

Advanced Planning

Flash Point

Pension Protection Act of 2006

On August 17th, 2006 the President signed into law the *Pension Protection Act of 2006 (PPA '06)* encompassing pension funding reform, new cash balance requirements, participant investment enhancements, retirement savings provisions and other important benefit plan law changes. While the main intention of this bill is to shore up the federal pension insurance system, there are a number of provisions that apply to IRAs, non-qualified deferred compensation and company owned life insurance. These are the provisions we will focus on.

The new law repealed the sunset provisions of existing law. That, in effect, makes the pension provisions of EGTRRA '01 permanent. The provisions that increased the contribution limit for IRA contributions, 401k contributions, etc. are now permanent. The catch-up contributions to IRAs and employee deferral plans for individuals age 50 plus are also now permanent.

Non-Qualified Deferred Compensation

New taxes are imposed under Internal Revenue Code Section 409, if a company's defined benefit plan is underfunded or the company is in bankruptcy and a non-qualified plan directly or indirectly sets aside amounts to provide benefits for highly compensated individuals. Those assets set aside would become immediately taxable to those individuals and are subject to an additional 20% tax and interest due from the date of initial deferral. If the company grosses-up payment to those individuals to offset the adverse tax impact, those payments would also be subject to immediate income taxation, plus the additional 20% tax and interest. This provision is intended to stop the diversion of funds to key employees to the detriment of others (think ENRON).

Charitable IRA Rollover in 2006 and 2007.

The Act provides that for 2006 and 2007 only, a person age 70½ or older can make charitable gifts of up to \$100,000 per year directly from an IRA. The donor will not have to report the IRA distributions as taxable income, nor will the donor be able to claim a charitable income tax deduction for the gift.

The new law makes no changes to the rules that cover charitable bequests. It only changes the rules for lifetime charitable gifts from IRAs. In order to qualify for this special treatment, the distribution must meet the definition of a "qualified charitable distribution" (QCD). There are six requirements to qualify:

1. Donor must be at least age 70½
2. IRAs only
3. Directly from IRA to the charity
4. Must be a public charity or a conduit private foundation
5. Payment would otherwise qualify for a tax deduction
6. Distribution would otherwise be a taxable distribution

Planning Opportunities for Charitable IRA Rollovers

In effect these are tax-free distributions which could be utilized by the charity to purchase life insurance on the donor's life. Eligible IRA owners can use charitable gifts from their IRAs to satisfy their annual minimum distribution requirements. Who will benefit most from this new provision? Donors who do not itemize deductions on their income tax returns now have the equivalent of an unlimited charitable income tax deduction. Also, donors who are subject to the 50% charitable deduction limitation will benefit.

Corporate-Owned Life Insurance (COLI)

New Internal Revenue Code Section 101(j) requires that when an employer receives death proceeds from any life insurance policy owned by the employer on an employee (for Buy/Sell, Key Person, and Non-Qualified Deferred Compensation), the new rule mandates that the money will be taxed as ordinary income – except to the extent of the premiums paid by the employer. There are exceptions to this income inclusion rule. Generally, contracts meeting



both notice and consent requirements and certain exception rules will be able to exclude the full amount of death benefits for income tax purposes. The exception rules are designed to ensure that the coverage does not include rank and file workers.

There are three elements to the notice and consent requirements:

Before the issuance of a COLI contract:

1. The employee must be notified in writing that the employer intends to insure employees life and the maximum amount of coverage.
2. The employee must provide the employer with written consent to being insured under the contract and that the employer may continue coverage after termination of employment.
3. Employee must be notified in writing that the employer will be a beneficiary of any death benefits and the maximum of insurance coverage at the time the contract is issued.

If all three notice and consent requirements are met, and if one or more of the following exceptions applies, the death proceeds will be income tax free.

- A) Recent employee – insured must have been an employee during the 12-month period before death
- B) Insured was a director or “highly compensated employee” (as defined by the Internal Revenue Code)
- C) The death benefit is paid to the insured’s heirs

The notice and consent requirement imposed by Section 101(j) is between the employer and the employee. The insurance carrier is not a party to the notice and consent requirement. As a convenience, Sun Life Financial’s third party administrator, The Pangburn Company, will provide a sample notice and consent form for plans it administers. Failure to obtain the required notice and consent will result in the income taxation of the policy death benefit.

Reporting and Record Maintenance Requirements

Employers are required to file a return with the IRS for each year the contracts are owned.

Section 101(j) generally applies to COLI contracts issued after August 17, 2006. The rules do not apply to a contract issued after that date pursuant to a Section 1035 Exchange. However, in many exchanges, the availability of the 1035 exception will be unclear, with the result that employers may want to follow the rules for all exchanges.

Because of the uncertainty surrounding the scope of the Section 1035 exception, (i.e. a material increase in death benefit would result in a new contract) employers contemplating a COLI policy exchange will want to consider the new notice and consent rules, and limit coverage to highly-compensated employees, as if the Section 1035 exchange exception did not exist.

Annuities and Long Term Care

Prior law permitted the tax free transfer of cash value from a life insurance contract to pay for qualified long term care (LTC) insurance provided under the contract or a rider to the contract. That rule is extended to annuities which previously could not have LTC riders. In addition, the Section 1035 rules for tax free exchanges are extended to stand-alone, long term care contracts and combination life/annuity and long term care contracts. These changes significantly enhance the ability to add a LTC benefit to an annuity contract, to use the contract values to pay for the benefit, and to exchange existing contracts for ones with LTC features. They are generally effective for contracts issued after 1996 but only with respect to taxable years beginning after December 31, 2009.

Other Miscellaneous Provisions Intended To Encourage Retirement Plan Participation Include:

Investment Advice – Certain investment advice provided by an advisor in employer-sponsored retirement plans is allowed. The goal is to minimize confusion and retain participants in the plan.

“**Safest Annuity Available**” standard for annuity investments by fiduciaries does not apply to annuities paid as distributions from defined contribution qualified plans. This makes it easier to use annuities to distribute benefits from retirement plans.

Rollover Provisions

- ▶ Allows the transfer of after-tax amounts in 403(b) annuity contracts to qualified plans.
- ▶ Allows certain direct rollovers from retirement plans to Roth IRAs without the 10% early withdrawal tax.
- ▶ Allows non-spouse beneficiaries to roll amounts inherited from qualified plans, 403(b) annuities and IRAs to another plan or IRA. This will delay current taxation on those amounts and will generate sales activity of rollover plans.

Withdrawal Provisions

- ▶ The 10% premature distribution tax for distributions from qualified retirement plans before age 59½ does not apply for individuals called to active duty for at least 179 days.
- ▶ The 10% premature distribution tax no longer applies to certain distributions of pension plans for public safety employers.

Sun Life Financial Advanced Planning

Janice Forgays, Esq., CLU, ext. 1846

Jerry Weihs, JD, MBA, CPA, CLU, ChFC, ext. 1756

Warren Yanoff, Esq., ext. 1969

This publication is not intended as legal, accounting or tax advice. The reader should consult their own attorney and/or tax advisor for advice regarding application of concepts to their particular situation.

©2006 Sun Life Assurance Company of Canada. In New York, ©2006 Sun Life Insurance and Annuity Company of New York. All rights reserved. Both are members of the Sun Life Financial group of companies. Sun Life Financial and the globe symbol are registered trademarks of Sun Life Assurance Company of Canada.

All guarantees are based on the claims-paying ability of Sun Life Assurance Company of Canada and Sun Life Insurance and Annuity Company of New York.

Not FDIC/NCUA insured. May lose value. No bank/credit union guarantee. Not a deposit. Not insured by any federal government entity.