Advanced Planning

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DETAILED ANALYSIS OF THE PENSION PROTECTION ACT OF 2006

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 (the Act). As the name implies, the Act contains significant pension reforms including new funding rules and permanent extensions of many of EGTRRA's retirement savings provisions. However, the Act's scope isn't limited to pension matters; among its other provisions are new requirements for employer owned life insurance, permanent rules for college savings plans, and tax incentives for long term care insurance and charitable gifts. Given the depth and variety of these provisions, the Act offers numerous planning opportunities. However, many of the provisions are subject to delayed effective dates, making some opportunities available sooner than others.

Please see the Table of Contents following this page to find specific topics. Sections on each topic include a summary of current law, the new law, its effective date and, where appropriate, observations.

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I. DEFINED BENEFIT PLANS

A. Funding Changes

Current Law: Liberal assumptions allowing pension actuaries to calculate liabilities and the funding obligation for defined benefit plans often produce unrealistic results. Substantial underfunding results when the assumptions are missed by a wide margin.

New Law: The Act basically replaces the old funding rules. Funding assumptions are tightened, and prior year shortfalls now require additional contributions over a seven year phase-in period to ultimately achieve 100% funded status. Use of credit balances (actuarially-determined credits and contributions in excess of the required minimum contribution from prior years) to offset the minimum required current year contribution is restricted.

"At-risk" plans (less than 80% funded, or less than 70% funded with special assumptions) require an additional contribution. Also, any increase in benefits is prohibited unless additional contributions are made. Use of credit balances is not permitted. Small employers (those with fewer than 500 employees) are exempt from the "at-risk" plan requirements.

When a pension plan is in "at-risk" status, non-qualified deferred compensation plan contributions and asset transfers to a rabbi trust or other similar arrangement are restricted, and tax penalties under § 409A apply. Transfers to a rabbi trust occurring before the plan runs afoul of the at-risk rules are not affected by this rule. Treasury is authorized to issue additional guidance on the types of arrangements that are considered similar to a rabbi trust.

Paying so-called "shutdown" benefits when a plan is terminated (these enhanced benefits were sometimes used as a payoff to union employees), as well as lump sum and other accelerated benefits, are prohibited if a plan is less than 60% funded. In addition, no further accruals are permitted in these situations.

Effective Date: For plan years beginning January 1, 2008, with some phase-in features from 2007 through 2011.

B. Interest Rate and Other Actuarial Assumptions in Calculating Liabilities

Current Law: Prior to 2005, the average of 30-year government bonds was used to calculate the present value of a defined benefit plan's assets

(*e.g.,* a bond portfolio) and liabilities. Since 2005, the Pension Funding Equity Act (PFEA) requires use of a two-year weighted average of investment grade corporate bonds in order to provide some relief to distressed plans (the higher rate made plan liabilities appear smaller). A smoothing of results is allowed over five years for assets and four years for liabilities. Any reasonable mortality assumptions are allowed in determining the mortality of plan participants and their spouses.

New Law: Use of the PFEA corporate bond average is extended for 2006 and 2007. After 2007, interest rates are calculated based on a segmented yield curve of corporate bond rates, phased in over five years.

In calculating a lump-sum distribution, a plan must use an interest rate equal to the greatest of 5.5%, 105% of the rate described in the preceding paragraph, or the plan rate.

Starting in 2008, smoothing of results is permitted but not beyond 24 months, and Treasury-imposed mortality tables are required with some exceptions for large plans.

Finally, § 412(i), which provides special rules for fully-funded defined benefit plans used by small businesses, is renumbered § 412(e)(3), but its substance and usefulness for that market remain unchanged.

Effective Date: The lump-sum calculation rules apply to distributions made in years beginning after December 31, 2005. The PFEA corporate bond average is extended through 2007.

Observation: The extension of the PFEA corporate bond average may cause a problem for distributions already made in 2006 if the plan used interest rate assumptions that do not comply. The I.R.S. will need to provide relief for these situations.

C. Pension Benefit Guarantee Corporation (PBGC)

Current Law: The flat rate premium for single-employer plans is $30 per participant. The variable rate premium applies to the extent a plan is underfunded. Also, a "distress termination" requires a surcharge of $1,250 per participant, which is due to expire in 2010.

New Law: The old rules for calculation of the variable rate continue through 2007 except that, for a plan with 25 or fewer employees, the

variable premium is capped at $5 per participant. In 2008, a three-segment yield curve to determine the variable premium must be used. Underfunded vested benefits will affect this calculation. (There is no change to the flat rate fee; it continues as before.)

The distress termination surcharge is made permanent.

Effective Date: As noted above.

D. Cash Balance Plans

Current Law: The legal status of cash balance defined benefit plans is in doubt under the pension non-discrimination rules of ERISA and the Age Discrimination in Employment Act (ADEA).

New Law: Cash balance plans that meet certain vesting and interest crediting rules meet the non-discrimination rules of ERISA and ADEA. However, the Act contains "no inference" language suggesting that plans in existence before June 29, 2005 can still be challenged.

Effective Date: For new plans or converted plans, retroactive to June 29, 2005; for the interest crediting and vesting rules, beginning after December 31, 2007.

E. Disclosure and Notice Requirements

Current Law: Form 5500-EZ must be filed by an owner-only plan with assets over $100,000; Form 5500 must be filed if the plan covers any common law employee. Summary Annual Reports (SARs) generally are required.

An annual funding notice to participants is required when a cutback in benefits or termination is involved.

New Law: More detailed information is required on Form 5550. Form 5500-EZ need only be filed for owner-only plans if plan assets are over $250,000.

Single-employer defined benefit plans are exempt from providing an SAR.

An annual funding notice to participants is required within 120 days of the plan's year end, even if there is no cutback of benefits or plan termination. However, when a plan is determined to be in

"shutdown" status or if future accruals cease, notice to participants is required within 30 days.

Effective Date: For plan years beginning on or after January 1, 2007.

Observation: The preceding comments are but a brief summary of the hundreds of pages contained in the Act. Since Northwestern Mutual does not provide pension, actuarial or administrative services, an in-depth review is consciously not provided. For a more detailed description of the Act's pension features, consider contacting an actuarial consulting firm that is involved in the regular application of the new provisions.

The Act, while well intentioned in its effort to improve the funding status of pensions, substantially limits the funding flexibility currently available to defined benefit plans. This could increase the volatility of annual contributions to these plans. In addition, it may hasten the termination of existing defined benefit plans for larger employers (unless the employer is an airline, defense contractor or certain other favored entity). On the other hand, the ability to increase contributions (with corresponding tax deductions) will provide greater incentives to provide pension benefits, particularly to financially successful smaller businesses that are trying to provide meaningful retirement benefits to older, long-term employees, as well as to the business owners.

By clarifying the rules surrounding cash balance plans, the Act may result in more traditional plans converting to cash balance plans where accruals generally create a slower growth of liabilities.

Only time will tell if the laudable intent of the Act – to ensure that the benefits promised by employers are kept – will actually happen or if defined benefit plans will follow leisure suits and vinyl records into the archives of history.

II. INCREASE IN PENSION PLAN DIVERSIFICATION, PARTICIPATION AND OTHER PENSION PROVISIONS

A. Eligible Combined Plan (aka DB(k)) for Employers with 500 or Fewer Employees

Current Law: Each plan is treated and tested separately for qualification under ERISA and tax rules. Separate plan documents and Form 5500 are required.

New Law: The Act creates an eligible combined plan, consisting of:

1. a defined benefit component that incorporates either a cash balance formula increasing with age, or a 1%-of-pay formula for up to 20 years, and

2. a (k) component designed as a 401(k) safe-harbor plan using automatic enrollment with a deferral of up to 4% of pay. A fully vested matching contribution of 50% on the up-to-4% deferral is required. Non-elective contributions are permitted, and these contributions, combined with the defined benefit component, must fully vest after three years.

Effective Date: For plan years beginning after December 31, 2009.

Observation: Simplified administration and filing (only one Form 5500 is required) may provide an incentive for smaller employers to provide a basic defined benefit plan while allowing the employees to participate in the potential of a 401(k) plan. In addition, when safe harbor designs are used, the plans are automatically deemed *not* to be top-heavy and to pass the ADP/ACP salary testing. This allows highly compensated employees to defer the maximum allowable. However, the delayed effective date makes the potential benefits of these plans somewhat illusory.

B. Diversification of Qualified Plan Investments

Current Law: ERISA allows retirement plans to purchase certain qualifying employer securities or interests in qualifying employer real property. For some types of plans, ERISA imposes a limit on the purchase of such assets. A defined benefit pension plan or money purchase pension plan may not hold employer securities or employer real estate that exceeds 10% of the fair market value of all plan assets. The 10% limit generally does not apply to an "eligible individual account plan", which includes a defined contribution plan that is:

1. a profit sharing, stock bonus, thrift, or savings plan;
2. an employee stock ownership plan (ESOP); or
3. a pre-ERISA money purchase plan.

The Taxpayer Relief Act of 1997 extended the 10% limitation on these investments to elective deferrals and their earnings under 401(k) plans if they are required to be invested in employer

securities or real property pursuant to plan terms or the direction of a person other than the participant. This restriction does not apply if:

1. the amount of elective deferrals required to be invested in employer securities and real property does not exceed more than 1% of any employee's compensation;

2. the fair market value of all the employer's defined contribution plans is not more than 10% of the fair market value of all of the employer's retirement plans; or

3. the plan is an ESOP.

Despite the requirement that ESOPs invest primarily in qualifying employer securities, certain employees are allowed to diversify their ESOP accounts. Under the diversification requirements, an employee who has attained 55 and who has at least 10 years of plan participation must be permitted to direct that a portion of the employer securities in his or her account be diversified in other investments. During the five years after meeting the eligibility requirement, the participant may elect to diversify up to 25% of his account balance and in the sixth year, up to 50%. To satisfy a diversification request, the plan may:

1. distribute the applicable amount to the participant within 90 days after the election;

2. offer at least three investment options and, within 90 days after the election, invest the applicable amount per the participant's election; or

3. transfer the applicable amount within 90 days of the election to another qualified defined contribution plan of the employer providing at least three investment options.

New Law: The Act imposes diversification requirements on a defined contribution plan holding publicly-traded employer securities. A plan must permit a plan participant or a beneficiary who is entitled to exercise participant rights to direct that the portion of the account held in employer securities be invested in alternative investments.

The diversification requirements do not apply to an ESOP that:

1. does not hold contributions that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions; and

2. is a separate plan from any other qualified retirement plan of the employer.

The diversification requirements also do not apply to a one-participant retirement plan where the plan:

1. only covers the 100% owner and/or the owner's spouse;

2. meets the minimum coverage requirements without being combined with any other plan that covers employees;

3. provides benefits only to the 100% owner and his or her spouse;

4. does not cover a business that is a member of a controlled group or of an affiliated service group; and

5. does not cover a business that uses the services of leased employees.

A participant must be permitted to direct that employer securities attributable to 401(k) elective deferrals or after-tax contributions be invested in alternative investments. A participant who has at least three years of service or a beneficiary of a deceased participant must be permitted to direct that employer securities attributable to contributions other than elective deferrals or after-tax contributions be invested in alternative investments.

Under a transition rule, a participant must be allowed to direct that one third of the employer securities acquired before 2007 be invested in alternative investments for each of the first three years that the new diversification rules apply to the plan.

A plan subject to the diversification requirements must give participants a choice of at least three investment options, each of which is diversified and has materially different risk and return characteristics.

Effective Date: For plan years beginning after December 31, 2006. There are deferred effective dates for collectively bargained plans and for ESOPs holding certain types of preferred stock.

Observation: It is obvious that the diversification requirements are a reaction to the losses suffered by Enron employees who were encouraged to invest their account balances in Enron stock. The provision does not limit the extent to which a participant may invest in employer securities but provides diversification opportunities to participants in plans that automatically allocate plan contributions to employer stock.

C. Participation in Automatic Contribution Arrangements

Current Law: The recent trend in qualified retirement plans has been toward 401(k) plans that allow participants to make elective contributions. Many employers encourage their employees to participate by making matching contributions. Generally, an employee must affirmatively elect to participate in the plan. In some cases, an employer automatically enrolls employees in the plan once they meet the eligibility requirements, with the employee being able to elect out of participation.

A special nondiscrimination test applies to the elective deferrals under a 401(k) plan, called the actual deferral percentage (ADP) test. The ADP test compares the rate of elective deferrals made by the eligible highly compensated employees to the rate of elective deferrals made by the eligible nonhighly compensated employees. The plan generally satisfies this test if the ADP of the highly compensated employees is either:

1. not more that 125% of the ADP of the nonhighly compensated employees for the prior plan year, or

2. not more than 200% of the ADP of the nonhighly compensated employees and no more than two percentage points greater than the ADP of that group for the prior year.

If the participation rate among nonhighly compensated employees is low, the highly compensated group can be severely limited in the percentage of compensation it can elect to defer.

Under a safe harbor, a 401(k) plan is deemed to satisfy the ADP test if the plan satisfies a notice requirement and one of the following contribution requirements:

1. The employer must match 100% of elective deferrals up to 3% and 50% of elective deferrals over 3% and up to

5%. The match for nonhighly compensated employees may not be lower than the match for highly compensated employees.

2. The employer must contribute at least 3% of compensation for each nonhighly compensated employee eligible to participate in the plan.

Employer matching contributions are also subject to another nondiscrimination test, the actual contribution percentage (ACP) test. The standards are similar to the ADP test, and there is a safe harbor available. The safe harbor is satisfied if:

1. there are no matching contributions for elective deferrals over 6% of compensation;

2. the rate of matching contribution does not increase as the employee's elective deferrals increase; and

3. the matching contribution rate for the elective deferral rate of a highly compensated employee is not greater than the matching contribution rate for the same elective deferral rate of a nonhighly compensated employee.

The same safe harbors apply to 403(b) plans; a plan that satisfies the safe harbors is deemed to satisfy the top heavy rules.

New Law: A 401(k) plan with an automatic enrollment feature that satisfies the following requirements meets the ADP test for elective deferrals and the ACP test for matching contributions:

1. Unless electing out, an employee is treated as making an elective deferral under the 401(k) plan.

2. The maximum automatic deferral is 10%, and the minimum automatic deferral is 3% in the first year of eligibility, 4% in the second year, 5% in the third year, and 6% thereafter. The stated percentage in the plan must be uniform for all eligible employees.

3. The employer must match 100% of the first 1% of elective deferrals and 50% of elective deferrals over 1% but not over 6%, or the employer must contribute 3% of compensation. The provision also applies to 403(b) annuities.

4. A plan with an automatic enrollment feature that provides for matching contributions satisfies the ACP test if:

   a. there are no matching contributions for elective deferrals over 6% of compensation;

   b. the rate of matching contribution does not increase as the employee's elective deferrals increases; and

   c. the matching contribution rate for highly compensated employees is the same as the rate for nonhighly compensated employees.

5. Any matching or other employer contribution taken into account in determining whether the requirements for a qualified automatic enrollment feature are met must vest at least as rapidly as under two-year cliff vesting.

6. Each eligible employee must be notified of the terms of the plan. The notice must be written in such a way that it is understood by the average employee. It must explain the employee's right to opt out of automatic enrollment, the employee's right to defer a different amount and how contributions will be invested absent any investment election by the employee. There must be a reasonable time between receipt of the notice and the deferral to make an alternate election for contributions and investments.

The new law provides for corrective distributions of automatic elective deferrals that are contributed in error. The 10% additional tax on early withdrawals does not apply to corrective distributions, and the distributions do not cause the plan to violate any nondiscrimination rules or prohibitions on early distributions. Likewise, the law provides relief from the excise tax on excess contributions made under an automatic elective deferral plan if the excess contributions are distributed within six months after the close of the plan year.

Effective Date: For years beginning after December 31, 2007.

Observation: Despite the comments made in the general press and on national newscasts, the new law does not require that 401(k) plans include an automatic enrollment provision; it allows 401(k) plans to include this provision and supersedes any state law prohibitions. The law provides an alternative method for 401(k) plans to satisfy the safe harbor requirements under the ADP and ACP

nondiscrimination rules. The open question is: "What would motivate an employer to incorporate an automatic enrollment provision in its 401(k) plan?" Aside from satisfying its paternalistic instinct to encourage employees to save money for retirement, adopting an automatic enrollment feature provides no economic benefit to the employer. From a cost perspective, the minimum match required to qualify for the automatic enrollment safe harbor is slightly lower than the minimum match needed to qualify for the standard safe harbor. Nevertheless, that factor is likely to be more than offset by a higher level of participation and higher rate of elective deferrals under a plan with an automatic enrollment feature.

D. Faster Vesting of Employer Nonelective Contributions

Current Law: A participant's accrued benefit from employer contributions in a qualified plan must provide for:

1. 100% vesting upon five years of service; or
2. 20% vesting after three years of service with an additional 20% vesting over each of the following four years, resulting in full vesting after seven years of service.

Faster vesting applies to employer matching contributions as follows:

1. 100% vesting upon three years of service; or
2. 20% vesting after two years of service with additional 20% vesting over each of the following four years, resulting in full vesting after six years of service.

New Law: The minimum vesting schedule for matching employer contributions now applies to all employer contributions under defined contribution plans. The minimum required vesting for defined benefit plans remains unchanged.

Effective Date: Generally effective for contributions in plan years beginning after December 31, 2006, with special rules for collectively bargained plans.

E. Distributions Prior to Retirement

Current Law: Under ERISA, a pension plan is a plan, fund or program established by an employer that:

1. provides retirement income to employees; or

2. results in income deferral by employees for periods extending to the termination of covered employment or beyond.

This definition encompasses all forms of retirement plans, including defined benefit pension plans, money purchase pension plans, profit sharing plans, stock bonus plans and ESOPs.

A pension plan must be maintained to provide systematically for the payment of definitely determinable benefits for a period of years after retirement. Pension plans are prohibited from paying benefits prior to separation from service. On the other hand, profit sharing plans, stock bonus plans and ESOPs are allowed to make in-service distributions to participants within certain limits.

New Law: A distribution from a plan, fund, or program made to an employee who has attained age 62 and has not separated from service is treated as retirement income. Pension plans may make distributions to participants who have attained age 62 but have not separated from service.

Effective Date: Applies to distributions in plan years beginning after December 31, 2006.

Observation: The availability of pension plan distributions to active employees who have attained 62 reflects the changing demographics in the work force and the concern over the low rate of savings in this country. The aging of the Baby Boom generation will result in a smaller work force, and many employers are likely to prevail on employees to continue working beyond normal retirement age. On the other side of the coin, the decline in defined benefit pension plans has shifted the responsibility of saving for retirement to individual workers. Many are in for a rude awakening when they realize that their meager savings will not support them in retirement, and they will have to continue working beyond normal retirement age.

III. PROHIBITED TRANSACTION EXEMPTION FOR GIVING INVESTMENT ADVICE REGARDING DEFINED CONTRIBUTION PLANS AND IRAS

Current Law: Under ERISA § 406 and § 4975, one who provides specific investment recommendations to participants and beneficiaries in IRAs and defined contribution plans is subject to the prohibited transaction rules. The prohibited transaction rules forbid self-dealing, including using fiduciary influence to encourage or steer a client into an investment product that generates compensation to the fiduciary. Fiduciaries do not violate the prohibited transaction rules if they qualify for a prohibited transaction exemption.

New Law: A new prohibited transaction exemption allows "qualified fiduciary advisers" to offer personal investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of defined contribution plans and IRAs (and also to owners of health savings accounts, Archer medical savings accounts, and Coverdell education savings accounts).

This arrangement must meet certain requirements and either:

1. provide for level compensation for investment advice or

2. use a computer model that generates investment advice that occurs solely at the direction of the participant or the beneficiary (this computer model requirement is currently only available in the case of a defined contribution plan, not an IRA).

In a defined contribution plan, this arrangement must be expressly authorized by a disinterested and independent plan fiduciary. The arrangement must be independently audited annually, in writing.

By December 31, 2007, Treasury and Labor must determine if there is any computer model investment advice program that meets the PTE requirements that may be used by IRAs. Additionally, the fiduciary adviser may be required to have a written policy requiring that any advice provided is not biased in favor of investments offered by the investment advisor or a related firm and annually appoint a person to verify unbiased advice is being so provided.

Some relief is provided to plan sponsors and plan fiduciaries. If the investment advice is provided under an eligible investment advice arrangement by a fiduciary adviser who acknowledges in

writing that he is a plan fiduciary for all investment advice given to plan participants and beneficiaries, plan sponsors and plan fiduciaries are not held responsible for violating the self-dealing rules and, to a limited extent, the ERISA general prudence guidelines. However, plan sponsors have a continuing duty to prudently select and monitor fiduciary advisers dispensing investment advice for plan participants and beneficiaries. The plan sponsor has no duty to monitor the specific investment advice given by the fiduciary adviser.

Effective Date: August 17, 2006 for the provision for the Labor/Treasury study; January 1, 2007 for all other provisions.

Observation: This new exemption for investment advice delivered through computer models or a level compensation arrangement is substantially limited compared to the original broader exemption passed by the House of Representatives. If narrowly interpreted, this new exemption may not provide any more flexibility than the current law's independent computer modeling options or the fee offset approach. Moreover, there are now significant new audit and disclosure conditions for fiduciary advisers providing investment advice to plan participants and beneficiaries.

DOL has consistently held that, absent a prohibited transaction requiring an exemption, a registered representative's activity solely as a salesperson offering investment information and education is not treated as providing specific investment advice under ERISA. Nothing in this new exemption disturbs this education exception approach, which may continue to be used by many who offer general advice at the asset class level regarding qualified plan and IRA investment assets. In addition, this new PTE does not limit the availability of other ERISA exemptions.

The use of the exemption could be increased depending on how the DOL interprets several provisions. The new law does not apply to providing plan level investment advice to either the plan sponsor or the trustee, nor does it apply to discretionary managed accounts.

IV. BENEFIT ACCRUAL STANDARDS

Current Law: In June 2004, the I.R.S. withdrew proposed regulations applying the age discrimination rules to certain types of defined benefit pension plans, such as cash balance plans and pension equity plans, commonly referred to as hybrid plans. In the absence of any guidance, courts were divided on whether the age discrimination rules applied to hybrid plans.

New Law: The age discrimination test is satisfied for all defined benefit plans if a participant's accrued benefit is not less than the accrued benefit of any similarly-situated younger employee. Defined benefit plans where the accrued benefit is calculated as the balance of the participant's hypothetical account or an accumulated percentage of the participant's final average compensation (applicable defined benefit plans) are not inherently age discriminatory as long as benefits are fully vested after three years of service and interest credits do not exceed a market rate of return. For conversions of traditional defined benefit plans into applicable defined benefit plans after June 29, 2005, the Act prohibits wear away of pre-conversion accrued benefits. Finally, the Act solves the "whipsaw" problem by allowing the lump sum distribution from an applicable defined benefit plan to be equal to the hypothetical account balance or the accumulated percentage of final average pay.

Effective Date: Generally effective for periods beginning on or after June 29, 2005.

Observation: Although this provision resolves some issues that had been the subject of litigation, it does not address the status of applicable defined benefit plans established prior to the effective date. This leaves the age discrimination and whipsaw issues as unresolved as they were before the passage of the Act.

V. INCREASE IN DEDUCTION LIMITS

A. Single-Employer Plans

Current Law: For defined benefit pension plans, employers can generally deduct contributions equal to 100% of the plan's current liability. Employers are only allowed to make a deductible contribution equal to the plan's "termination" (i.e., overall) liability in the year of termination. Excess contributions are subject to a 10% excise tax.

New Law: For contributions in 2006 and 2007, the maximum deduction is increased to 150% of the plan's current liability. For contributions after 2007, employers can deduct an amount equal to the year's normal cost plus the amount necessary to fully fund the funding target.

Effective Date: Generally for years beginning after December 31, 2007; for the maximum deduction limit, years beginning after December 31, 2005.

Observation: The prior rules discouraged employers from contributing more than the plan's current liability. The increased deduction limits should encourage employers who sponsor defined benefit plans to contribute more than the amount necessary to fund the plan's current liability, hopefully resulting in fewer underfunded plans.

B. Multiemployer Plans

Current Law: Deductions to multiemployer plans are limited to 100% of the plan's current liability.

New Law: Deduction limits for multiemployer plans are increased to 140% of the plan's current liability.

Effective Date: For years beginning after December 31, 2007.

Observation: Again, the goal is to encourage employers to make increased contributions to defined benefit plans in excess of the plan's current liability.

C. Combination of Plans

Current Law: Employers who sponsor a defined contribution plan and a defined benefit plan have a combined limit on deductible contributions. The combined limit is the greater of the defined benefit limitation or 25% of participant compensation.

New Law: For contributions in tax years after 2005, employer contributions to a PBGC-covered defined benefit plan are deductible without affecting the combined limit. For non-PBGC covered plans, the combined limit only applies to the extent that employer contributions to the defined contribution plan exceed 6% of compensation.

Effective Date: For contributions made in years beginning after December 31, 2005.

Observation: By increasing the deduction limits for employers who sponsor both a defined contribution and a defined benefit plan, this provision should encourage employers to continue making contributions to defined benefit plans, rather than freezing or terminating them. The complete lack of a deduction limit for contributions to PBGC-covered plans adds extra tax incentive for employers with severely underfunded plans.

VI. PENSION PROVISIONS UNDER EGTRRA MADE PERMANENT

A. Pension and Individual Retirement Arrangement Provisions

Current Law: The Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") made numerous changes to pensions and IRAs that are set to expire at the end of 2010.

New Law: The Act makes permanent many of the rules, including the following:

1. The dollar limit on plan benefits, expressed as an annual benefit, is increased to $160,000, with cost of living adjustments ($175,000 for 2006).

2. The dollar limit on annual additions to a defined contribution plan is increased to $40,000, with cost of living adjustments ($44,000 for 2006).

3. Individuals age 50 and over can make additional "catch-up" contributions to 401(k), SEP and SIMPLE IRA plans ($5,000 for 2006).

4. The limitation on deductible contributions to profit-sharing, stock bonus plans and SEP IRAs is increased from 15% to 25% of compensation.

5. The IRA and Roth IRA contributions limits are increased in increments from $2,000 to $5,000 in 2008.

6. Allocations of employer stock held by an S corporation's employee stock ownership plan (ESOP) to "disqualified persons" who together own 50% or more of the S

corporation's shares are treated as distributions and are subject to a 50% excise tax.

Effective Date: August 17, 2006.

Observation: This is one of the least surprising provisions of the Act, as there would have likely been great uproar if many of the provisions of EGTRRA, such as the increased 401(k) deferral amounts and the ability of participants to make "catch-up" contributions, had been allowed to expire. With increased attention to retirement savings (due to apprehension about the fate of the social security system, increasing health care costs and the slow death of the defined benefit pension plan), qualified plan participants need more ability to save money for retirement. Although we'd like to see these limits further increased, the continuation of these EGTRRA provisions is a step in the right direction.

B. Saver's Credit

Current Law: Eligible taxpayers receive a nonrefundable tax credit for qualified retirement savings contributions.

New Law: The Act makes the saver's credit permanent. In addition, any income tax refund attributable to the credit now may be deposited directly into an IRA, qualified retirement plan, 403(b) annuity or governmental 457 plan.

Effective Date: For the saver's credit, August 17, 2006; for the income tax refund provision, tax years beginning after December 31, 2006.

Observation: The saver's credit will reduce the amount of income tax that lower-income taxpayers pay in two ways. First, by contributing to a qualified plan, the taxpayer reduces income, which lowers her tax liability in the year of the contribution. Second, the saver's credit for the contribution further reduces the taxpayer's tax bill.

VII. ROLLOVER AND DISTRIBUTION RULES

A. Direct Rollovers from Retirement Plans to Roth IRAs

Current Law: Qualified plan assets must be rolled to an IRA first, then to a Roth IRA.

New Law: A taxpayer can roll a qualified retirement plan directly to a Roth IRA. "Qualified retirement plan" includes a 401(k), 403(b) and 457(b) plan.

Effective Date: Applies to distributions starting January 1, 2008.

Observation: Although the rollover is still taxable, one step will be needed to accomplish what now requires two. Taxpayers must still meet the requirements to convert to a Roth IRA – namely, having AGI less than $100,000 and a tax filing status other than married filing separately. However, these two requirements are eliminated beginning in 2010.

B. Modification of Rules Governing Hardships and Unforeseen Financial Emergencies

Current Law: 401(k) assets may not be distributed to participants unless an exception applies, such as hardship. This hardship exception applies if the hardship is for medical, educational, and funeral expenses of a family member or dependent.

New Law: This new law requires that regulations be modified to provide that if a qualified plan participant can take a hardship withdrawal because the hardship occurred to a family member or dependent, then a participant can take the withdrawal if the hardship occurs to a beneficiary of the account.

Effective Date: Regulations are to be modified within 180 days of the enactment of this law.

C. Rollovers by Nonspouse Beneficiaries of Certain Retirement Plan Distributions

Current Law: Only a spouse may transfer assets income tax-free from a deceased employee's qualified plan to an IRA. A nonspouse beneficiary may take distributions only as the qualified plan allows and may not roll the plan balance to an IRA. This means that a nonspouse beneficiary may be forced to receive a distribution as a lump sum (all currently subject to tax) if this is the only distribution option the plan allows.

New Law: A nonspouse beneficiary of a qualified plan can roll the assets to an IRA by requiring the plan administer to make a trustee-to-trustee transfer of the plan assets to an inherited IRA.

Effective Date: Applies to distributions starting January 1, 2007.

Observation: This will allow a nonspouse beneficiary (for example, a deceased employee's child) to transfer qualified plan assets directly to an inherited IRA and receive distributions – and pay income tax – over the child's life expectancy. The idea here isn't new – this ability currently exists for nonspouse beneficiaries of IRAs. This legislation simply extends this ability to nonspouse beneficiaries of qualified plans.

Note that the transfer under this new law must be "trustee-to-trustee", meaning that the funds must pass directly from the qualified plan to the IRA without passing through a beneficiary's hands. A 60-day income tax-free rollover of funds received in cash by a nonspouse beneficiary continues to be unavailable.

D. Direct Payment of Tax Refunds to IRAs

Current Law: A taxpayer can receive a tax refund in cash and contribute that cash to an IRA.

New Law: Taxpayers can transfer part of their tax refund directly to an IRA.

Effective Date: Applies to refunds for tax years beginning 2007.

Observation: This further inducement to save for retirement will presumably be subject to all the current limits related to IRA contributions. Further guidance should also spell out in which tax year the contribution is deemed made.

E. Allowance of Additional IRA Payments in Certain Bankruptcy Cases

Current Law: Taxpayers are limited to a yearly maximum deductible IRA contribution ($4,000 in 2006).

New Law: Employees who receive a match of employer stock on at least 50% of their contribution to a qualified plan can make an additional $3,000 contribution to an IRA, provided their employer meets certain requirements. The employer must be part of the esteemed group that was, in the prior year, in bankruptcy ***and*** indicted or convicted on a business transaction related to the bankruptcy.

Effective Date: Applies to tax years 2007 through 2009.

Observation: The $3,000 is "additional", meaning that the taxpayer must also be able to make the maximum deductible contribution to an IRA. This may result in limited applicability because many employees will exceed the adjusted gross income thresholds for making deductible contributions to an IRA if they have access to a qualified plan at work. And if unemployed – maybe due to the bankruptcy of a malfeasant employer – they will not have the compensation necessary to qualify for deductible contributions without relying on a spouse's compensation.

VIII. LONG TERM CARE INSURANCE

A. Long Term Care Insurance (LTCi) Combined with Life Insurance or an Annuity Contract

Current Law: LTCi can be provided as a rider on or as part of a life insurance contract. No medical expense deduction is allowed for payment of a LTCi premium from the life insurance contract's cash value unless the payments are included in income.

New Law: LTCi can be provided as a rider on or as part of a life insurance contract, as well as most non-qualified annuity contracts. Benefits received under this type of LTCi contract are treated the same way as those received under a stand-alone contract. A medical expense deduction is not available for any payment made from combined products.

Effective Date: Applies to contracts issued after December 31, 1996, but only for tax years beginning after December 31, 2009.

Observation: LTCi combination products already exist in the insurance marketplace, but they represent only a small portion of it. This could be partly attributed to the absence of tax rules on the annuity and LTCi combined product. The Act not only removes the cloud of uncertainty surrounding that product's tax treatment, it goes a step further by creating tax incentives for paying premiums for it and the life insurance combo product (see explanation of the additional provisions below). However, insurers face other obstacles, perhaps most pressing is the complexity inherent in designing products that cover multiple risks. Because the provisions are not effective until January 1, 2010, insurers will have time to consider their options.

B. Tax Treatment of Life Insurance and Annuity Contracts with an LTCi Feature

New Law: Any premium paid from the cash surrender value of an annuity or a life insurance contract for qualified LTCi which is a part of or a rider on that contract is deemed to come:

- first from tax-free investment in the contract (commonly referred to as basis), and
- then from the income on the contract – but even this is tax-free as well.

Effective Date: Applies to contracts issued after December 31, 1996, but only for tax years beginning after December 31, 2009.

Observation: These rules apply only to "combo LTC products" and are significant for at least two reasons: (i) withdrawals from the normally taxable "gain" portion of life insurance and annuities are tax-free if used to pay for LTCi coverage; and (ii) it changes the ordering rule of withdrawals from MECs and annuities from gain-first to basis-first. The normal ordering and taxation rules still apply for withdrawals from a combo LTC product made for a reason other than paying for coverage on the LTCi rider. Also, withdrawals from non-combo life or annuity contracts are still taxed (or not) the same as before, whether or not the withdrawal is used to pay premium on a separate LTC contract.

C. Tax-Free Exchanges Involving Long Term Care Insurance

New Law: The Act expands the types of § 1035 tax-free exchanges to include the following transactions:

1. life insurance for LTCi,
2. endowment for LTCi,
3. annuity for LTCi, and
4. LTCi for LTCi.

When applying the § 1035 rules, a life insurance contract combined with LTCi is still treated as a life insurance contract. The same holds for an annuity contract combined with LTCi. Consequently, types of exchanges that were previously allowed (life insurance for life insurance, life insurance for an annuity and annuity for annuity) can now involve combined LTCi.

Effective Date: Applies to exchanges occurring after December 31, 2009.

Observation: Because annuities stand to benefit the most from the tax-free withdrawal rule (discussed above), the most popular type of exchange figures to be one for an annuity combined with LTCi. The frequency at which others may occur (like life insurance, an annuity contract or an endowment contract for LTCi) isn't as clear.

Since LTCi can't provide a cash surrender value, what is to be done with the surrender proceeds exceeding the LTCi premium? One possibility is to distribute them. This could trigger taxable gain. Another possibility is to execute a series of annual exchanges where the amount going into the LTCi each year equals its premium. While there is authority qualifying partial exchanges of annuities as tax-free, there is no clear authority for other partial exchanges. Perhaps the most viable option from a tax perspective is exchanging into a LTCi contract that accepts a single premium or into a LTCi contract that applies the excess proceeds to future LTCi premiums. The problem here is that most insurers do not currently offer those types of LTCi contracts. For the time being, the issue can be bandied about by tax attorneys and LTCi product gurus. Those in the real world won't be doing any of these types of exchanges until 2010.

D. Informational Reporting

New Law: When a tax-free withdrawal for LTCi is taken from a life insurance or an annuity contract, the insurer is required to file a return showing:

1. the amount of the withdrawal,
2. the basis reduction of the life insurance or annuity, and
3. the name, address and TIN of the contract holder.

The insurer will also have to provide a similar statement to the contract holder. Penalties apply for failing to comply with these requirements.

Observation: Font type and size left to the discretion of the insurer?

IX. EMPLOYER-OWNED LIFE INSURANCE

Current Law: The death benefit on employer owned life insurance is income tax-free unless:

1. it is subject to C corporation alternative minimum tax, or

2. the employer gave consideration for the policy in a transaction that does not qualify for an exception to the § 101 transfer-for-value rule.

New Law: In addition to the rules above, there are new requirements for employer-owned life insurance to qualify for a tax-free death benefit. Employer-owned life insurance is life insurance of which the employer is the owner and a beneficiary and the employee is the insured. Among other things, these requirements affect key person, nonqualified deferred compensation, SERP, entity purchase buy-sell and death-benefit-only arrangements.

Death benefits are taxable unless each of the following requirements is satisfied prior to the issuance of the policy:

1. The insureds are limited to individuals who, at the time the policy is issued, are either:
   a. directors;
   b. among the five highest paid officers;
   c. 5% owners during the current or preceding year;
   d. employees who make at least $100,000 per year (adjusted for cost-of-living); or
   e. among the highest paid 35% of employees.

   Other eligibility provisions allow tax-free death benefits if the insured was an employee at any time during the 12-month period before his death, has the right to name the policy beneficiary, or is insured under a business buyout arrangement.

2. Before the issuance of the policy, the insured employees receive written notice that:
   a. the employer intends to insure the employee's life and the maximum face amount for which the employee could be insured;
   b. the employee will be insured under the contract; and
   c. the employer will be a beneficiary of any death proceeds.

3. Before the issuance of the policy, the insured employees consent in writing to being insured under the policy and to the continuance of coverage after termination of employment.

The new law also requires the employer to file a return for each year any employer-owned policy is owned, showing:

1. the number of employees at the end of the year;

2. the number of employees insured under the contracts at the end of the year;

3. the total amount of insurance in force at the end of the year under the contracts;

4. the name, address, TIN and type of business of the employer; and

5. that the employer has a consent from each insured employee, and the number of insured employees from whom no consent was obtained (if any).

The law directs the I.R.S. and Treasury to issue guidance for complying with these reporting requirements.

Observations: The Technicalities of Notice and Consent. An employee's demonstration of consent by virtue of signing the insurance application, by itself, is not adequate under this provision. Therefore a separate consent – with the appropriate recitals – is necessary.

Because the three new requirements are tied to the "issuance" of the policy and that term is undefined in the law, we recommend that they be satisfied prior to the date the application is signed. Under Northwestern Mutual procedures, the issue date is generally the later of the application date or the medical exam (if any). That means that in some cases notice should be provided to the employee and his consent obtained *before* the application is signed.

But what about the situation where a policy was purchased initially by an individual – say an owner– and only later contributed to the company. Unless the transfer was anticipated, it would be impossible to provide notice and obtain consent before the issuance of the policy. Although there is no guidance that dictates a course of action for this type of situation, it makes sense for the

company to give notice and obtain consent before the transfer. At least this complies with the spirit of the legislation.

There are certainly additional unanswered questions dealing with these requirements and the applicability of the COLI provisions in general. Hopefully all will be answered in due time. In the meantime, what's a prudent planner to do? Give notice to the employee and obtain the required consent – just in case.

"Janitor Insurance". In theory, the rule that allows for a tax free death benefit if an insured was employed within 12 months of his death still leaves the window open for employers to buy so-called "janitor insurance." Nevertheless, the employer must still satisfy the notice and consent provisions below and comply with state law insurable interest standards.

Applicability to Split Dollar. Because the threshold test is that the employer be named owner *and* a direct or indirect beneficiary, it is unclear whether all split-dollar plans are affected by these rules. Endorsement split dollar plans likely are subject to them because the employer is the policy owner and typically receives part of the death benefit. It is possible, however, for an employer to endorse out the entire benefit, in which case it isn't a beneficiary and might avoid the new rules (unless the employer acquires an interest in the death benefit later on).

The application of the rules to collateral assignment plans depends on the employer's interest in the policy. In an economic benefit type plan (where the greater of cash value or premiums is assigned to the employer) the employer is deemed to own the policy under the § 61 split dollar regulations. For that reason, a strong argument can be made that the new rules apply. Under a loan arrangement, the employer is neither an owner nor a beneficiary, but merely receives an assignment of the policy as a lien—but like the endorsement situation above, termination of the plan could result in the employer becoming owner and beneficiary later on. Because the new rules do not define ownership, it is best to assume the rules apply to both endorsement and collateral assignment plans as a preventative measure.

Effective Date: These rules are effective for policies issued after August 17, 2006 unless the policy is issued pursuant to a 1035 exchange of a grandfathered policy. However, a material increase in the death benefit or other material change after August 17, 2006 may cause a policy to be treated as newly issued. The term "material" is not defined in the legislation, but the technical explanation provided by

the Joint Committee on Taxation states that increases in the death benefit attributable to § 7702 "definition of life insurance" tests or those that occur under the terms or operation of the original contract (e.g., paid up additions) are not material changes.

X. CHARITABLE PROVISIONS

A. IRA Distributions to Charity (aka Charitable IRA Rollover)

Current Law: If an individual wants to use IRA funds to make a charitable gift, the individual must withdraw the funds as a taxable distribution (subject to a 10% penalty, if under age 59½) and then make a gift to charity. This results in income and a charitable contribution as an itemized deduction. Even though it appears that the income and the deduction should offset each other, this very well may not be the case due to adjusted gross income (AGI) limitations on the amount of charitable contributions allowed as an itemized deduction and also due to the phase out of the itemized deduction.

New Law: An individual, upon attaining 70½, can make a lifetime gift of IRA funds from the IRA directly to a qualified charity, without including the amount in income and, of course, without taking a charitable deduction. The maximum gift is $100,000 per year for each of 2006 and 2007. The transfer must be made by the IRA trustee, meaning that the funds must not touch the individual's hands. The distribution counts as part of the individual's required minimum distribution (RMD). If the IRA has any basis, the contribution is deemed to come first from the taxable portion. If any portion is non-taxable, the individual can count that amount as a charitable contribution and take it as an itemized deduction. The entire payment must be a charitable contribution; if the donor receives a benefit (i.e., a $5,000 donation to attend a dinner where the cost of the dinner is $75), none of the payment qualifies for this treatment. This charitable IRA rollover treatment does not apply to SEP or SIMPLE IRAs nor to qualified plans. Also, distributions must be to a public charity or conduit private foundation; distributions to a donor-advised fund, charitable remainder trust or supporting organization do not get this treatment.

Effective Date: For distributions after December 31, 2005 and before January 1, 2008 (that is, 2006 and 2007).

Observations: Just because the law permits charitable IRA rollovers does not mean that IRA custodians will allow this. After all, we don't envision administrators relishing issuing hundreds of checks for

small amounts from IRAs to charities. The more likely scenario is that administrators will establish a minimum amount for doing so – perhaps something like $1,000. One wonders whether IRA custodians will even establish this program, after balancing the administrative burden, effort and cost for something that will be in effect for only two years.

This change, albeit short-lived, is great for those taxpayers who:

1. Do not itemize since, under old law, they would have included the distribution in income without any deduction. Under the new law, they do not include the amount in income.

2. Itemize because the income exclusion keeps their AGI lower, which translates to a potential increase in itemized deductions and personal exemptions if they are phased out and a lower floor for medical expenses (7.5% of AGI), non-business casualty losses (10% of AGI) and miscellaneous expenses (2% of AGI).

3. Don't need their RMDs. This change will lower their tax liability, and the charitable contribution will lower the account value, which will result in lower future RMDs.

4. Receive social security benefits; it may help to keep their income low enough to decrease or even eliminate the portion of social security benefits that are subject to income tax.

5. Live in states without state charitable deductions; this will lower their taxable income while still allowing them to make charitable contributions.

6. Make charitable gifts greater than the 50% AGI limitation; a charitable IRA rollover will garner a tax benefit without being subject to this limitation.

One word of advice – be sure to comply with all the requirements; failure to do so will result in having taxable income and a charitable contribution as an itemized deduction.

B. Required Reporting by Exempt Organizations Holding Certain Insurance (ChOLI Provisions)

New Law: If an exempt organization has a "reportable acquisition" in certain insurance, annuity or endowment contracts, it must file a return, disclosing the name, address and taxpayer identification number of the organization and the insurance issuer. A reportable acquisition occurs when an exempt organization acquires a direct or indirect interest in a life insurance, annuity or endowment contract where another person also has a direct or indirect interest in the contract (not necessarily at the same time) and where the acquisition is part of a structured transaction involving a pool of such contracts.

This requirement does not apply to a life insurance, annuity or endowment contract if:

1. All persons other than the exempt organization have an insurable interest in the insured.

2. The sole interest of the exempt organization or other person is as a named beneficiary.

3. The sole interest of each person other than the exempt organization is as a beneficiary of a trust with an interest in the contract if the person was named as a trust beneficiary without consideration and solely on a gratuitous basis.

4. The sole interest of each person other than the exempt organization is as a trustee with an interest in the contract held in a fiduciary capacity solely for the benefit of the exempt organization or persons described in the three previous exceptions.

The penalty for intentionally disregarding the requirement to file the return or to include the required information is the greater of $100 or 10% of the value of the contract.

Treasury must conduct a study on use of contracts by exempt organizations and whether it is consistent with the organization's tax exempt status.

Effective Date: Applies to acquisitions of contracts after August 17, 2006 and before August 18, 2008.

Observation: In recent years, transactions between investor groups and charities involving life insurance have sprung up. The charity, with an

insurable interest, allows an investor group, without an insurable interest, to share in the life insurance contract. The government initially wanted to impose an excise tax on transactions involving charities, insurance and investor groups; however, there were serious issues with the wording of proposed legislation for an excise tax. This new section reflects the government's struggle to define the situations demanding an excise tax. Perhaps the government will sift through the reported transactions to narrowly draft legislation imposing an excise tax on those situations deserving of an excise tax.

Although this is simply a reporting requirement imposed on the charity, we may be catching a glimpse of where future legislation will be going. If so, it doesn't appear that the typical planning with life insurance will be affected since our planning concerns situations where insurable interest is present. However, do the above requirements show an ever-so-slight chipping away of the typical rule about judging insurable interest only at the inception of the life insurance? After all, this provision determines insurable interest – at least for its purposes – at the time the charity acquires the interest.

C. Limit on Deductions of Clothing and Household Items

Current Law: None (other than the general rule that deductions are based on the fair market value of the donated property).

New Law: An individual, partnership or corporation can take a deduction for contribution of clothing or household items (furniture, furnishings, electronics, appliances, linens and other items but not food, paintings, antiques, art objects, jewelry, gems and collections) only if it is in good used condition or better. This requirement does not apply for a single item where the deduction is more than $500 if the taxpayer includes a qualified appraisal with his tax return. For an S corporation or partnership, this treatment is applied at the entity level but any denial of the deduction is made at the partner or shareholder level.

Effective Date: For contributions made after August 17, 2006.

Observation: The new law reflects the I.R.S.'s struggle with the administratively burdensome and highly-factual task of determining the fair market value of tangible personal property. Unfortunately, because "good used condition or better" is not defined, the struggle will continue.

D. Recordkeeping Requirements

Current Law: For cash contributions under $250, the taxpayer needs to keep the canceled check, a receipt with the donor's name, date of the gift and amount of the gift or other reliable record. For cash contributions of $250 or more, the taxpayer needs a contemporaneous written acknowledgment.

New Law: For contributions of cash, check or a monetary gift, regardless of the amount, the donor must maintain a bank record or a written communication from the donee, with name of donee, date of contribution and the amount of the gift.

Effective Date: For contributions made in taxable years beginning after August 17, 2006.

Observation: It appears that a reliable record is no longer acceptable proof of a cash contribution. The law remains unchanged with respect to the need for a contemporaneous written acknowledgment for cash gifts of $250 or more.

E. Fractional Interests in Tangible Personal Property

Current Law: A taxpayer can get income tax, gift tax and estate tax charitable deductions for a gift of an undivided portion of a taxpayer's entire interest in tangible personal property. The amount of the deduction for a fractional gift, including any later fractional gift of the same property, is based on the fair market value at the time of the gift.

New Law: <u>Income Tax and Gift Tax</u>. A taxpayer can get income tax and gift tax charitable deductions for a gift of an undivided portion of a taxpayer's entire interest in tangible personal property if all interests before the contribution are held by either the taxpayer or the taxpayer and the charity. If an additional contribution is made after the initial contribution, the fair market value of the item is the lower of the fair market value as of the date of the initial contribution or the subsequent contribution.

The income tax and gift tax deductions only "stick" as long as:

1. the taxpayer gives the remaining interest to the charity at the earlier of ten years after the initial contribution or the donor's death *and*

2. the charity has had substantial physical possession within the earlier of ten years after the initial contribution or the donor's death *and*

3. the charity puts the property to a related use within the earlier of ten years after the initial contribution or the donor's death.

If these requirements are not met, there is a recapture of the deduction plus a penalty of 10% of the recaptured amount.

Estate tax: If an additional contribution is made after the initial contribution, the fair market value of the item is the lower of the fair market value as of the date of the initial contribution or the subsequent contribution.

Effective Date: For contributions made after August 17, 2006.

Observations: The new law makes significant changes to gifts of fractional interests in tangible personal property. Following is an illustration of a gift which, under old law, was deductible but is not deductible under the new law. Two brothers jointly own a painting. One brother decides to give his 50% share to a charity. There is no charitable deduction because, before the gift, a person other than the donor or the charity has an interest in the painting.

For subsequent gifts of appreciating property, the new valuation rule mandates a consistent value, i.e., the fair market value at the time of the initial gift is used as the fair market value at the time of the subsequent gift. While there may be some appeal to this type of consistency, it falls apart rather quickly with depreciating property. In that instance, the lower fair market value at the time of the subsequent gift is used.

With subsequent gifts of fractional interests in appreciating property, a taxable gift or a taxable bequest can occur. Consider this situation: a donor gives 40% of a valuable painting worth $1 million to a charity during life. The remaining 60% is given to the charity when the painting is worth $1.5 million. For gift or estate tax purposes, the painting is valued at the time of the gift ($900,000), while the charitable deduction is the lower fair market value at the time of the initial gift ($600,000), unfairly resulting in a taxable gift or taxable bequest of $300,000.

The new law discourages fractional gifts and provides some incentive for a taxpayer to give the entire property interest to the charity at one time.

F. Charitable Deduction Reduction/Recapture for Contributions Over $5,000 Not Used for a Related Use

Current Law: No provision for reduction or recapture of the charitable deduction.

New Law: A deduction for related-use tangible personal property is reduced or recaptured under the following circumstances:

1. The deduction is based on the fair market value of the property.
2. The charity specifies (on Form 8283) that the property will be put to a related use.
3. The charity disposes of the property within three years of the gift.
4. The charity does not make a certification, which it gives to the donor, as to related use of the property.

If the charity disposes of the property in the same year as the contribution, the deduction is reduced to basis. If the charity disposes of the property in a different year, the portion of the deduction over basis is recaptured.

Effective Date: For contributions after September 1, 2006.

Observations: This law applies to contributions of appreciated tangible personal property where the deduction claimed is more than $5,000. This law encourages donors and charities to be surer about stating that tangible personal property will be put to a related use in that it provides consequences if the donor claims related use when the opposite turns out to be true – no matter how much good faith is present.

G. Returns for Disposition of Donated Property (aka Tattle-Tale Section)

Current Law: If a charity disposes of property donated to it within two years of the contribution, the charity must report it to the I.R.S. on Form 8282, including the name, address and taxpayer identification

number of the charity and the donor, description of property, date of contribution, date of disposition and amount received. This only applies to property other than marketable securities where the deduction claimed was more than $5,000.

New Law: The two-year time frame is increased to three years. In addition to the information to be supplied to the I.R.S., the charity must include a description of the charity's use and whether it was a related use. If it was a related use, then the charity must also include its related-use certification if one is made under § 170(e)(7).

Effective Date: For contributions reported on returns filed after September 1, 2006.

Observation: This provision, coupled with the one preceding and the one following, indicate the I.R.S.'s attempt to tighten up the rules relating to donations of related-use tangible personal property where the deduction is more than $5,000.

H. Penalty on Related Use

New Law: A penalty of $10,000 is imposed on any person identifying tangible personal property as related-use property when that person knows the property is not intended for a related use.

Effective Date: For identifications made after August 17, 2006.

Observation: Related use is identified by the charity on Form 8283 when the donation claimed is more than $5,000. This law then imposes a penalty on the person signing the Form 8283 on behalf of the charity.

I. Additional Regulation and Excise Taxation of Donor Advised Funds

Current Law: Donor advised funds (DAFs) are typically established by community foundations (and more recently, by financial institutions) to receive contributions from donors, with the donor receiving a current income tax charitable deduction. The DAF then makes grants to charities. Donors are typically able to suggest (but not direct) the timing, amount and charity receiving grants made from their fund.

There is very little guidance from the Service on DAFs. DAFs are not currently subject to the many and burdensome rules that govern private foundations.

New Law: The new law gives us some more certainty about DAFs, but also creates additional regulation. A new code section - § 4966 – now defines DAFs and sponsoring organizations:

1. A DAF is a fund that is separately maintained with respect to a donor or donors, controlled by a sponsoring organization and with respect to which the donor (or donor's designee) has an advisory role in the investment or distribution of amounts held in the fund.

2. Sponsoring organizations are certain public charities that maintain one or more DAFs.

Theses new Sections impose excise taxes of 20% of the distribution on the sponsoring organization and 5% on the fund manager for making taxable distributions – essentially distributions to noncharitable beneficiaries and certain supporting organizations. New § 4967 imposes an excise tax of 125% of the benefit on the donor (or other person giving the "advice") and an excise tax of 10% of the benefit on the fund manager for making a distribution that provides more that an incidental benefit to a disqualified person – generally the donor and his family and the investment advisor and his family.

The private foundation rule on excess business holdings now applies to DAFs.

In order to obtain a deduction for a contribution to a DAF, the donor must obtain a written acknowledgment from the sponsoring organization indicating that the organization has "exclusive legal control over the assets contributed."

The Secretary of the Treasury is instructed to study DAF for one year to determine whether the deductions taken by donors are appropriate given the donor's retained "control" and whether the distributions made by the funds are appropriate in keeping with their charitable purpose.

Effective Date: Effective generally for transactions after August 17, 2006 and for tax years beginning after that date.

Observations: The new rules will bring DAFs closer in line with private foundations in terms of regulation and taxation. Costs of administration (both in terms of dollar cost and burden) are still less for DAFs, making them the more appropriate option for donors who are contributing smaller amounts.

With respect to the Secretary's study – does this hint that Congress is concerned with abuses related to DAFs? Are these funds too good to be true? Stay tuned…

J. S Corporation Stock Basis Adjustment

Current Law: When an S corporation makes a charitable contribution of property, the S corporation shareholder's basis is decreased by his or her pro-rata share of the fair market value of the charitable contribution.

New Law: When an S corporation makes a charitable contribution of property, the S corporation shareholder's basis is decreased by the shareholder's portion of the property's adjusted basis.

Effective Date: For contributions made in taxable years beginning after December 31, 2005 and before January 1, 2008.

Observation: The net result is that, for a charitable contribution of appreciated property, the shareholder's basis will be higher under the new law than under the old law – a plus in the event of a stock sale or S corporation distributions.

K. Limitations on Donations of Qualified Conservation Contributions

Current Law: Qualified conservation contributions are deductible despite being a partial interest; however, the general charitable deduction rules and limits apply. Very generally, an individual's deduction for long-term capital gain property is the fair market value of the property, subject to a 30% AGI limitation; the deduction for short-term capital gain property is the lower of basis or the fair market value of the property, subject to a 50% AGI limitation. A corporation's deduction is limited to 10% of its taxable income, with some adjustments. The maximum carry-forward for any excess amount for both an individual and a corporation is five years.

New Law: For individuals, the limitations on a qualified conservation contribution are 50% of AGI with a carry-forward of 15 years; any

other limitation does not apply (i.e., long-term capital gain property having a 30% AGI limitation). If the individual is a qualified farmer or rancher, then the AGI limitation is 100%, provided that the property is restricted to remain available for agriculture or livestock production.

For a corporation which is a qualified farmer or rancher, if the donated property is restricted to remain available for agriculture or livestock production, and after accounting for donations subject to the 10% limitation, the AGI limitation is the balance of the corporation's taxable income, with a 15 year carry-forward.

Effective Date: For contributions made in tax years beginning after December 31, 2005 and before January 1, 2008.

Observation: A qualified conservation contribution may not be used often, but the new law provides tax-favored incentives for these contributions by individuals and corporations. Permissible recipients include certain governmental units, public charities that meet certain public support tests and certain supporting organizations.

L. Penalty on Appraisers

New Law: If an appraiser knows or should have known that an appraisal will be used with a return or claim for refund and there is a substantial or gross valuation misstatement, then there is a penalty on the appraiser. The penalty is the greater of $1,000 or 10% of the underpayment, but no more than 125% of the appraisal fee. There is no penalty if the appraisal value was more likely than not the proper value.

Effective Date: For appraisal prepared for returns filed after August 17, 2006.

Observation: The new law is not limited to people who are in the business of doing appraisals; it applies to anyone who prepares an appraisal. Arguably, this new law only applies to appraisals for income tax purposes, not for estate or gift tax purposes.

M. Penalty Excise Taxes on Public Charities, Social Welfare Organizations, Private Foundations and Foundation Managers

Current Law: Penalties and taxes are imposed for various acts by a foundation and/or a foundation manager.

New Law: Penalties and taxes continue to be imposed, but the amounts are doubled; see below.

Tax	Old	New
Initial tax on foundation manager who knowingly • participates in self-dealing between disqualified person and private foundation • makes a taxable expenditure	2½%	5%
Initial tax on disqualified person for self-dealing between disqualified person and private foundation	5%	10%
Initial tax on a foundation manager for knowingly making a jeopardy investment		
Initial tax on private foundation for • excess business holdings • jeopardy investments		
Initial tax on a private foundation for taxable expenditures	10%	20%
Initial tax on a private foundation for failure to distribute all income	15%	30%
Maximum initial tax on a foundation manager, per act, for knowingly making: • a jeopardy investment • a taxable expenditure	$5,000	$10,000
Maximum initial tax on foundation manager, per act, for knowingly participating in self-dealing between disqualified person and private foundation	$10,000	$20,000
Maximum additional tax on foundation manager, per act, for refusing to agree to: • part or all of the correction of self-dealing between disqualified person and private foundation • part or all of the correction for a taxable expenditure • part or all of the removal of the jeopardy		
Maximum initial tax on organization manager, per transaction, for knowingly participating in an excess benefit transaction		

Effective Date: For tax years beginning after August 17, 2006

N. Contributions of Book Inventory to Public Schools and Food Inventory

Current Law: Deductions for charitable contributions of book inventory to public schools and of food inventory are scheduled to expire at the end of 2005.

New Law: The deduction for these contributions is extended through December 31, 2007.

Effective Date: For contributions made after December 31, 2005 and before January 1, 2008.

XI. QUALIFIED TUITION PROGRAM RULES MADE PERMANENT

Current Law: Provisions of EGTRRA relating to qualified tuition plans (529 plans) are scheduled to expire after December 31, 2010.

New Law: EGTRRA's provision affecting 529 plans are permanent. Some of the notable rules that avoid the sunset include:

1. income tax-free distributions for qualified higher education expenses,

2. tax-free rollovers allowed once every 12 months,

3. a 10% penalty on nonqualified distributions,

4. qualified distributions for education expenses of special needs students, and

5. the cap on room and board expenses.

Effective Date: August 17, 2006.

Observations: This is great news for parents saving to send their children to college after 2010. They no longer have to worry about taxable 529 distributions for Junior's tuition. Instead, they can spend more time worrying about whether their 529 account balance is increasing as fast as tuition rates.

The permanent extension applies to both 529 savings and prepaid plans. However, there are no permanent extensions for provisions relating to another education savings technique, the Coverdell Education Savings Account (ESA). If these provisions are not extended under other legislation, starting in 2011, contributions to ESAs will be limited to $500 and qualified distributions will only be allowed for higher education expenses. Parents with ESAs should not hit the panic button. Even if Congress doesn't act, parents can use ESAs to pay for elementary and secondary education expenses through 2010.