June 5, 2006

Recent Legislative Activity as Pension Conference Continues to Move Slowly

As Congress prepared to leave for the Memorial Day recess, they enacted two pieces of legislation which had implications for employee benefit plans. Of more significance, however, was what didn't happen. The pension reform legislation was not resolved and negotiations among the conferees continue.

A. Tax Increase Prevention and Reconciliation Act

After a long conference, Congressional leaders passed a budget-related tax cut bill (H.R. 4297, the Tax Increase Prevention and Reconciliation Act) that, among other things, extends the lower tax rates on capital gains and dividend income for two additional years through 2010 (when all of the so-called Bush tax cuts will expire), and provides temporary relief for some taxpayers from the alternative minimum tax.

1. Elimination of Income Cap for Roth IRA Conversions

The tax cut bill was scored at just under the "$70 billion over five years" cap that Congressional tax-writers had to stay within to protect the measure from a potential filibuster under special budget rules. Thus, the tax-writers had to come up with a number of revenue raisers as offsets for the tax relief provisions, including costs occurring outside the five-year budget window. The largest of these revenue raisers is a provision that would eliminate the income limit on conversions of traditional IRAs to Roth IRAs. This provision, however, is not effective until 2010 because tax-writers needed to raise revenue in the years following 2010 to stay within the $70 billion cap.

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Under current law, taxpayers who hold traditional IRAs can generally convert their account balances to Roth IRAs, but only if their adjusted gross income ("AGI") in the year of conversion does not exceed $100,000. If traditional IRA amounts are converted to a Roth IRA, taxpayers are required to pay taxes on all untaxed amounts in the year in which the conversion occurs.

Effective for tax years beginning after 2009, the $100,000 AGI limit would be eliminated, thereby allowing taxpayers with income over this amount to convert their traditional IRA to a Roth IRA. A special rule would allow taxpayers converting in 2010 to pay the resulting tax liability from the conversion ratably in 2011 and 2012, unless the taxpayer affirmatively elects to pay the tax in 2010. Certain tax consequences arise if the amounts converted in 2010 are distributed before 2012. Conversions made after 2010 must be included in income in the taxable year in which the conversion is made.

As a result of the $70 billion dollar cap, tax-writers were forced to drop from the final bill provisions that would have extended a number of other popular provisions, including temporary extensions of research and development tax credit, the tax credit for college tuition, and the state sales tax deduction for states without income tax. Congressional leaders have indicated that these provisions may be attached to the pension reform legislation that is currently in conference.

2. Tax Shelters and Employee Benefit Plans

The bill also contains provisions meant to curtail the investment by tax-exempt entities in transactions which provide inappropriate tax benefits to taxable entities (also known as a "tax shelter"). The provision adds a new excise tax on the tax-exempt entity and applies a tax on the individual or entity that approves or otherwise causes the tax-exempt entity to be party to the tax shelter transaction. Most surprising to employee benefit professionals is that the tax applies to certain tax-exempt employee benefit plans, such as voluntary employees' beneficiary associations ("VEBAs"), and to persons managing the investments for an even broader class of employee benefit plans.

The tax shelter transactions covered by the new law are "listed transactions" and "reportable transactions" that are either confidential or have contractual protections. The IRS publishes a list of various transactions that they believe are tax shelters and do not provide the tax benefits that they are promised to taxpayers by those promoting the transaction. These "listed transactions" are currently outlined in IRS Notice 2004-67 and more recent announcements. Under the existing rules, a taxpayer entering into these transactions (or "substantially similar" transactions) is required to disclose on the taxpayer's tax return that the taxpayer had entered into the transaction. The IRS would be on notice that the taxpayer had taken a position on the tax return that the IRS believed was incorrect and the IRS could decide to challenge that tax position. Some of these listed transactions would involve a tax-exempt entity as an accommodation party to the transaction to assist the transaction in achieving the tax results that were being promoted in the tax shelter.

Under this new provision, the tax-exempt entities that participate in these listed transactions would be subject to new excise taxes because of their participation. VEBAs (welfare benefit trusts exempt from tax under Code section 501(c)(9)) that invest in these transactions would be subject to this new excise tax. This tax (generally at the 35% rate, under current rate structure) generally would be based on the tax-exempt organization's net income from the transaction – or on the proceeds that the tax-exempt organization received from entering into the tax shelter transaction – and would apply each year the investment was held. The tax is even greater if the tax-exempt entity knew or had reason to know that this was a tax shelter transaction.

In addition to the tax on certain tax-exempt entities, an entity manager of a tax-exempt organization will be subject to a $20,000 "tax" for each subject transaction that the organization entered into. Generally, an entity manager is the person who approves or otherwise causes the tax-exempt entity to be a party in the tax shelter transaction. This tax would be imposed without regard to whether the manager knew or should have known a tax shelter was involved. Significantly, for purposes of the tax on entity managers, tax-exempt organizations include not only VEBAs, but also tax-favored retirement plans (defined benefit and defined contribution plans, including 401(k) plans), 403(a) and (b) plans, governmental 457(b) plans and IRAs, as well as medical savings accounts, education savings accounts and other tax-free savings vehicles.

Many have expressed concern about the scope of what would be considered a tax shelter transaction and whether a pension fund asset manager could be considered an entity manager subject to the $20,000 per transaction tax. Particularly troubling is the reference in the statute to confidential transactions and transactions with contractual protections as potentially being tax shelter transactions. Some are concerned that the law may apply to investment contracts that require the asset manager not to enter into transactions where unrelated business taxable income (UBIT) is generated. The Treasury Department and the IRS are instructed to provide guidance on what sort of confidential transactions and transactions with contractual protections would be considered tax shelter transactions. Based on the Treasury and IRS's prior thinking on tax shelter transactions, it seems likely that they will be concerned with deals where the transaction documentation would require that the parties to the transaction keep the details of the transaction confidential or where the transaction promises tax benefits and gives parties to the transaction some recourse if the promised tax benefits are not achieved. Under those assumptions, the requirement that an asset manager not enter into a transaction where UBIT would be generated hopefully would not be enough to make such a transaction a tax shelter transaction. We understand that the IRS is currently working on a guidance project to implement this new law, so some clarification on this issue should be forthcoming.

In addition to the taxes imposed on the tax shelter transaction, new reporting requirements would apply. The tax-exempt entity involved in the tax shelter transaction will have to disclose the transaction to the IRS. In addition, the taxable entity involved in the transaction must disclose to the tax-exempt entity that this is a tax shelter transaction. The fact that the taxable entity must make this disclosure to the tax-exempt entity may make it easier for tax-exempt entities to understand whether they are entering into a tax shelter transaction in the first place.

This new provision is generally effective immediately, but no tax applies to income or proceeds received on or before September 15, 2006.

B. Heroes Earned Retirement Opportunities Act

Currently, military combat pay is not taxable. As a result, such non-taxable amounts cannot be contributed to an IRA. Under a new law, however, men and women in the U.S. military may take advantage of retirement saving vehicles just like civilians, and contribute a portion of their combat pay to an IRA, including combat pay earned in 2004 and 2005.

Under the Heroes Earned Retirement Opportunities Act (H.R. 1499, signed into law on Memorial Day (P.L. No. 109-227)):

- combat pay (which is generally excludible from income under Code section 112) is includible in a soldier's income for purposes of determining the IRA contribution limit. The basic IRA contribution limit is the lesser of $4,000 in 2006 or 100 percent of the taxpayer's gross income;
- military men and women have until May 29, 2009, to retroactively make 2004 and 2005 IRA contributions based on combat pay, up to the applicable limits for those years; and
- contributions that were otherwise made in 2004 and/or 2005 (albeit incorrectly) do not need to be returned.

C. Pension Reform Continues to Move Slowly

Negotiations to reconcile differences between the House and Senate versions of the pension reform legislation (H.R. 2830) continue to move along very slowly. Disagreements over whether to tie plan funding requirements to the plan sponsor's credit rating, the treatment of "credit balances," and whether to place mandates on cash balance plan conversions have contributed to the delay. It does appear, however, that conferees have begun to make significant progress in recent weeks. For example, it appears that the conferees have agreed to provisions providing special relief to plans sponsored by commercial airlines.

Key members and staffers close to the negotiations are now saying that action may take place some time in June, which invariably means that Congressional leaders will target the July 4th recess as the next deadline for passing a bill. If a bill is not agreed to by that date, there's been some speculation by key staffers that comprehensive pension reform may not happen at all this year.

Proposals to attach the "trailer" tax items (noted above) to the pension bill may have a couple of significant effects on the negotiations. Doing so may give further urgency to negotiations on the pension reforms, but also may increase the cost of H.R. 2830, and could force the conferees to drop certain high-cost provisions, including a provision to make the employee benefit-related EGTRRA provisions permanent. In addition, significant increases in the bill's cost may subject the pension reforms to the Senate budget rules requiring 60 votes instead of a straight majority of 51 votes.