



Advanced Planning Strategies

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Dear Reader,

The recent election will probably result in significant changes to tax policy. Although President Bush has been successful in achieving broad tax cuts, there were many items on his annual budget proposals that did not receive serious consideration. Notably, we have reported in the past about proposed Lifetime Savings Accounts and other saving vehicles that would encourage individuals to save in mechanisms that would have tax advantages similar to Roth IRAs. Individual savings accounts for Social Security contributions will also be proposed. In the past, such proposals were severely limited by both the allowable size of the accounts and the eligibility requirements to create the accounts. Expect a political struggle over any attempt to create private alternatives in Social Security.

The first item on the agenda will most likely be the “sunset” provisions of the tax cuts from 2001 and 2003. Most of the tax relief provided by these statutes will end by 2011 or earlier. The sunset was required by procedural budgetary constraints. The long-run status of the “PAY-GO” provision for tax reductions will soon become a hotly debated item. Again, this provision requires that any tax cuts must be coupled with federal spending decreases to be enacted. The President may have enough votes in the Senate to make the tax reductions permanent without requiring fiscal offsets. This could be applied to the entire package of the tax cuts or could be selectively used to permanently enact specific tax provisions.

A major overhaul of the Internal Revenue Code will be proposed. The complexity of the Code and tax compliance always generates interesting debate, but never seems to be resolved. The recent tax legislation added over 30 new code sections and increased compliance burdens in many areas. A concise explanation of the new requirements for nonqualified deferred-compensation agreements is the topic of the inside report.

Knowledge is not power. Only knowledge in use is power.

THE AMERICAN JOBS CREATION ACT OF 2004 NEW DEFERRED-COMPENSATION PROVISIONS

The American Jobs Creation Act of 2004, signed by the President on October 22, 2004, includes new rules for nonqualified deferred-compensation plans. These rules seem to be aimed mainly at preventing Enron-type corporate abuses (where executives, wary of future financial problems, take money prematurely from corporate plans), but they apply to all nonqualified deferred-compensation plans. The good news is that nonqualified plans remain an advantageous retirement-planning mechanism, but planning and design will become more formal to meet the new requirements.

DISTRIBUTION RULES FOR NONQUALIFIED DEFERRED-COMPENSATION PLANS

The new law limits distributions from nonqualified deferred-compensation plans. Distributions may be made only after

- *separation from service.* A distribution to a key employee of a publicly traded company cannot begin until at least 6 months after separation.
- *disability.* Disability is either the strict Social Security definition of total and permanent disability, or disability under the company's accident and health plan.
- *death of the employee*
- *a time specified under the plan.* An event, such as the employee's son's graduation from high school, is not considered payment at a specified time.
- *a change in ownership or control*
- *unforeseeable emergency.* Examples are (1) a severe financial hardship to the participant resulting from an illness or accident of the participant, spouse, or dependent, (2) loss of the participant's property due to casualty, and (3) other similar extraordinary and unforeseeable circumstances beyond the participant's control. The amount cannot exceed the amount necessary for the emergency plus taxes on the distribution.

The new rules will end the common practice of using "haircut" provisions. These provisions allowed employees to withdraw amounts at any time with a small penalty (such as 6 percent) subtracted from the amount withdrawn. This was an important security feature. A haircut provision enabled the employee to get money from the plan if the employee felt that financial or other conditions within the company might threaten the deferred-compensation benefit.

Acceleration of the time or schedule of any payment under the plan is generally prohibited. However, an accelerated distribution could be permitted if it is not elective and is beyond the employee's control, such as a distribution to comply with a court-ordered divorce settlement.

EMPLOYEES' ELECTIONS TO DEFER

The new law adds rules similar to the familiar rules for 401(k) plans:

- An election to defer compensation for a particular year must be made not later than the close of the preceding taxable year.

- For the first year of eligibility, the election may be made within 30 days after eligibility.
- For performance-based compensation, the election may be made no later than 6 months before the end of the period.
- An election to *delay* payment of an existing lump sum or stream of payments must generally be made at least 12 months before it is effective.

LIMITATIONS ON EMPLOYEE'S SECURITY OF PAYMENT

A nonqualified plan is effective only if it is “unfunded,” that is, based only on the corporation’s unsecured promise to pay the benefits involved. The employer can set assets aside as an asset reserve and can place these assets within a “rabbi trust” that limits the employer’s access to the assets, without the plan’s being considered funded, as long as the assets are subject to the employer’s creditors. The new law does not change this, but it penalizes two of the more aggressive methods to improve security of asset reserves in nonqualified deferred-compensation plans:

- offshore asset reserves. If assets set aside are located or transferred outside of the United States (except for a non-U.S. employee), the value of the assets, and subsequent income earned by the assets, will be treated as current compensation income to the employee.
- trigger provisions. Asset restrictions or payouts that take place upon a change in the employer’s financial health are similarly penalized.

COVERAGE AND EFFECTIVE DATE

The new rules cover most nonqualified deferred-compensation plans, even those for a single executive. Qualified plans are not affected, and there are other exemptions such as vacation and sick leave. Stock-option plans (without deferral features) are also exempted. Amounts of deferred compensation must now be reported on Form W-2 or 1099.

If a plan fails to include any of the new restrictions, amounts deferred for all taxable years are included in compensation along with interest at the underpayment rate plus 1 percent and a 20 percent penalty. These sanctions apply only to employees affected by the violations, not to the whole plan.

Generally, the new law is effective for amounts deferred in taxable years beginning after 2004. Amounts deferred before 2005 are generally governed by prior law, unless the plan under which the deferral is made was materially modified after October 3, 2004. Regulations clarifying the new law, including transition relief, are expected shortly from the Treasury.

RECENT CASES AND RULINGS

ESTATE TAX DEDUCTION DISALLOWED FOR INCOME TAXES PAID FOR IRA DISTRIBUTION

The decedent's estate included an account balance in an IRA, and the estate incurred an estate tax. The estate had a liquidity shortfall after the payment of its debts and expenses and could not pay the estate taxes without taking a distribution from the IRA. The IRA distribution was subject to ordinary income taxes, with an allowable deduction under IRC Sec. 691(c) for the estate taxes paid attributable to the inclusion of the IRA in the gross estate. The 691(c) deduction was less than the income taxes caused by the IRA distribution, and the executor took the position that the excess income taxes should be allowable as an estate tax deduction either as (1) a claim against the estate or (2) an administrative expense for selling the property to pay the estate tax.

The IRS denied the deduction and cited regulations (Treas. Reg. Sec. 20.2053-6) stating that income taxes are deductible on the estate tax return as an administrative expense only if the income was includible on the decedent's income tax return for a period prior to death. Because the IRA distribution and the resulting income taxes occurred after the decedent's death, no part of the income taxes were deductible on the estate tax return. In other rulings, the IRS has also denied a discount to the value of an IRA on the estate tax return for the built-in income taxes. It is important to plan for the liquidity of an estate in all events and particularly to prevent the forced taxable distribution from an IRA or other tax-deferred retirement vehicle.

DONOR'S RETAINED CONTROL OVER INVESTMENT IN AMOUNTS CONTRIBUTED TO CHARITY DOES NOT CAUSE LOSS OF CHARITABLE TAX DEDUCTION

The case involves two donations to a qualified charity. Cash and marketable securities were contributed from an individual donor and a limited liability company to a tax-exempt college. As part of the agreement with the charity, the donations are placed in a brokerage account owned by the charity, and the donors or their investment manager are given the power to manage the investments under a limited power of attorney. The agreement prevents the donors from engaging in self-dealing and restricts the investments to a specified list of allowable categories of investment securities. The donors cannot invest in their own businesses and the investment control terminates in 10 years. In addition, the charity can terminate the agreement and withdraw the funds at its discretion for any reason, including a severe loss.

The IRS held that these retained investment powers did not create a nondeductible partial-interest donation and allowed the donors to take income and gift tax charitable deductions for the donation. (Ltr.200445023)

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

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for the future*



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