

Pension Protection Act of 2006

On August 17, 2006, the President signed the Pension Protection Act of 2006 which not only strengthens traditional pension plans, it also extends and, in some cases, improves over 20 retirement tax-savings benefits. It also adds extensive new rules governing specific charitable donations; imposes tighter controls on exempt organizations; and impacts over a dozen other major tax provisions.

The pension reform portion of the law addresses pension funding, participant education, hybrid plans, multi-employer plans, and plan terminations. The final provisions are complex, representing the first comprehensive pension legislation in more than 30 years.

FOR BUSINESSES

STRENGTHENING TRADITIONAL PENSION PLANS

The new law identifies troubled private pension plans and helps to stabilize them before employers resort to bankruptcy while strengthening the Pension Benefit Guaranty Corporation (PBGC). The tax law implements a traditional carrot-and-stick approach: allowing a higher limit on the amount of deductible employer contributions while requiring higher funding levels in order to continue qualified plan status.

Roughly 44 million Americans are covered by traditional pension plans. Many plans are seriously financially strapped. As pension costs skyrocketed over recent years, many employers abandoned traditional plans for 401(k) and other savings plans.

Deduction Limits

The new law encourages plans to create a funding cushion. Under current law, an employer is allowed a tax deduction for plan contributions up to 100 percent of the plan's current liability. Contributions above that amount are subject to a 10 percent excise tax.



For plans beginning in 2006 and 2007, the new law increases the maximum deductible amount to 150 percent of current plan liabilities. After 2007, deductible contributions

may be made up to an amount equal to the excess of the funding target, normal costs, and a "cushion account" equal to 50 percent of target liability plus accountability for projected compensation increases over the value of the plan assets. Plans with 100 or fewer participants get a break on computing benefit increases for highly compensated employees. The deduction limit for multi-employer plans increases to 140 percent of current liability.

The new law also increases allowable deductions for an employer that maintains both a defined contribution plan and a defined benefit plan by excluding contributions to defined benefit plans insured by the PBGC.

Full Funding

The new law requires most pension plans to become fully funded over a seven-year period. The transition from current 90 percent funding to 100 percent full funding is gradual.

The funding rules apply to plan years beginning in or after 2008. Plans that are not fully funded at the start of 2008 may work on meeting interim targets of 92 percent in 2008, 94 percent in 2009, and 96 percent in 2010.

Plans in existence in 2007 that have a prefunding balance may maintain a funding standard carryover balance until it reaches zero. Plans established after 2007 are not entitled to most transition rules.

An estimated 30,000 pension plans are now underfunded and will be required to better fund their plans. The Labor Department estimates that plans are currently about \$450 billion underfunded.

At Risk Plans

Having an "at risk" plan will subject the employer-sponsor to even stricter funding requirements. The result is accelerated contributions. Under the rules, a plan "at risk" is: (1) less than 80-percent funded, without regard to at-risk liabilities and (2) less than 70-percent funded counting at-risk liabilities. At risk liabilities are determined by assuming that employees eligible to retire in the next 10 years will retire as early as possible.

Benefit Limitations

Companies that are below 80-percent funded are prohibited from using credit balances for funding or making promises to provide any enhanced or new benefits. Plans that are less than 60-percent funded will be restricted from offering any lump sum benefit payments and new accruals are frozen in those plans. Payouts under nonqualified deferred compensation plans, as well as special pension plans for executives, will be restricted in the case of those severely underfunded plans, starting immediately on date of enactment.

Valuing Pension Liabilities

Measuring liabilities is critical to determining what constitutes full funding under the new law. Pension plan liabilities are determined by valuing a plan's current liabilities, which in turn are generally measured by benefits accrued to date. This can be positive or negative depending on your perspective.

The interest rate used for 2006 and 2007 can be based on investment grade corporate bonds. In 2008, the interest rate will be based on a three-segmented yield curve. Mortality tables are updated and use of a substitute table that reflects

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a plan's actual experience and projected trends is permitted.

A combination of asset valuation and liabilities determines a plan sponsor's "minimum required contribution" each year. As under current law, a failure to fund incurs an excise tax equal to 10 percent of the funding deficiency.

Hybrid Plans

Rather than leave employees with no pension plan at all by pulling out of the system, Congress wants to encourage opting for hybrid "cash balance" plans—part pension and part savings plans. Some employers have been worried about lawsuits based on claims of age discrimination because the conversion could hurt older employees who have too few years to build up a savings nest egg. The new law insulates employers from those claims on further conversions.

Participant Education

The new law requires plan sponsors to educate participants about their rights and responsibilities, including investment education and the tax consequences of various payout options.

Multi-Employer Plans

There are new benchmarks for identifying when a multi-employer plan is in trouble and new additional funding rules. In some cases, plans will be barred from increasing benefits if those increases would further jeopardize the health of the plan. The law also imposes heightened notice requirements on troubled plans to fully inform participants.

NEW AND ENHANCED RETIREMENT-SAVINGS INCENTIVES

Automatic Enrollment

It is now easier for employers to automatically enroll their employees into the company's 401(k) plan. In such an arrangement, employees must affirmatively opt-out in order not to participate. Employers make default contribution decisions which employees can change.

Investment Advice

The new law permits 401(k), IRA and similar providers to offer personalized investment advice to accountholders. The investment advice arrangement must provide that any fees, including commission, received by the fiduciary advisor do not vary depending on the basis of any investment option selected or a computer model must be used.

Although 401(k) providers can give personalized investment advice to accountholders, they cannot advise employers about which funds and investments to include in their plans.

FOR INDIVIDUALS

IRAs and Tax Refunds

Taxpayers will have more options when it comes to depositing their tax refunds. Under the new law, taxpayers can direct the IRS to deposit their refund into an IRA of their choosing.

401(k) Hardship Withdrawals

The new law instructs the Treasury to issue rules within 180 days of enactment that allow 401(k) plan withdrawals for hardships and unforeseen financial emergencies with respect to any person who is listed as a beneficiary under the 401(k) plan. The Treasury rules are to be consistent with hardship withdrawals

now allowed for spouses and dependents.

Nonspouse Beneficiaries

A taxpayer may now roll over his or her deceased spouse's interest in a qualified retirement plan, government plan, or tax sheltered annuity into an IRA. The taxpayer will not be taxed except as normal distributions are taken. The new law extends this special treatment to nonspouse beneficiaries.

Direct Plan-to-Roth IRA Rollovers

Effective for distributions after December 31, 2007, the new law will allow direct rollovers from a qualified retirement plan, tax-sheltered annuity, or governmental plan directly to a Roth IRA and will treat it as a Roth conversion if all other conversion qualifications (e.g., income below the \$100,000 level before 2010) are met.

And Much More...

- Waiver of excise tax on nondeductible contributions for household workers
- Notification of reduction in plan benefits
- Rollovers of after-tax annuity amounts to qualified plan
- Enhanced catch-up rules for IRAs when employer becomes bankrupt
- Use of annuity contracts for longterm care
- Combined use of defined benefit and 401(k) plans for small employers
- Reporting simplification
- New rules for Indian tribal government and church plans
- Indexed income limits for IRAs and Saver's Credit
- Reinvestment of ESOP dividends



PERMANENT EGTRRA RETIREMENT PROVISIONS

Economic Growth & Tax Relief Reconciliation Act of 2001 2010 Sunset Eliminated

The major EGTRRA retirement provisions that would be made **permanent** rather than sunset at the end of 2010 include:

- Higher dollar amount for IRA contributions (\$4,000 starting in 2006, \$5,000 in 2008, inflation adjusted thereafter)
- Higher dollar limits on defined contribution plans (\$44,000 in 2006), elective deferrals (including \$15,000 in 2006 for 401(k) plan deferrals), 457 plan deferrals (\$15,000 in 2006), SIMPLE plan contributions (\$10,000 in 2006).
- Increases in the annual benefit limit under a defined benefit plan (\$175,000 for 2006)
- Catch-up contributions for older workers (\$1,000 after 2005 for IRAs, \$2,500 for SIMPLE plans, \$5,000 for 401(k) plans)
- Faster vesting of employer matching contributions (full vesting under three- or six-year schedules)
- Greater portability for 403(b) and 457 plans
- Higher deductible amounts for employer contributions to employee retirement plans (inflation-adjusted to \$220,000 in 2006; 25-percent compensation deduction limit for stock bonus and profit sharing plans)
- Roth 401(k)s and 403(b)s
- Start-up tax credit for new small employer-sponsored plans (maximum \$500/year for each of the first three years)
- Deemed IRAs set up under an employer plan allowing separate employee contributions
- Enhanced rollover rules (including qualified plan rollovers of distributions of after-tax contributions, direct rollovers from IRAs to employer plans, and rollovers of distributions from governmental 457 plans, 403(b) plans, or cash-outs)
- ESOP enhancements
- Modifications to the top heavy non discrimination and coverage rules.

None of the post-2010 extensions appear to require any immediate action, with the exception of the Roth 401(k) and 403(b) option for employee-share contributions. While the Roth 401(k) option has been available since the start of 2006, many employers have not revised their plans out of concern that the expense of maintaining separate Roth accounts for employees would outweigh the benefits if further Roth contributions were not allowed after 2010. Now that the future of the Roth 401(k) is secure, many employers are expected to amend their plans by the end of this year. These rules apply equally to 403(b) plans.

Defined benefit plan limits. EGTRRA's "permanent extensions" are not exclusively focused on defined contribution plans. EGTRRA increased the maximum annual defined benefit plan limit. In 2001, only the lesser of 100 percent of three-year-high average compensation or \$140,000 could be paid out annually. EGTRRA initially boosted it to \$160,000 and indexed it for inflation in \$5,000 increments; today it is \$175,000.

Saver's Credit

The new law makes the Saver's Credit permanent. Under this provision, lower- and middle-income taxpayers can claim a nonrefundable tax credit for their contributions or deferrals to retirement savings plans and IRAs.

The credit amount is equal to the credit rate (50, 20, or 10 percent) times the dollar amount of qualified retirement savings contributions for the year (not to exceed \$2,000), based on income and filing status.

Section 529

College Savings Plans

As a last-minute addition, the new law also permanently extends the rules allowing for Sec. 529 qualified tuition programs. Starting out slowly after EGTRRA, Sec. 529 plans have taken off recently, with current taxpayer funds in those plans doubling during last year alone. The new law also adds stricter rules related to the operation of Sec. 529 plans to prevent abuse.

CHARITABLE DONATIONS

Clothing and household goods

Under the new law, no charitable deduction is allowed for used clothing and household items unless the items are in "good" condition.

Household items include furniture, furnishings, electronics, appliances, linens, and similar items. Food, paintings, antiques, objects of art, jewelry, gems, and collectibles are not household items.

There is a limited exception for donated single items appraised at more than \$500.

Cash

In a major change, no deduction is allowed for any contribution of cash, check or other monetary gift unless the donor can show a bank record or a written communication from the charity indicating the amount of the contribution, the date the contribution was made, and the name of the charity.

IRAs

Under the new law, taxpayers will be able to make tax-free distributions from IRAs for charitable purposes through December 31, 2007. The maximum annual cap is \$100,000.

For more information, contact your Alpern Rosenthal representative.

