan.

In August, the IRS released new proposed Section 125 regulations. These new regulations provided clarifications and additional details on the Section 125 non-discrimination tests. This *Advisor* details the following key areas of Section 125 non-discrimination testing:

- Timing of Non-Discrimination Tests
- Defining Highly Compensated Employees
- Eligibility Test
- The Contributions and Benefits Test
- Key Employee Concentration Test
- Consequences of Having a Discriminatory Section 125 Plan

- Concluding Thoughts

A cafeteria plan must pass all three tests above to prove it does not discriminate.

### Timing of Non-Discrimination Tests

Initially, Section 125 did describe non-discriminating tests but gave no



guidance on when and how frequently non-discrimination tests needed to be performed. Now Section 125 regulations specify that non-discrimination tests must be performed as of the last day of the plan

year, taking into account all non-excludible employees (or former employees) who were employees on any day during the plan year.

Employers have welcomed this clarification. However, it does complicate the process:

- Employers really should perform the tests more than once a year. If an employer conducts the tests only on the last day of the plan year, highly compensated employees or key employees will not have time to make changes to avoid discriminatory tax

penalties. On the other hand, if your plan performs the tests as of the first quarter of the year, key employees or the highly compensated can modify their elections to avoid discrimination issues. Regardless, employers will need to conduct the tests again as of the last day of the plan year to meet the timing requirements.

- Employers typically performed tests on a snapshot basis. They conducted tests based on who was covered and eligible as of a certain date. This new clarification complicates the testing



process because the tests need to incorporate anyone covered during the plan year. Since the IRS has asked for comments on the proposed Section 125 regulations, vendors are requesting the regulation be amended to allow snapshot testing as of the last day of the plan year.

The new regulations also clarify the anti-abuse rules. The proposed rules require employers to make a reasonable effort to prevent discrimination in Section 125 plans. Also, a plan should not make repeated changes to the plan testing method or plan provisions solely to manipulate the results of the non-discrimination tests. This provision is not intended to discourage plans from allowing highly compensated or key employees to change elections to avoid discriminatory plan operation, but to dis-

courage employers from manipulating testing procedures or plan designs repeatedly to obtain passing non-discrimination test results.

### Defining Highly Compensated Employees

Different non-discrimination tests examine different groups of employees. The employees being examined are called the *prohibited* group.

For the Eligibility Tests and the Contribution and Benefits Tests, the prohibited group consists of highly compensated participants.

The new regulations define a highly compensated participant in much greater detail. A highly compensated participant is an individual who is:

- Eligible to participate in a cafeteria plan.
- An officer of the organization.
- A shareholder owning more than 5% of the voting power or value of all classes of stock of the employer.
- Considered a highly compensated participant.
- A spouse or dependent of any of the above.

The new regulations also explain in detail how to identify employees that should be considered in the highly compensated participant class.

### An Officer

One of the drawbacks of the initial Section 125 regulation was it did not define an officer of the company. The new regulations specifically define officers. Highly compensated individuals are considered to be officers if they meet the following criteria:

- In the preceding plan year (or the current plan year in the case of the first year of employment) the individual was an officer of the employer. There is no limit on the number of officers an organization can have.
- Certain facts and circumstances apply including:
  - The individual has been in regular and continuous service.
  - The individual has real authority, not merely a job title. For example, senior sales personnel assigned the title of Assistant Vice President when the position has no real administrative authority would not be considered officers under Section 125.
  - The individual is an officer of a sole proprietorship, partnership, association, trust or labor organization.

To conduct the non-discrimination tests, an organization must first identify its officers.

### More than 5% Shareholder

Again the proposed Section 125 regulations clarify who should be considered a "more than 5% shareholder" participant. This group includes anyone who in either the pre-

ceding plan year or the current plan year, owns more than 5% of the voting power or value of all classes of stock of the employer determined without attribution. Employees owning just 5% of stock are not included in this group.

**The Highly Compensated**

Initially, Section 125 did not formally define *highly compensated employee*. The proposed Section 125 rules now define highly compensated employees as follows:

- An individual or participant who for the *preceding* plan year (or current plan year in the case of the first year of employment) has compensation in excess of the compensation amount specified in Section 414 (q)(1)(B). That amount for 2008 is \$105,000. It was \$100,000 in 2007.
- The employer also has the option of using the “top-paid” group if it helps with the non-discrimination tests. For employers with a fairly high average compensation, this approach may make more sense. Identifying the top-paid 20% is a two step process. First, the employer must determine the number of employees in the top 20% of the workforce. Then the employer must determine which employees are in the 20% because of their compensation for the look-back year.



More specifics of the “top-paid” group include:

- Top 20% of employees ranked by compensation.
- IRS control group rules apply when determining the top 20% paid. The IRS does permit the employer to exclude certain employees including:
  - ✓ Employees who have not completed six months of service.
  - ✓ Employees who normally work less than 17.5 hours a week.
  - ✓ Employees who normally work less than 6 months during any year.
  - ✓ Employees who are under age 21.
  - ✓ Employees who are covered by a collective

bargaining agreement (this exclusion applies only if at least 90% of all employees are covered by a collective bargaining agreement and if the plan being tested covers only non-union employees).

Employers do have some flexibility. The limitations listed above are the outer limits. Employers may exclude employees with less than three months of service or employees who are under age 20. These modifications are allowed as long as they are consistent and uniform.

The initial regulations also did not define compensation. The new regulations formally define compensation as it is defined in Section 415 (c)(3). Compensation includes salary reductions under Section 125, salary reductions under a qualified transportation plan, elective deferrals under a Section 401(k) plan, any salary reductions under a simplified employee pension plan or a Section 408 SIMPLE plan, and any salary reductions for a 403 (b) plan or a Code 457 plan. These amounts need to be added back into compensation when determining the highly compensated.

**Spouse or Dependent**

A spouse or dependent of any of the following individuals should also be included in the Section 125 prohibited group:

- Any officer.
- A more than 5% shareholder.
- A highly compensated employee.

The Section 152 definition of *dependent* should be used to determine the dependents to be included in the prohibited group. This definition is the same definition that employers use for dependents eligible for tax-favored health benefits.

**Identifying the Highly Compensated Employees**

Although determining which employees should be placed in the highly compensated category for non-discrimination testing is fairly clear, determining which employees should be placed in the *prohibited* group is not that easy. To make that decision, take the following steps:

**Step 1:** Determine who the employer is and which employees should be counted. Use controlled group rules to determine which entities should be treated as one employer. List the employees that should be included in the testing.

**Step 2:** List the prior plan year's compensation for all the employees included in the testing.

**Step 3:** Identify highly paid employees. Using the 414(g) annual limit, determine which employees have been paid more than the highly compensated dollar threshold for the year being considered.

**Step 4:** Determine the number of employees in the top-paid group. Identifying the top-paid individuals after defining the highly compensated employee group should help determine which group an employer should use for non-discrimination testing. You can disregard the excluded employees defined in the previous section.

**Step 5:** Sort the employees in descending order by annual compensation. Include the employees that were excluded in Step 4 in this group (except for collectively bargained employees). Identify which employees are in the top 20%.

**Step 6:** Compare the top 20% group with the highly compensated group.

Identify which group will be more favorable from a testing standpoint (usually the group with fewer participants). If the 20% group is more favorable, you need to amend your plan to use that group in testing.



**Step 7:** Whichever group you choose (either the highly compensated or the top 20%) add back the more than 5% shareholders, officers, and spouses and dependents

of all included employees. These individuals only needed to be added if they do not appear in the highly compensated group.

The group of employees and dependents determined in Step 7 is considered prohibited and must be tested separately for non-discrimination purposes.

### Eligibility Test

Plans must meet the following three elements to pass the eligibility test:

1. **Employment Requirement:** No one can be required to work more than three years to participate, and the same requirements must apply to all employees.
2. **Entry Requirement:** Entry into the Section 125 plan is not delayed.

3. **Non-Discrimination Test:** Plan meets a non-discriminatory classification test when it determines who benefits from the plan.

These three requirements constitute the eligibility test. **If all your employees are eligible to participate in your cafeteria plan, employees all have the same new hire waiting period and it is less than three years, your plan automatically passes the eligibility test.** The tests are fairly complicated. The easiest way to pass the eligibility tests is to require the same waiting period (less than three years) for all employees.

If you cannot pass the test by virtue of plan design, your organization's plan needs to pass the following three tests:

#### 1. **Employment Requirement**

To pass this part of the eligibility test, a plan cannot impose a service requirement (new hire waiting period) of longer than three years. The regulation uses the terms *service requirement* and *employment requirement* interchangeably and unfortunately does not define either term.

This requirement also states the new hire waiting period must be the same for all employees. Employers cannot pass this requirement if they have a 120-day waiting period for one group of employees and then impose only a 60-day new hire waiting period for a different group of employees.

## NOTABLE THOUGHTS

**YOU LEARN MOST WHEN YOU PLAY AGAINST  
AN OPPONENT WHO CAN BEAT YOU.**

**RICHARD BACH**

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Cafeteria plans with different waiting periods for different classes of employees generally violate the employment requirement. However, the proposed regulations state employers can vary aspects of the employment requirements by setting up separate cafeteria plans for variable employment requirements.

**2. Entry Requirement**

The entry requirement defines when an individual is eligible for coverage under the plan. A plan must allow individuals that have satisfied the employment requirement to participate in the plan no later than the first day of the first plan year after they complete the service requirement.

For many plans this entry requirement will not be an issue because it is fairly standard to cover new hires as soon as they complete the waiting period or on the first of the month after they complete it.

**3. Non-Discriminatory Classification Requirement**

A plan meets the non-discriminatory classification requirement if:

- The plan benefits employees who qualify under a reasonable classification that is established by the employer.
- The group of employees included in the classification satisfies the *safe harbor percentage test* or

the *unsafe harbor percentage component of the facts and circumstances* test.

In order for a classification to be considered reasonable, it must be based on objective business criteria. For example, distinctions could be based on salaried or hourly status, full- or part-time status, or even based on geographic location. Meeting the reasonable classification requirement is subjective, which does allow room for interpretation. If the plan is going to offer different benefits or plan provisions to different employee groups, it is best to use



objective business criteria.

The second requirement, that the classification be considered non-discriminatory, is

much more difficult to determine. The plan can satisfy either an objective safe harbor percentage test or a subjective facts and circumstances test to demonstrate it is non-discriminatory. Most plans resort to the facts and circumstances test *only* if they are unable to pass the safe harbor test first.

**Safe Harbor Percentage Test**

The safe harbor percentage test examines the relationship between non-highly compensated individuals and highly compensated individuals to see whether both groups benefit from the plan.

The proposed regulations also allow certain employees to be excluded from the safe harbor percentage test. These employees include:

- Employees (except key employees) covered by a collectively bargained benefit plan.
- Employees who are non-resident aliens receiving no U.S. sourced earned income from the employer.
- Employees participating in a cafeteria plan under COBRA.

To conduct this test, follow these steps:

**Step 1: Determine the Plan's Ratio Percentage.** To determine this percentage, divide the percentage of non-highly compensated employees (non-HCEs) that benefit from the plan by the percentage of highly compensated employees (HCEs) that benefit from the plan.

The equation is as follows:

**Ratio Percentage =**

$$\frac{\text{Non-HCEs who benefit}}{\text{All non-excludible, non HCEs}} \div \frac{\text{HCEs who benefit}}{\text{All non-excludible HCEs}}$$

**Step 2: Determine the non-HCE concentration percentage:**

**Non-HCE Concentration Percentage =**

$$\frac{\text{Non-excludible non-HCEs}}{\text{Total non-excludible non-HCE and HCEs}}$$

Non-HCE Concentration %	Safe Harbor %	Unsafe Harbor %	Non-HCE Concentration %	Safe Harbor %	Unsafe Harbor %
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.24
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	29.00	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	25.25	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

**Step 3:** Using the Ratio Percentage and the non-HCE concentration percentage, employers can determine whether they meet the safe harbor requirement. The employer must use the Non-Discriminatory Classification Table published by the IRS (see table at top of page).

Compare the ratio percentage calculated in Step 1 with the Safe Harbor percentage that corresponds to your ratio percentage (listed on chart as non-HCE concentration):

1. If your plan's ratio percentage is equal to or greater than the corresponding safe harbor percentage, your plan is deemed to be non-discriminatory. For example, if your plan's ratio is 75%, the safe harbor percent is 38.75% and

your plan passes. If your plan passed the service requirement and entry requirement, your plan has passed the eligibility portion of the non-discrimination test.

2. If the plan ratio percentage is less than the safe harbor percentage, the plan does not meet the safe harbor. The plan can still, however, pass the eligibility test if:
  - The plan's ratio percentage is greater than or equal to the Unsafe Harbor Percentage (listed in the table above) **or**
  - The classification satisfies the Facts and Circumstances test discussed below.

The other requirements for the eligibility test must be met (the service requirement and entry requirement).

***Unsafe Harbor Percentage Component of the Facts and Circumstances Test***

The facts and circumstances test is subjective. Based on all the facts and circumstances, the classification must be found to be non-discriminatory. The IRS will consider several factors including:

- The underlying business reason for the classification.
- The percentage of employees benefiting under the plan.
- The number of employees benefiting from the plan across all salary ranges in the employer's workforce.
- The difference between the plan's ratio percentage and the safe harbor percentage. The smaller the difference, the more likely the plan will pass.

The new regulations list examples of possible permitted business reasons for differing benefits across classes of employees. Those differences include:

- Salaried and hourly differences.
- Full-time and part-time differences.
- Differences based on type of job, for example, factory workers and professional class differences.
- Geographic location differences—varying contributions and benefits in different areas of the country.

**Possible Discrimination Issues with Various Eligibility Tests**

Certain common plan provisions may violate the eligibility tests. If employers include any of the following plan designs in their cafeteria plans, they should consult an attorney to determine whether there may be non-discrimination issues:

- Different waiting periods for different classes of employees. The proposed regulations suggest employers should establish separate plans for the classes of employees offered different waiting periods.
- Different benefits to different classes of employees. For example, a credit-based flex plan where credits are different for various classes of employees may be a problem. If the credits or benefits are unequally distributed and favor highly compensated employees, the plan will likely fail the non-discrimination tests.

To avoid any potential discrimination issues, employers can offer all employees the same plan with the same benefit levels. However, if the organization has a legitimate business need to offer different benefit levels, the safe approach would be to establish separate plans. The separate plans will still need to pass the non-discrimination tests on their own merits, but the plan design will not create potential issues.

**The Contributions and Benefits Test**

This test determines whether contributions and benefits are non-discriminatory. It also determines whether highly compensated employees are allowed to choose more tax-free benefits than non-highly compensated employees can.

Plans should consider several issues in relation to the contribution and benefits test:

- Safe harbor for health benefits
- Availability standard
- Utilization standard
- Non-discriminatory requirement

**Safe Harbor for Health Benefits**

Section 125 offers a safe harbor to cafeteria plans that include health benefits. If your plan meets the safe harbor requirements, your plan is not considered discriminatory in contributions or benefits, and you can skip to the next section of this *Advisor*, the Key Employee Concentration Test.

The requirements of the safe harbor are:

- The plan must provide health benefits. Health benefits are not defined, but it appears they include comprehensive medical coverage, such as an HMO, PPO or POS plan and not just ancillary coverage such as dental, vision and health FSAs.
- The plan must meet the 100% or 75% test. Under this test,

the employer must pay 100% of the coverage cost for the plan most HCEs elect **OR** the employer pays an amount for each participant equal to or exceeding 75% of the cost of the most expensive health benefit plan option for similarly situated participants.

*Similarly situated* refers to geographic region or coverage election (single or family).

- If plan contributions or benefits exceed the amounts needed for the 100% or 75% standard, the excess contributions must bear a uniform relationship to compensation. The plan meets this requirement if it does not provide any excess contributions or benefits.

If a plan meets the three requirements for the safe harbor, it meets



the contribution and benefits non-discrimination requirements. If not, plans must pass the availability standard, the utilization standard and

the non-discriminatory requirement to pass the contribution and benefits test.

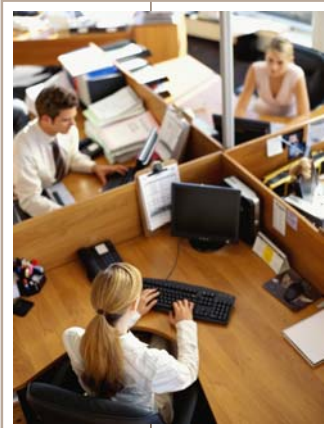
**Availability Standard**

The government also provided new guidelines on the benefit availability standard:

- A plan must give each similarly situated participant the same opportunity to elect benefits. This seems to mean the same qualified benefits must be

made available to similarly situated participants at the same price.

- A plan must also give similarly situated participants a uniform election with respect to employer contributions. This seems to mean that available contributions for all similarly situated participants must be the same and individuals must have the same opportunities to use them.
- These rules do not mean the employer has to offer everyone the exact same benefits and options; this standard applies only to similarly situated participants. The regulations point out plan benefits can be different for certified business reasons such as different for different geographic locations, employment status (full or part-time), coverage status (single or family coverage) and so on.



The key to passing the availability standard is to demonstrate your plan does not favor highly compensated employees. A plan can meet this standard if it can demonstrate one of the following:

1. *Employer* contributions are non-discriminatory.
2. Benefits are non-discriminatory.

The easiest way to meet the availability standard is to show all participants get the same employer contribution or at least all similarly situated employees get the same

employer contributions. Contributions can differ; for example, the employer can contribute different amounts for single coverage than for family coverage.

If a plan cannot show that employer contributions are non-discriminatory, the plan can still meet this standard by showing the benefits are non-discriminatory. For this standard, an employer needs to show tax-free benefits and total benefits are non-discriminatory. If plan participants can choose among the same benefits, this standard is satisfied.

Employers should consider the following issues to decide whether participants can indeed choose among the same benefits:

- Non-highly compensated individuals cannot be charged more than highly compensated individuals for the same benefits.
- Equal contributions are considered in determining whether participants are offered the same benefits.
- From a benefits perspective, this standard does allow employers to offer different levels of benefits in different regions. If the benefits are comparable, they will be considered the same. For example, when cost varies by region, the employer funding can also vary by region, if funding is represented as a percentage of cost.

### **Utilization Standard**

In order for a plan to be considered non-discriminatory, highly compensated employees must not disproportionately select tax-free benefits while other employees select taxable benefits. The utilization standard compares the percentage of highly compensated employees who select tax-free benefits with the percentage of other participants who do not.

The new regulations provide two new objective tests to determine whether benefit utilization is discriminatory:

- **Test #1:** The actual election of qualified benefits through the plan must not be disproportionate. This test measures the qualified benefits of the highly compensated relative to their income and compares the qualified benefits of non-highly compensated relative to their income.
- **Test #2:** Employer contributions for qualified benefits must not be disproportionate. This test measures the employer contribution as it relates to the income of highly compensated participants and compares it to the employer contributions of the non-highly compensated participants' election as it relates to their income.

Employers welcome the specific tests set forth in the new regulations; previously Section 125 offered no details on how plans could conduct a compensation and benefits test. However, there seems to be very little difference between Test 1 and Test 2. The regulations do not state whether passing one or

both tests is a requirement for meeting the utilization standard.

The new regulations also provide a safe harbor for premium only plans. These plans are set up to allow pre-tax contributions for qualified benefits but do not include flexible spending accounts. If your plan is able to meet the safe harbor percentage test for the year, the plan is considered non-discriminatory. An employer with a premium only plan that passes the safe harbor percentage test would not need to pass a contributions and benefits test. The regulations are silent on whether the employment and entry date requirements must be met.

#### ***Non-Discriminatory in Operation***

The plan must also not discriminate in operation. If your plan has met the other contribution and benefit standards, it is unlikely the plan will be considered discriminatory in operation.

The one area that can be an issue, however, is the maximum set for the health flexible spending account. For example, if you have a large number of low to moderately paid employees and offer a \$20,000 maximum on a health FSA, your organization could very well be considered to be discriminating in operation. It is likely only the highly compensated will elect amounts close to such a high maximum. If HCEs do elect close to the \$20,000 maximum, your plan will not pass the non-discrimination in operation standard.



As a general rule of thumb, keeping your health FSA maximum under \$5,000 should allow your plan to pass the non-discrimination in operation standard.

**Union employees are the only exception to the discrimination tests. A cafeteria plan is not discriminatory if it adheres to a collective bargaining agreement. Although Section 125 does not directly refer to this issue, it appears that union employees can be excluded from contribution and benefits tests.**

#### **Key Employee Concentration Test**

The final test is the Key Employee Concentration test. This test determines whether key employees' tax-free benefits are more than 25% higher than all employees' tax-free benefits.

This test involves looking at covered key employees. The prohibited group for this test includes only key employees. Key employees

are defined as:

- An officer paid more than the indexed threshold (for 2008 - \$150,000 a year).
- A more than 5% owner.
- A more than 1% owner paid more than \$150,000 a year.

Key employee status should be determined based on the plan year.

There are two exceptions to the key employee concentration. One is a plan that is part of a collective bargaining agreement. The other exception is the plan of a governmental entity.

On the surface, the key employee concentration test appears to be fairly simple. An employer would identify the key employees' tax-free benefits and compare them with all employees' benefits. Key employees tax-free benefits cannot be 25% higher than all employees tax-free benefits.

Benefits under a cafeteria plan include pre-tax contributions for health plan coverage and also any funds set aside in a health care reimbursement FSA or a dependent care reimbursement FSA.

If a cafeteria plan can pass all three non-discrimination tests (Eligibility Test, The Contributions and Benefits Test, Key Employee Concentration Test), the plan is considered non-discriminatory under Section 125.

#### **Consequences of Having a Discriminatory Section 125 Plan**

Certain plan participants will be affected if your plan fails any of the non-discrimination tests:

- If a cafeteria plan fails the eligibility test or the contributions and benefits tests, then each highly compensated participant will have imputed income equal to his or her salary reductions plus the greatest value of other taxable benefits that he or she could have received. It is not particularly clear what this

means, except the penalty may exceed the actual value of the highly compensated participants' salary reductions.

- If a cafeteria plan fails to pass the key employee concentration test, then each key employee will have imputed income equal to his or her salary reductions plus the greatest value of other taxable benefits that he or she could have received. It is not particularly clear what this means, except the penalty may exceed the actual value of key employees' salary reductions.



Even if a plan fails any of the non-discrimination tests, it does not affect the qualified status of a cafeteria plan or any non-highly compensated participants or non-key employee participants.

Only highly compensated and/or key employees are assessed a tax penalty if a plan is found to be discriminating.

### Concluding Thoughts

Even with new key clarifications, the Section 125 non-discrimination tests remain complicated. However, to protect the tax savings for your

highly compensated and key employees, your plan must not discriminate in their favor. Because these tests are complicated, it may not make

sense to perform them in-house. Many flexible spending account administrators will perform the non-discrimination tests for you. The vendor will charge a fee for conducting the tests, but typically these fees are very reasonable.

If you have any questions regarding the Section 125 non-discrimination requirements, please contact your McGraw Wentworth Account Director. **MW**

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