

PENSION PROTECTION ACT OF 2006

September 1, 2006

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Dear Clients and Other Friends-

Your immediate reaction to this bill may be that it does not apply to you since you are either not covered by a pension plan, or you figure the Act only affects the plans of the large companies. Well, like most tax laws they have stuffed all kinds of things into the PPA, including issues not related to pensions.

In this newsletter I will cover the parts of the PPA which I feel affect you. Out of respect for the name of the Act, I will start with the pension related issues.

But first, what this Act did not do. In addition to pension reform, three other hot items were on Congress' agenda: extend expiring tax breaks, eliminate/modify estate taxes and raise the minimum wage. At different times, these were part of the Pension Act. Finally, through various maneuvers the pension reform was put in its own bill and the other three were put together. However, the bill containing the other three did not pass. Two of the more popular expiring tax breaks that are now in limbo are the research and development credit, and the sales tax itemized deduction.

What the Act did do.....

Eliminate sunset provisions:

One of the more important pension changes in the Act for those not in a large company plan was to make permanent a number of retirement plan and IRA liberalizations that were added to the tax laws in 2001 but were set to sunset after 2010. As you may recall, Congress outdid itself with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Although EGTRRA substantially increased pension and individual retirement account (IRA) contribution limits, all these improvements were scheduled to sunset after 2010, at which time everything would revert to the limits existing prior to 2001. Oh, what clever budgeting.

For example, prior to 2001, the maximum amount that a taxpayer could contribute to an IRA was \$2,000 a year. EGTRRA increased that limit in steps to \$5,000 by 2008. (The limit is \$4,000 today.) The \$5,000 limit will then be increased each year after 2008 to reflect inflation. The 2001 legislation similarly increased the limits on the maximum tax-deductible amount that an employee can contribute to an employer-sponsored defined contribution retirement plan such as a 401(k) plan. This limit was increased in steps from the \$10,500 a year in effect in 2001 to \$15,000 a year in 2006. That limit will then be adjusted to reflect inflation in years after 2006. EGTRRA also instituted new catch-up contributions for individuals age 50 and older—allowing them to annually contribute an extra \$5,000 to 401(k) plans and an extra \$1,000 to IRAs (this is a very popular benefit).

In short, the new law, by making EGTRRA permanent, preserves the advantages of higher employee contribution limits for employer plans, higher IRA contribution limits, more flexible plan rules, portability, a catch-up for those over 50, and an increase in employer contribution limits.

New disclosure rules for qualified plans:

One of the overarching themes of the Act is that there should be more pension transparency so workers, regulators and investors can better keep tabs on the financial health of traditional pension plans. To meet this need, the Act requires plans to include more detailed and specific information on their annual filings to the IRS and Department of Labor and requires companies to give workers quarterly benefit statements that include information about accounts, including the value of their assets, their rights to diversify, and the importance of maintaining a diversified portfolio.

New investment advice rules:

The Act clarifies the investment advice rules. This may not sound like a large issue. However, many participants in company plans do not bother to determine how to best invest their funds which obviously affects the growth of their retirement fund.

In the past, federal conflict-of-interest laws prohibited firms from both managing investment plans and offering advice for fear that they would recommend their own high-fee funds to maximize their fee income, at the expense of the best interests of the plan participants. Financial institutions, however, have long lobbied Congress to be allowed to provide this type of investment advice, and their lobbying has borne fruit. The new rules let 401(k) providers give personalized investment advice to participants of employer-sponsored plans as long as the advice is based on a computer model that has been certified as bias-free by an independent third party.

Liberalized plan payout and rollover rules:

By making it easier to take out their funds, employees are encouraged to participate in their company's plans.

Provisions in the Act that liberalize plan payout and rollover rules include the following:

- after 2007, taxpayers will be permitted to make direct rollovers from qualified plans to Roth IRAs;
- for purposes of the 401(k) hardship distribution rules, "hardship" includes hardship of any beneficiary under the plan (not just a spouse or dependent);
- members of the National Guard and Reserves called to active duty through 2007 can make penalty-free withdrawals from retirement plans. Withdrawn amounts may be repaid to the IRA or pension plan within two years of the distribution;
- the 10% early withdrawal penalty for distributions to public safety employees over age 50 (including police, fire, and emergency medical services) who may retire early is waived;
- effective for post-2006 distributions, nonspouse designated beneficiaries are allowed to make rollovers of inherited amounts in qualified plans, governmental Sec. 457 plans, or tax-sheltered annuities to their own IRAs (treated as inherited IRAs).

Now, for some non-pension items in the PPA.....

Charitable Giving Incentives:

The Act contains a charitable giving incentives package designed to encourage charitable donations. The incentives include:

- *Tax-free distributions from IRAs for charitable purposes.* The new law permits taxpayers to exclude from gross income certain distributions of up to \$100,000 from a traditional individual retirement account (IRA) or Roth IRA which would otherwise be included in income. The charitable distribution must be made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.
- *Charitable deduction for contributions of food inventory.* Under the new law, an enhanced deduction for donations of food inventory which was formerly available only to C corporations is extended to all trades and businesses, effective for two years through 2007.
- *Basis adjustment to stock of S corporation contributing property.* The Act provides that if an S corporation contributes property to a charity, an S corporation shareholder only has to reduce his basis in stock of the S corporation by his pro rata share of the adjusted basis of the contributed property, rather than by the amount of the charitable contribution that flows through to him. For example, if an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500, the shareholder will be treated as having made a \$500 charitable contribution and will reduce the basis of the S corporation stock by \$200. The provision is effective for two years through 2007.
- *Charitable deduction for contributions of book inventory.* The provision extends the current-law provision that adds public schools to the list of eligible donees for the enhanced deduction for contributions of qualified book inventory by C corporations. The provision is effective for two years through 2007.
- *The tax treatment of certain payments to controlling exempt organizations.* Under prior law, rent, royalty, annuity, and interest income paid to a tax-exempt organization by a controlled taxable subsidiary was generally treated as unrelated business income, which was taxable to the tax-exempt parent organization. The new law modifies that rule such that only the portion of such payments which is not regarded as fair market value will be treated as unrelated business taxable income. Exempt organizations are required to report certain amounts received from controlled organizations. The provision is effective for two years through 2007.
- *Qualified conservation contributions.* The new law raises the charitable deduction limit—from 30% of adjusted gross income to 50%—for qualified conservation contributions, as long as it does not prevent the use of the donated land for farming or ranching purposes. The charitable deduction limit is raised to 100% of adjusted gross income for eligible farmers and ranchers. Unused contributions can be carried forward for up to 15 years. The provision is effective for two years through 2007.

Charitable reform:

The Act also imposes new requirements and restrictions on exempt organizations. Some of the new rules:

- Double the fines and penalties applicable to certain activities by charities, social welfare organizations, private foundations and exempt organization managers.

- Clarify the terms of facade easements in historic districts, and also clarify that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property.
- Limit the basis for donated taxidermy property to the cost of preparing, stuffing and mounting an animal and provide that the value of the deduction is equal to the lesser of basis or fair market value (so much for the donation of my bear rug.....).
- Require the recapture of any tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed if the property is not used for an exempt purpose of the donee organization. The change is effective for contributions made after Sept. 1, 2006.
- **Prohibit deductions for contributions of clothing and household items unless they are in good used condition or better. In addition, IRS may deny a deduction for any item with minimal monetary value.** (Ya think they are concerned about all the “Goodwill” contributions?) These rules, which are effective for contributions made after the enactment date, don't apply to any contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer includes with his return a qualified appraisal for the donated property.
- **Require that in the case of a charitable contribution of money, regardless of the amount, the donor must maintain a cancelled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution.** The change is effective for contributions made after the enactment date.
- Lower the threshold for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required.
- Apply an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that with respect to such fund is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person.

As always, this recaps a complex law. If you feel you need more information on a specific topic, please contact me.

Enjoy what is left of our summer.

Thanks,

Tim

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