Business Insurance Opportunities Under the 2004 Jobs Creation Act

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When a new law is passed that affects businesses, their owners and key executives, we have an opportunity to visit with prospects and clients to see how the new legislation impacts them as well as identify new ways in which our services and products can help them to meet their planning objectives particularly in light of the newly passed law.

The American Jobs Creation Act of 2004 is no exception. Whether or not the Act, as we will call it from now on, will live up to its name and help create jobs is anyone's guess but we do know, as several legislators stated at the time of its passage, that it is the most significant corporate tax reform bill in decades.

There are three primary areas of interest impacted by the Act for life insurance planning professionals. These are:

1. Non-qualified deferred compensation;
2. S-Corporations; and,
3. Anti-tax shelter measures.

We will cover each area, particularly the first one in depth, and identify the related insurance sales opportunities created for you by the Act. You'll see how the various portions of the Act give you a variety of reasons to meet with your business clients to review their ongoing objectives.

In the non-qualified deferred compensation planning arena, the Act added Internal Revenue Code Section 409(A) specifically addressing non-qualified deferred compensation. As you all know, non-qualified deferred compensation plans are commonly offered to highly compensated and valued executives of mid-size and large companies. A small company may also offer such a plan in order to retain just one or two prized employees offering valuable skills and services to the organization.

These plans offer additional income deferral to highly compensated individuals and possibly other incentives in the form of company matches to the deferral or additional contributions to the plan based on individual and/or company performance. Some plans may have no income deferral element but offer benefits paid solely by the

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employer for the participant's future benefit. Even when income deferral is not part of the plan, it is still considered a deferred compensation plan since the plan benefits are not currently recognized for income tax purposes and income tax is paid when benefits are actually received by the plan participant.

Under these plans, in exchange for the executive's ability to defer taxable income, the sponsoring employer is not allowed an income-tax deduction at the time of deferral and the assets backing the promised plan benefits are treated as general business assets subject to the claims of the company's creditors.

For years, these plans have been informally funded with life insurance policy cash values and death benefits and, fortunately for us, this new law has no direct impact on the use of business-owned life insurance for that purpose.

Instead, the new law tightens the rules for non-qualified plans and offers clear guidelines in designing and developing such plans. The new legislation makes these plans closer, from an operations standpoint, to qualified plans while still allowing sponsoring employers to selectively choose plan participants from the ranks of the highly compensated employees.

For us, this means an opportunity to meet with companies sponsoring these types of plans, their professional advisors and with plan participants to discuss how these new rules affect them. Every non-qualified plan in the country needs to be reviewed and, if not already done so, new language added to the plan document to satisfy the new statutes.

While larger organizations may have advisors who have already helped them meet these new rules, it's quite possible that smaller organizations are not even aware of the changes. After a thorough review, some companies may choose to install new plans that will be subject to the new rules while keeping their grandfathered plan intact to take advantage of the prior legal environment. You can provide a huge service in helping these business clients determine their course of action in meeting the new rules as you work with them and their other professional advisors.

According to a 2004 LIMRA survey, 27% of businesses with executive benefits plan to add an additional benefit within 12 months, so approaching these businesses about the impact of the Act can lead to new insurance sales for you both with the existing plan and perhaps with other benefit needs.

You can also review the current funding level of these plans. Remember, that non-qualified plans are often informally funded with cash value life insurance policies and as I stated before, such funding is not impacted directly by the new law. But, are the policies performing adequately? Do they need additional insurance policies as new people have joined the plan?

In addition, if you work with individuals participating in these plans, you can help them understand how the legal changes affect them and if other solutions are needed to help the individual meet his retirement or insurance planning needs. This can lead to a whole range of new sales opportunities.

Another great opportunity brought about the Act is the ability to use it for prospecting with attorneys and CPA's. You can share with them these major tax law changes and might consider conducting a seminar to update them. Firms that specialize in these areas will likely be up to speed but you can concentrate on general practitioners who may be less familiar with non-qualified plans than with other areas of tax law. When you offer this type of valuable information you become, in their minds, the source for non-qualified plans or structuring a buy-sell for Sub-S owners. Right now, this summer, is a great time to conduct these seminars before the busier third and fourth quarters of the year.

In order to have these discussions with our clients, of course, we need to understand the major provisions of the new law.

Before we look at the new provisions in detail, let's identify the primary reasons for these changes to non-qualified plans. The new law is based on Congressional belief that:

- Many non-qualified deferred compensation plans have allowed for improper deferral of income.

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- There often exists an inappropriate level of participant control or access to amounts deferred under a program and an inappropriate use of trust instruments such as offshore rabbi trusts; and,

- Due to recent abuses with some plans, there should be specific statutes governing these plans similar to qualified plans as both the public and Congress were unpleasantly surprised when big companies such as Enron and Adelphia went into bankruptcy, but their top officers, who some claimed were responsible for the financial collapse, still had access to their non-qualified plan benefits.

Under the Act, the definition of a non-qualified plan is broad and includes any arrangement or agreement, including those covering only one person that provides for the deferral of compensation. Arrangements that are specifically excluded from Section 409(A) include qualified plans, any bona fide vacation leave, sick leave plans, compensatory time, disability pay and death benefit only plans. The new Code Section will not apply to annual bonuses or other annual compensation paid within two and one-half months after the close of the tax year in which services were provided.

Government representatives have told industry groups, most notably AALU, that severance plans may be covered and Treasury is considering an exception for broad-based severance arrangements that cover rank and file employees. However, these government representatives are concerned that if they provide any additional exceptions for severance arrangements that just cover executives and highly-compensated employees, there would be significant potential for abuse so likely those plans will fall under the scope of the Act.

While Act applies to many types of non-qualified plans, I'll limit my comments to the type of plan that allows a selected employee to defer income often in excess of a company-sponsored 401(k) plan. The non-qualified plan may provide additional employer matches to the amounts deferred. Keep in mind, a company does not have to offer a 401(k) plan to offer this type of additional non-qualified plan but generally most do so.

One of the most fundamental requirements for effective deferral of income under a non-qualified deferred compensation plan is the "substantial risk of forfeiture" doctrine. The participating employee must have a real risk that if certain conditions are not met, the amounts deferred under the program will be forfeited. Under prior law, no specific guidelines were available. Determining whether amounts could be effectively deferred from income taxes depended upon the "fact and circumstances" of the arrangements relying on past IRS rulings and court cases.

Now, however, Section 409(A) sets specific requirements for a "substantial risk of forfeiture" to exist. These requirements cover certain restrictions in the areas of distributions, acceleration of benefits and the use of election deferrals.

We'll start with the key area of distributions as this area has some of the most dramatic changes. Under the Act, distributions of benefits under a non-qualified plan are limited to one of six specific events:

1. Separation from service
2. Disability of a plan participant
3. Death
4. A time or fixed schedule specified under the arrangement as of the date of deferral
5. Change in ownership or control of the corporation, or a substantial portion of the corporation's assets.
6. The occurrence of an "unforeseeable" emergency.

Let's look at each one of these in a little more detail. For separation from service, distributions to "specified employees" cannot be made sooner than either 6 months after separation from service or the date of the employee's death. A "specified employee" is defined as a key employee working for a publicly traded company who is one of the following:

- An officer with annual compensation greater than $130,000 (adjusted for inflation) and limited to 50 employees of the company;

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- A 5% owner; or
- A 1% owner having annual compensation from the employer greater than $150,000.

Meeting the separation from service definition is confusing when an employee terminates employment from one company that is owned by another company where the employee then begins new employment. So the Act has employer aggregation rules. If an employee stops working for one entity within a control group but starts or continues to be employed by another entity within the same group, he or she will not have met the separation from service requirement for a plan distribution. We don't yet have the definition of control group but the IRS is expected to provide guidance on employer aggregation rules and these regulations will likely be similar to rules for qualified plans.

For the next distribution event, disability, the participant must be unable to engage in any substantial activity due to physical or mental impairment that can be expected to result in death or that the condition will last for a continuous period of at least 12 months. Also, disability can be defined as a situation where, because of physical or mental impairment, the participant has received disability income benefits for a period of not less than 3 months under the employer's accident or health plan.

Of course death is a rather extreme distribution event and one not likely popular with many of our clients but it does allow for plan benefits to be distributed to the plan beneficiary.

The schedule requirement for a distribution is one of the bigger changes for most plan participants in that the use of a schedule has now eliminated the common use of an event as a trigger for distribution of benefits. For instance, in the past, many plans had language allowing a distribution of a certain percentage of plan benefits when a participant's child began college. College attendance by a dependent was the event that triggered a partial payout. Now, since such a provision would be considered an "event," it cannot be the trigger for any benefit payments to the participant.

The Congressional Committee Report cited the college example specifically as an event that could not trigger a benefit payment but it went on to state that the attainment of a specified age, such as 65, would not be considered an event and could qualify for distribution under a schedule.

So, we can still have distributions made for a child's college expense but rather than specifying college attendance as the trigger, a corresponding date or age of the participant should be used such as distribution at age 50, which is the same year when the participant's child will likely attend college. Of course the downside is the child may choose Europe over college and our plan participant would still receive a distribution since he attained age 50 and would have to pay ordinary income tax on it.

Another event that can cause a distribution is change in ownership or control of the corporation sponsoring the non-qualified deferred compensation plan. The IRS will release regulations concerning what constitutes a change in ownership or control allowing for a distribution of plan benefits to participants.

Distributions under the occurrence of an unforeseen emergency include a severe financial hardship due to an illness or accident of the participant, his or her spouse or dependent. It also includes loss of the participant's property due to casualty or other similar extraordinary and unforeseeable circumstances beyond the participant's control.

As an example, it's likely that distributions under the unforeseen emergency provision could have been made last year when three hurricanes hit Florida and homeowner's insurance coverage was limited. Then, even highly paid individuals may have had problems raising the capital needed to repair their homes. The Act states that the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution.

Another change affecting distributions is that the time and form of distribution must be selected at the time of initial deferral election. If a plan allows a subsequent election to delay payment or the form of payment,

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the following requirements must be met under the plan document:

- The change cannot be effective until at least 12 months after the date the election is made so if we elect to change our distribution age from 55 to 60 such an election would need to take place by the time we reach age 54 to be effective.
- For an election related to an additional deferral of payment, unless the payment is due to disability, death or an unforeseeable emergency, the first payment must be deferred for a period of at least 5 years from the date on which the payment would otherwise have been made. So again, if we're age 55, our election to defer to age 60 would work, but we could not have elected age 57 when payments were to begin since the deferral would be for less than 5 years.
- Any election related to a payment made at a specified time or fixed schedule, cannot be made less than 12 months before the date of the first scheduled payment. Let's say the initial election was for a lump sum payment on the first day of the month the individual turned age 60 which, in our example, we'll say is May 1, 2006. In July of 2005, the participant realizes he doesn't want a lump sum benefit in one year that greatly boosts his income so he wants to elect to receive payments on a quarterly basis over 5 years. Unfortunately for him, it is too late. His payment is scheduled to be made within the next 12 months and the new election is not valid.

Under the new law, non-qualified plan participants also lose the ability to accelerate benefits. In the past, a plan could accelerate distribution of benefits as long as the accelerated benefit was subject to a haircut provision. A haircut results in some reduction of the amount distributed to the participant, typically 10%. Under the Act, any acceleration of benefits except for the distribution situations we've already covered will not be allowed. There is pending guidance from the IRS that might give us some acceleration exceptions such as a distribution under a divorce decree.

These new distribution rules greatly limit a participant's ability to get an in-service distribution except in situations similar to a qualified plan. Therefore, highly compensated executives will need to give greater weight to their short-term liquidity and income needs when deciding if they want to defer income under a non-qualified plan and to what extent they are comfortable in deferring a relatively large portion of their income given these tighter distribution rules.

For life insurance producers, these new provisions might lead some of these executives to consider diverting some of the money that would have been deferred into a non-qualified plan, into personal retirement planning vehicles such as variable or fixed deferred annuities as well as variable or fixed life insurance policies which can allow greater access to the money if it is needed before retirement.

Of course, these annuity and insurance products are funded with after-tax dollars so the executive gets no immediate income tax relief and deferred annuities do have a 10% income penalty tax if the owner is under age 59½ at the time of withdrawal. But a non-modified endowment life insurance policy would have no such penalty. So these products with their tax-deferred growth and those in the variable arena that additionally have the ability to transfer funds between sub-accounts on a tax free basis, could see increased favor by highly-taxed individuals formerly deferring a relatively large portion of their income into a non-qualified plan.

Not only distribution but initial deferrals are also an area that has come under greater regulation. Now, in general, compensation for services performed during the taxable year can only be deferred if the election is made no later than the close of the preceding tax year or at another time as provided by further regulations.

So the election to defer income in 2006 must be made in 2005. However, there is an expected exception for performance based compensation such as a bonus earned in 2005 but payable in 2006. While I said earlier that bonus plans, in and of themselves are not subject to the new rules, if an individual wants to defer any of his or her

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taxable bonus, the deferral must comply with 409(A). So that bonus, though it was earned in the year of the election, can be subject to the deferral since it is paid in the following year as long as services were performed for a period of at least 12 months and the election for deferral is made no later than 6 months before the end of effective period, usually the calendar year. So for a 2005 calendar year plan, the election would need to be completed no later than July 1, 2005 for a bonus paid in 2006 but based on 2005 service.

In 2004 and likely in 2005, the Service has provided an exception to the six month rule since non-qualified plans did not have clear guidance and last year did not have the time to meet the requirement. Whether or not, the Service will continue to make exceptions for the 6 month rule is unclear pending final regulations.

Lastly, for the first year of eligibility, the election for deferral must be made within 30 days after the date the participant becomes eligible to defer income under the plan. Eligibility is often based on some minimum compensation amount or the attainment of a certain rank in the company such as vice president. Upon that occurrence then, the election for future deferral must be made within 30 days.

Another area of Congressional concern addressed by the Act is the use of foreign trusts to hold non-qualified plan assets. The Act effectively eliminates the use of offshore trust since the placement of any assets in such a trust will result in immediate income taxation to the plan participant under Code Section 83, which is the code section under which an employee recognizes income when services are performed in exchange for property.

Here again, Congress was concerned that the assets in these trusts actually gave the non-qualified plan participant a greater degree of security in obtaining the assets than was available to the company's general creditors and that the executives had discretion over these assets in a manner inconsistent with a non-funded non-qualified deferred compensation program.

The financial collapse of high profile companies in the past few years also led Congress to require that a non-qualified deferred compensation plan could not provide that the deterioration of the sponsoring employer's financial condition would trigger payment of plan benefits. Under the Act, the mere inclusion of such a trigger in the plan document will cause inclusion of income, again under IRC Section 83, even if the assets are available to satisfy the claims of the company's general creditors.

The Act has some severe penalties if a deferred compensation plan fails the requirements of the new code section 409A resulting in previously deferred compensation being now included in taxable income. Not only would ordinary income tax be due based on the inclusion but in addition, the tax is increased by interest starting the day that the deferred compensation was no longer subject to a substantial risk of forfeiture.

The interest is based on the underpayment rate plus 1%. While not exactly clear at this point, it appears the underpayment rate is likely referenced using the Section 6621(a)(2) underpayment rate so in total, the rate is likely equal to the federal short term rate plus 4%. Right now, that rate would be equal to something like 7%. In addition to the interest rate, the amount owed to the IRS is also increased by a 20% of the amount of compensation previously deferred. So plan participants could lose anywhere from 30 to 50% of their benefits to income and penalty tax when a plan violates the new Act so making sure a plan conforms is of huge importance.

The effective date of these changes was December 31, 2004 meaning that amounts deferred and vested before January 1 of this year will be considered deferred before the effective date and will not be subject to the new rules. However, a material modification of a pre-January 1, 2005 plan after October 3, 2004 will make the plan subject to the new rules.

What is a material modification? Under the Committee Report, the addition of any benefit or feature is considered a material modification but the exercise or reduction of any existing benefit, right or feature will not be considered a material modification.

For example, adding a haircut provision will be a material modification but removing such a provision would

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not be one. A change in plan administrator would not be a material modification. The changing of life product used to informally fund a plan from one carrier to another should not be considered a material modification since life insurance policies are used to informally fund a plan and are not tied directly to any benefit or feature of the plan.

So in summary, the Act's changes do bring more qualified plan type rules to non-qualified plans in the key areas of distribution by defining certain external events such as separation from service, disability or death that will trigger a payout. The Act eliminates the ability to generally access any plan benefits while still employed by the plan sponsor by eliminating most benefit triggers for a participant but careful drafting of the plan document can provide some in-service benefit payments.

The Act also adds new rules concerning deferral elections and when they must take place to effectively defer taxable income. It effectively eliminates the use of off-shore trusts to hold assets and places a significant tax burden through the form of interest and a penalty if the plan violates any of these areas.

So is there any good news? Yes. Non-qualified plans can continue to offer income tax deferral and enriched benefits for selected employees in a business. The plans can continue to be informally funded on a tax favored basis using cash value life insurance and to the extent the plan participant is leery of the inability to access funds before the schedule mandated in the plan, he or she might use annuity and life insurance products to enrich his personal retirement savings.

Let's now turn our attention of another area of change brought by the Act and that is S corporation reform. As we've seen, the S form of corporate entity is hugely popular providing flow through income taxation to the business owners so there is no income tax recognition at the business level while offering other traditional corporate benefits such as limited liability, shares of stock for ownership transfer and unlimited life of the corporation.

S corporations were first established in the Code in the 1980's and needed updating so the Act makes it easier for businesses to qualify and operate as an S corporation with most provisions effective the first day of this year. One of the changes is increasing the maximum number of shareholders allowed for an S corporation from 75 to 100. In addition, members of a family, up to six generations, are treated as one shareholder and this can include an adopted child.

The definition of family is very broad and includes all family members that have a common ancestor, lineal descendents of the common ancestor and the spouses, or former spouses, of the lineal descendents or common ancestor. So, under the Act, even cousins could be included in the definition of family member if they have a common ancestor such as a grandfather or grandmother.

Anytime that we have a law making it easier for businesses to select a popular form of taxation is a good time to visit with our small business owner clients. Even if they are already a sub S corporation as so many of them are, you can bring them up to date on the changes particularly in regard to family members being treated as one shareholder since this have become a problem for many of them. Once you are with them you can discuss with them their overall business succession planning.

Is there an up to date and funded business succession plan? According to LIMRA, less than half of all small businesses have a formal arrangement plan and of those arrangements, life insurance was used only 57% of the time. How are the other plans going to fund the obligation? For those with life insurance, is it up to date? Does the client have adequate coverage to meet the current valuation of the business? These discussions will lead to new sales for you.

The last area we'll cover today is not a sales opportunity but is an area that as insurance sales professional, you need to be aware of in regard to your sales activity. Under the Act, there are new anti-tax shelter provisions that increases penalties to taxpayers, promoters and advisors related to reportable transactions as defined by the IRS.

A reportable transaction is any transaction that the IRS determines has a potential for tax avoidance or

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evasion under Code Section 6011. Specifically, items subject to these rules are:

- Any listed transaction, and
- Any reportable transaction (other than a listed transaction) if a significant purpose of the transaction is to avoid or evade income tax

In Notice 2004-67, the IRS provided current listed transactions and they will alter this list periodically through new published bulletins. Of particular interest to us on the current list, is the inclusion of multiple welfare benefit and trust plans under Code Section 419(A)(f)(6). As you may know, these plans had been popular in the 1990's using cash value life insurance policies to provide pre-retirement death benefits. Further clarifications by the IRS in 2003 led many to believe that these plans could not contain permanent cash value life insurance policies.

Currently, the IRS is including these plans as a listed transaction meaning that the taxpayers participating in these plans will need to file an attachment to their income tax returns indicating involvement in a multi-employer welfare benefit plan. Obviously this could lead to a greater degree of scrutiny of that particular return by the IRS.

But this inclusion also has implications for us due to the material advisor rules established by the Act. A material advisor is defined broadly as anyone who is involved with a listed transaction and who derives gross income from that assistance in excess of $50,000 per individual or $250,000 outside of an individual arrangement such as through a corporate entity. Gross income for threshold amounts can include a combination of services, for example, promoting and selling, or organizing, promoting and insuring, directly or indirectly.

If we are considered a material advisor, we must also file an informational return with the IRS for the reportable transaction describing the transaction, any potential tax benefits expected and provide any other information that might be requested by the IRS. We must also keep a list of all the individuals who we have assisted in a particular listed transaction as a material advisor.

If we fail to file an informational return, the penalty is $50,000. We must also keep a list of all taxpayers that we assisted as material advisors in a listed transaction. If we fail to keep the list or have it available for the IRS, there is a $10,000 penalty per day that the list is not available. It appears these penalties will only be waived in rare circumstances.

The penalty is higher if the transaction is a listed transaction and could be even higher if there is an intentional disregard by the material advisor of the disclosure requirements.

Here is exactly how it works: There is a $50,000 penalty for each failure, if the failure relates to a listed transaction; the penalty is increased to the greater of (1) $200,000, or (2) 50% of the gross income received by the material advisor attributable to the aid, assistance, or advice which is provided to the listed transaction. If the penalty is related to an intentional disregard to the reporting rules, the penalty is increased to 75%

Even what appears to be rather bad news for some advisors can be used as a sales tool for many of us. You now have another reason to contact your business clients and share with them that certain transactions are now listed ones that must be reported to the IRS and you should ask to meet with them to see if any of the transactions apply to them. Based on your conversation with them, even though they likely are not participating in a listed transaction, you can then suggest planning options that meet their needs with your assistance. If they are participating in such a transaction, you can inform them that they must work with their professional advisors in adequately reporting the transaction.

Change is a salesman's best friend. And this Act, with changes in non-qualified deferred compensation plans, sub-S status rules and listed transactions, gives us plenty of opportunities to meet with our business clients and show them how our products and services can help them cope with the new law while meeting their planning objectives.