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The Pension Protection Act of 2006

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New Rules For Retirement Plans and Charitable Donations: On August 17, 2006, the Pension Protection Act of 2006 was signed with widespread repercussions for almost all retirement plans, as it is the most comprehensive pension legislation in the last 30 years. In response to the well known failures of many corporate pension plans, the Act imposes stronger rules for minimum funding requirements of employer provided defined benefit and defined contribution plans. In addition, the Act includes a wide range of provisions that impact employee funded plans such as 401(k) and IRA accounts, as well as charitable donations.

Here are some expanded highlights which are by no mean a comprehensive analysis of the Act:

> *Employer Provided Defined Benefit & Defined Contribution Plans:* Given the failures of many well known pension plans, the Act seeks to identify troubled pension plans in an attempt to stabilize them before they resort to bankruptcy. If a plan enters bankruptcy, the plan participants would likely only receive pennies on the dollar, and then, typically only if the plan was insured by the Pension Benefit Guaranty Corporation. Prior to the Act, pension plans were only required to be funded at 90% of the estimated liability, but many plans did not meet that requirement and some plans are less than 60% funded.
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> Under the Act, pension plans are now required to be 100% funded, but most plans will have seven years to comply. To encourage plans to ensure proper funding, the Act allows greater tax deductions and requires plans to take into account future compensation increases. Companies that are currently below 80% funding will be subject to stricter funding requirements that will require accelerated contributions by the corporation and may restrict the corporation from offering lump sum benefit payments.

Permanent EGTRAA Pension Reforms: The Act makes permanent many of the favorable pension rules previously enacted by the 2001 Tax Act (known by its initials as "EGTRAA"), but scheduled to expire in 2010. The current IRA contribution limits of $4,000 in 2006 and 2007, will rise to $5,000 in 2008, and will be increased for inflation thereafter. Without this permanency, the contribution limit would have reverted to $2,000 in 2011.

Individuals over the age of 50 will be able to make additional annual catch-up contributions subject to the following limits: $1,000 for IRA's, $2,500 for SIMPLE IRA's and $5,000 for 401(k) plans. The IRA catch-up contribution limit is still not indexed for inflation but SIMPLE IRA and 401(k) plan catch-up contributions will be indexed for inflation. Without this permanency, catch-up contributions would not be allowed as of 2011. In addition to increasing contribution amounts, the Act makes permanent provisions that established Roth 401(k) and Roth 403(b) accounts. Now that Roth features for 401(k) and 403(b) plans have been made permanent, more employers may adopt them.

Section 529 College Savings Plans: Especially important to clients with school age children, certain income tax benefits of Section 529 college savings plans are now made permanent. At present, distributions from 529 college savings plans are exempt from the federal income tax when used for qualified higher education expenses. However, the tax-free nature of the distribution was set to expire in 2010 and revert to being taxed to the student-beneficiary. The Act makes permanent federal income tax-free qualified withdrawals so if you have been hesitant to invest, now may be the time to reconsider.

401(k) And Other Retirement Plan Enhancements: The Act favors plans which automatically enroll new employees into an employer's 401(k) plan. If an employee is automatically enrolled, the employee's first year contribution will be 3% of their gross income, increasing by 1% per year, until the contribution reaches 6% of gross income. The employee may opt out of automatic enrollment in the plan. To protect employee contributions, companies are now prohibited from forcing employees to invest their own retirement contribution in the stock of the employer. However, any matching contribution the employer may provide can be required to be invested in the stock of the employer.

To aid individuals in making better retirement decisions, the Act allows 401(k) and IRA providers to offer personalized investment advice to account holders, although the amount of any fee or commission charged can not vary depending on the basis of the investment option selected. To further encourage saving for retirement, adjusted gross income limits for traditional IRA deductions and Roth IRA contributions will now be indexed for inflation which should allow more individuals to contribute to IRA's and Roth IRA's.

Expanded Retirement Plan Hardship Distributions: At present, a retirement plan participant may be able to take a hardship distribution from a plan without penalty if a hardship event (including the incurrence of a medical expense) occurs to the plan participant's spouse or dependent. The Act requires the IRS to expand the hardship rules to include any person who is a named beneficiary under the plan. This means that a significant other, domestic partner, or other non-dependent retirement plan beneficiary may benefit from penalty free distributions to the participant to pay a beneficiary's medical bills or other qualified hardships.

Public Service Personnel and Military: There are new rules that allow penalty-free withdrawals from government retirement plans for public safety officers such as police, firefighters, and individuals who provide emergency medical services who separate from service after age 50. Previously, if such an individual made withdrawals from such plans prior to age 55, the withdrawals were subject to a 10% penalty. However, the withdrawals are still subject to income tax. In addition, public safety officers who retire or become disabled may make income tax-free withdrawals up to $3,000 annually from government pension plans in order to purchase health or long-term care insurance.

In order to assist the vast number of individuals who have been or will be called to active military duty between September 11, 2001 and December 31, 2007, the Act provides that such active duty military personnel may receive penalty-free early distributions from their IRA or 401(k) plans. Also, as long as the withdrawn amounts are recontributed to the plan within two years after end of active duty status, no income tax is due either.

Nonspouse beneficiaries: Until now, only a spouse has been allowed to roll over distributions from a qualified retirement plan, tax-sheltered annuity, or governmental §457 Plan to an IRA. Effective for distributions after December 31, 2006, nonspouse beneficiaries will be able to roll over a deceased taxpayer's qualified retirement plan, governmental §457 Plan, or tax sheltered annuity into an IRA. Although the nonspouse beneficiary will not get the full deferral privileges of a "spousal rollover" by being allowed to roll the distribution to an IRA they can treat as their own, a nonspouse beneficiary will have complete control over the investment decisions, and will treat the IRA as an "inherited IRA" which means the IRA will be subject to the applicable required distribution rules for beneficiaries of an inherited IRA.

Charitable Donation of IRA or Roth IRA: For the remainder of 2006 and 2007, an individual, age 70 ½ or older, may make a direct distribution (donation) from an IRA or Roth IRA to a public charity without income tax consequences. To comply, the individual must be at least 70 ½ at the time of the distribution to the charity and the contribution must be limited to $100,000 per person per year. Because the taxpayer escapes income taxation on the distribution, there is no offsetting charitable income tax deduction. Prior to this change, an individual who wished to use an IRA to make a lifetime charitable donation first had to withdraw

funds from the IRA, include the withdrawn amount as income, and then take a charitable deduction in order to offset the income (assuming the individual's charitable deduction limitation has not been exceeded for that year).

Charitable Donation of Conservation Easements: For qualified conservation easement contributions made by individuals and private corporations in 2006 and 2007, the Act provides that the deduction limits are raised from 30% of adjusted gross income to 50% of adjusted gross income. In addition, contributions in excess of the limitation may be carried forward for 15 years rather than the typical 5-year period.

Charitable Donation of Appreciated Tangible Property: Prior to the Act, if a charitable organization sold, exchanged, or otherwise disposed of contributed tangible property with a claimed value of more than $5,000 within 2 years of the donation, the charitable organization was required to file a return with the IRS in order to show among other things, the amount received on disposition and the date of disposition.

The Act has imposed further restrictions on deductions for tangible appreciated property. Now, if the charity disposes of contributed tangible property with a claimed value of more than $5,000 within 3 years of the contribution, the donor's deduction will generally be limited to the basis in the property at the time of the donation. Therefore, the donor may be required to include as ordinary income in the taxable year in which the disposition occurs, the excess of the amount previously claimed for a deduction over the basis of the contributed property. However, no adjustment will be required if the charitable organization makes a certification to the IRS, under the penalties of perjury, that either the use of the property by the organization was related to the purpose or function constituting the basis for the charitable organization's exemption or that such use became impossible or infeasible to implement.

Charitable Donation of Fractional Interests: In general, a charitable deduction is not allowed for a contribution of a partial interest in tangible property, such as an income interest or a remainder interest, unless a special trust is used to make the gift. However, a charitable deduction has been allowed for the gift of an undivided fractional interest so long as the charitable organization is given the right, as a tenant-in-common with the donor, to possession, dominion, and control of the property for a portion of each year consistent with its interest in such property (i.e. if the charity has a 25% interest the charity must have the right to possession of the property for 25% of the year.)

The Act imposes substantial restrictions which drastically restricts the ability to take a charitable deduction for the contribution of a fractional interest. Now, in most cases, no income or gift tax charitable deduction will be allowed for a contribution of a fractional interest of tangible property unless immediately before such contribution, all interests in the property are owned by the donor or by the

donor and the charitable organization. (The Act provides that the IRS may issue regulations to provide an exception in cases where more than one individual holds an interest in the property. The regulations must provide that, in such cases, all persons who hold an interest in the property must make proportional contributions of an undivided portion of the entire interest held by such persons.) In addition, the value of a donor's future fractional interest contributions will be based upon the lesser of the value used for purpose of determining the charitable deduction for the initial contribution or the fair market value at the time of the subsequent contributions. Most importantly, the donor must contribute the donor's remaining interest to the same charitable organization by the earlier of 10 years from the initial contribution or the donor's death and the charitable organization must take substantial physical possession of the property during such period. Otherwise, all the related charitable income and gift tax deductions shall be recaptured with interest and subject to an additional 10% penalty.