



Pension Legislation Approved; “Trifecta” Bill Fails in Senate

On August 17, 2006, President Bush signed into law the *Pension Protection Act of 2006 (H.R. 4)*. While the primary focus of the legislation was to shore up the federal pension insurance system, the legislation also contained the long awaited “COLI Best Practices” provisions.

During the same evening voting session that saw the approval of the pension legislation, the Senate defeated a three-pronged bill, *H.R. 5970, Estate Tax and Extension of Tax Relief Act of 2006* (referred to as the Trifecta bill) that would have extended a group of popular tax breaks; increased the minimum wage; and permanently slashed estate taxes.

The discussion that follows is an overview of the provisions of the *Pension Protection Act of 2006*, with a focus on those areas that might be of the most interest to the financial professional industry. It is not meant to be an all-inclusive discussion of the bill’s provisions.

Retirement Plan Provisions

The bill includes a number of significant tax incentives to enhance retirement savings for millions of Americans, including:

Permanent Retirement and Savings Incentives. The *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)* substantially increased pension and individual retirement arrangement (IRA) contribution limits through 2010. It also made improvements in pensions and retirement savings through enhanced vesting, portability and reduced regulatory burdens. This legislation makes the EGTRRA changes permanent and also allows for indexing of the income limits for traditional, spousal and Roth IRAs for inflation adjustment purposes.

Nonqualified Deferred Compensation Funding. The legislation imposes restrictions on the funding of nonqualified deferred compensation plans if a company’s defined benefit plan is underfunded or the company is in bankruptcy. Specifically, through the addition of a new subsection to IRC § 409A, assets set aside for certain key executives when the defined benefit plan is at risk would be immediately taxable to such executives subject to an additional 20% tax as well as interest at the underpayment rate plus 1 percent. This provision makes it clear that the new restrictions also apply to amounts set aside in a Rabbi trust during a period of restriction even if the assets remain available to general creditors.

These rules apply to executive officers of companies subject to Section 16(a) of the Securities Exchange Act of 1934 (including the top five officers subject to the \$1 million cap on compensation imposed by IRC § 162(m)).

The new restrictions on funding nonqualified deferred compensation arrangements apply to any amounts set aside or restricted after the date of enactment of the legislation.

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Cash Balance/Hybrid Provisions. The legislation includes prospective provisions addressing age discrimination under cash balance plans; imposes interest credit and vesting requirements on cash balance plans; describes how lump sum benefits are to be determined; and outlines requirements for converting to cash balance plans.

Benefit Restrictions on Underfunded Plans. Under existing law, the funding rules allow underfunded plans to make up their funding shortfalls over too long a period of time, putting workers at risk of having their plans terminate without adequate funding. In general, under the new law, if a plan has a funding shortfall, employers are required to make additional contributions to erase the shortfall over a seven-year period.

Saver's Credit Made Permanent. The legislation makes permanent the nonrefundable Saver's Credit available to eligible taxpayers who make salary deferral contributions to employer sponsored 401(k), 403(b), SIMPLE, SEP, governmental 457 plans, and/or make contributions to their traditional or Roth IRAs. Currently limited to a maximum of \$2,000, this provision indexes the credit to prevent this benefit from being eroded by inflation.

Direct Deposit of Tax Refunds into IRAs. The legislation contains a provision requiring the Internal Revenue Service (IRS) to establish procedures for depositing tax refunds directly into an IRA.

Automatic Enrollment. The legislation creates a safe harbor to encourage employers to offer automatic enrollment in employer-sponsored defined contribution pension plans to encourage employee participation.

Transfer of Excess Defined Benefit Fund Assets for Retiree Health. The legislation allows assets in excess of 120 percent of current liability to be used to fund retiree health benefits. Additional contributions to the defined benefit plan would be required if asset values fall below 120 percent of current liability. This provision applies to both single employer plans and collectively bargained plans.

COLI Best Practices Provisions

The legislation codifies "best practices" standards for so-called "employer-owned life insurance" as follows:

Employer-Owned Life Insurance Broadly Defined. It is important to know that employer-owned life insurance is broadly defined to include insurance contracts that are:

- ✓ Owned by a person engaged in a trade or business,
- ✓ Where that person (or a related person) is directly or indirectly a beneficiary, and
- ✓ The contract covers an employee of the trade or business of the policyholder on the date the contract is issued.

Under the attribution rules contained in the legislation, a related person could include: certain family members; shareholders and corporations; corporations that are members of a controlled group; trust grantors and fiduciaries; tax exempt organizations and persons that control such organizations; commonly controlled S corporations, C corporations, and partnerships; estates and beneficiaries;

commonly controlled partnerships; and partners and partnerships. Detailed rules apply to determine the specific relationships.

- **Notice and Consent Required Before Policy Issue.**

- ✓ Requires employers to provide written notification of the employer's intention to insure the employee's life and to specify the maximum face amount for which the employee will be insured;
- ✓ Requires the employer to obtain the written consent of the employee confirming that he/she is aware of the insurance coverage and that the coverage may continue after the employee terminates employment; and
- ✓ Requires the employer to inform the employee in writing that the employer will be the beneficiary of any death benefits paid.

- **Income-Tax-Free Death Benefits.** Where the notice and consent requirements are met, death benefits received by an employer will be excluded from its income if one of the following exceptions applies:

- ✓ **The insured qualifies as a director or is a highly compensated employee.** The term "highly compensated employee" is defined as a 5 percent owner of the business at any time during the preceding year; an employee who received compensation in excess of \$95,000 (adjusted in the future for inflation) in the preceding year; or an individual who was one of the five highest-paid officers or among the highest-paid 35 percent of all employees.
- ✓ **The insured qualifies as a recent employee.** A recent employee is defined as an insured that was an employee at any time during the 12-month period before his/her death.
- ✓ **Death benefits paid to the insured's heirs.** Death benefits will not be taxable to the extent they are paid to a member of the family of the insured; an individual who is the designated beneficiary of the insured under the contract (other than the employer); a trust established for any such person; or the estate of the insured. This exception also includes death benefits used to purchase an interest in the employer from any of the preceding persons.

- **Reporting and Record Maintenance Requirements.** Employers who have employer-owned contracts will be required to file a return with the Internal Revenue Service (IRS) for each year the contracts are owned showing:

- ✓ The number of employees at the end of the year;
- ✓ The number of employees insured under the contracts;
- ✓ The total amount of insurance in force under the contracts;
- ✓ The name, address, and taxpayer identification number of the employer as well as the employer's type of business; and
- ✓ That the employer has a valid consent from each insured employee.

The new rules will generally apply to contracts issued after the date of enactment. The new rules will not apply to a "like-to-like" 1035 exchange for a contract issued on or before the effective date of enactment, however, any material increase in the death benefit or material change will cause the contract to be treated as a new contract (except with respect to a master contract, where the addition of covered lives is treated as a new contract only with respect to the added lives).

Charitable Provisions

The legislation contains a package of charitable giving incentives and a charitable reform package. While the industry has been concerned about “IOLI” (investor-owned life insurance), it is important to note that this legislation does not contain any IOLI charitable reform provisions.

Two charitable giving incentives of interest to financial professionals and their clients are:

- **Tax-Free Distributions From IRAs for Charitable Purposes.** This provision provides an exclusion from gross income for certain distributions of up to \$100,000 from a traditional IRA or a Roth IRA where a charitable distribution is made to a tax-exempt organization to which deductible contributions can be made. This provision is effective for two years (through 2007).
- **Basis Adjustment to Stock of S Corporation Contributing Property.** This provision provides that the amount of a shareholder’s basis reduction in the stock of an S corporation, by reason of a charitable contribution made by the corporation, will be equal to the shareholder’s pro rata share of the adjusted basis of the contributed property. The provision is effective for two years (through 2007).

Charitable reform provisions financial professionals should take note of include the following:

- **Treasury Report Required on Certain Life Insurance Contracts.** Certain tax-exempt organizations must report to the Secretary certain acquisitions of interests in certain insurance contracts for two years beginning on the date of enactment of the bill. Penalties apply if the tax-exempt organization does not file this report.

This rule applies to any life, annuity, or endowment contract with respect to which both the tax-exempt organization and a person other than the tax-exempt organization directly or indirectly hold an interest in the contract – whether or not at the same time. Exceptions apply. One such exception is where each party with a direct or indirect interest in the contract has an insurable interest in the insured, independent of any interest of the tax-exempt organization in the contract.

The bill requires the Secretary to commence a study and report within thirty days after the date of the enactment of the bill to the Ways and Means Committee on whether the acquisition of such contracts is consistent with the tax-exempt purpose of these organizations.

- **Fines and Penalties Applicable to Charitable Organization.** This provision doubles the amount of excise taxes applicable to certain activities undertaken by charities, social welfare organizations, private foundations, and exempt organization managers.

Other Provisions

Long-Term Care & Annuity Products. This provision allows annuity earnings to be used to provide coverage against long-term care needs by allowing annuities to carry a long-term care rider.

Permanent Extension and Grant of Regulatory Authority with Respect to Section 529 Qualified Tuition Programs. The provision permanently extends the rules for Section 529 qualified tuition programs and provides for regulatory authority to prevent tax abuse.