



# Advanced Planning Strategies

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Dear Reader,

Last month the President signed into law the third significant legislative act of 2006 that affects tax and estate planning. The Pension Protection Act of 2006 was a giant bill (the Joint Tax Committee's report alone was 376 pages). The law also includes other miscellaneous provisions unrelated to pensions and retirement planning. The inside report contains a planning summary of selected provisions that affect pensions and retirement planning; we'll provide more for you in upcoming reports.

Another bill passed earlier this year, the Deficit Reduction Act (DRA) of 2005 (signed into law February 8, 2006), received far less fanfare, but will have significant impact on many Americans. The DRA was enacted in an attempt to control the dramatically increasing costs imposed on the Medicaid system for long-term and other health-related care for qualifying individuals. The costs of the system will be burdened significantly by the aging of the U.S. population.

The impact of this trend has changed expectations concerning retirement and inheritances. The perceived expense of retirement has been exacerbated by longevity and the potential for diminished public benefits for retirement income and long-term and other health care costs. It was expected that there would be some relief from inherited wealth. The AARP Public Policy Institute published an interesting report (*In Their Dreams: What Will Boomers Inherit?*) that indicates some concern for the expectations of baby boomers (born 1946 to 1964). Less than 20 percent of households reported receiving at least one inheritance between 1989 and 2004. Over the same period, however, the boomers surveyed who expected inheritances dropped from 27 to 15 percent. Perhaps the boomers have watched the drain created by increased longevity and health care costs of aging parents.

Individuals can certainly plan to leave larger inheritances through life insurance and more disciplined planning for retirement expenditures. DRA included a provision for long-term care insurance partnership programs at the state level. The provision would allow an individual who may ultimately need Medicaid for nursing home care to protect more assets for his or her heirs if a qualifying long-term care insurance contract is purchased. This program must be approved at the state level and the details are still being explored, but it is one example of how private-sector solutions can mitigate the disturbing trends.

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

## **PENSION PROTECTION ACT OF 2006**

The following is a summary (necessarily incomplete) of some of the significant provisions of pension reform in the 900-plus-page legislation discussed in the opening letter.

### **NEW MINIMUM FUNDING RULES**

The Act contains complex provisions requiring, in effect, faster funding of defined-benefit plans, with revised minimum funding requirements (IRC Sec. 412) going into effect after 2007 and certain provisions for the interim period. There are special funding requirements for "at-risk" plans. The new rules generally will impose increased costs for many companies that maintain a defined-benefit plan now and in the future. Most observers believe that the net effect will be to accelerate the current rapid decline in defined-benefit plan coverage for employees.

### **FASTER VESTING RULES**

Under the new law, after 2006 all employer contributions to qualified defined-contribution plans will be subject to the minimum vesting requirements now applicable to employer matching contributions. That is, the existing 3- to 7-year and 5-year "cliff" vesting rules will be replaced by 2- to 6-year graduated vesting and 3-year cliff vesting rules.

### **NONQUALIFIED DEFERRED-COMPENSATION RESTRICTION FOR COMPANIES WITH AT-RISK DEFINED-BENEFIT PLANS**

A new provision in Code Sec. 409A (effective August 17, 2006) adds some new restrictions to nonqualified deferred-compensation plans (generally for select management participants). Under this provision, if the employer is in bankruptcy or has an at-risk defined-benefit plan, any assets added to an employer trust or similar arrangement for funding a nonqualified deferred-compensation plan will be treated as Sec. 83 amounts; that is, vested amounts will generally be taxed immediately to the participants covered under the nonqualified deferred-compensation plan. This treatment, however, is generally limited to executives or former executives of publicly held corporations (those covered under Code Sec. 162(m) or Securities Act Sec. 16(a)).

### **PROHIBITED TRANSACTION EXEMPTION FOR INVESTMENT ADVICE TO EMPLOYEES**

It has become increasingly important to provide good investment advice to participants in directed-investment 401(k) plans, but advice from employers or investment providers is discouraged by the current prohibited-transaction rules of ERISA. Effective after 2006, the new law adds an exemption from the prohibited transaction rules for an "eligible investment advice arrangement." The arrangement must be one that either provides for fees that do not vary with the type of investment selected, or uses a computer model. Additional safeguards also apply.

### **CASH-BALANCE PLANS**

In recent years, companies have attempted to exit from their defined-benefit plan problems by converting the plan to a cash-balance (guaranteed-return) formula. However, some recent federal court cases have held that a cash-balance formula inherently discriminates against older employees. Another line of cases questions the method for determining lump-sum payouts to early retirees from a cash-balance plan. These cases have effectively halted the

trend toward cash-balance adoptions or conversions.

The new law resolves the age discrimination issue by revising Sec. 411 and other provisions to offer guidelines for nondiscriminatory formulas and rules for cash-balance conversions. New rules are also provided for determining lump-sum payouts. This should clear the way for resuming the move toward cash-balance plans.

### **INCREASES IN DEDUCTION LIMITS (IRC SECS. 404 AND 4972)**

The new law expands the deductibility limit for employer contributions to a combination of defined-benefit and defined-contribution plans. The new rules may create a way to provide more adequate retirement benefits for all employees, and enhance benefits for key employees. Among other things, the new rules increase the deduction limit (beyond the current 25 percent of payroll) for contributions to a combination of defined-benefit and defined-contribution plans for a group of employees.

### **NEW COMBINED PLANS (DB/K PLANS)**

The Act adds a new Code Sec. 414(x), effective after 2009, that will permit a simplified combination defined-benefit and defined-contribution plan for small employers (2 to 500 employees). The two plans would be combined for documentation, administration, and ERISA reporting purposes, but participants' benefits would have to be accounted for separately.

The defined-benefit part of a DB/K plan must provide a specified minimum benefit. The defined-contribution part must be a 401(k)-type arrangement with a mandatory employer match of 50 percent, up to 4 percent of compensation. The ADP (actual deferral percentage) and Sec. 401(m) nondiscrimination tests would be deemed met if the plan complies with Sec. 414(x).

### **DIVERSIFICATION OF INVESTMENTS IN PLANS INVESTED IN EMPLOYER SECURITIES**

The Act adds new rules (Code Sec. 401(a)(35)) providing diversification rights for participants in a defined-contribution plan that holds publicly traded employer securities. The rules apply for all types of plans except for an ESOP without employee elective deferrals or matching contributions, and plans with one participant (or one participant and spouse). The plan must offer at least three options for reinvestment.

### **ROLLOVERS FROM RETIREMENT PLANS TO ROTH IRAs**

The Act amends Sec. 408A to permit rollovers after 2007 to a Roth IRA from a traditional IRA, qualified plan, 403(b) plan, or 457 plan. The rollover will generally be treated the same as a Roth IRA conversion under existing law; that is, the rollover will be taxable and will not be permitted for taxpayers with an AGI (adjusted gross income) of \$100,000 or more.

## **ROLLOVERS BY BENEFICIARIES OTHER THAN A SPOUSE**

The new law permits rollovers by a beneficiary other than the decedent's spouse to the beneficiary's IRA (referred to as the inherited IRA of such beneficiary). The rollover can occur for a beneficiary of an IRA, qualified retirement plan, Sec. 457 plan, or tax-sheltered annuity. Distributions must begin, at a minimum, over the beneficiary's life expectancy starting the year after the year of the participant's death. (Rollovers by a surviving spouse were already permitted under more favorable terms.)

### **RECENT CASES AND RULINGS**

## **TAX COURT UPHOLDS ESTATE'S TAX VALUATION OF DECEDENT'S CLOSELY HELD STOCK**

The decedent held stock in a closely held corporation involved in the manufacture of plumbing products and home furnishings, and also holds real estate businesses. The IRS determined the value of the stock to be almost \$100 million greater than the estate's appraisal and imposed an estate tax deficiency of \$53,650,374 and valuation accuracy-related penalties of more than \$10 million. The case also involved deficiencies and penalties regarding the gift taxes resulting from transfers made by other family members.

One important issue concerned the appropriateness of the use of the alternate valuation date for estates under Sec. 2032. This provision permits the valuation of estate assets at a date 6 months after the date of death for qualifying estates. Between the date of the decedent's death and the alternate valuation date, the corporation completed a tax-free reorganization under Sec. 368. The estate exchanged its stock for new stock as a result of the reorganization. There were newly created classes of stock and new transfer restrictions to inhibit transfers outside of the family. The IRS attempted to prevent the use of the alternate valuation date as a result of the reorganization and the newly issued stock's transfer restrictions. However, the court found that the regulations explicitly recognize the use of the alternate valuation date in the event the stock is reorganized under Sec. 368. The court then found that the opinion of the estate's appraisers was accurate and that the appraisers the IRS used did not meet the burden of proving that the estate's appraisers were incorrect. Because the deficiency was not upheld, the accuracy-related penalty is inapplicable. (Kohler, et. al. v. Commissioner, TC Memo 2006-152)

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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