

SENATE PASSES PENSION BILL CLEARING IT FOR PRESIDENT'S EXPECTED SIGNATURE

Late in the evening of August 3rd, the Senate approved the Pension Protection Act of 2006, (the Act). Since the measure was passed by the House on July 28th, it is now cleared for the President's signature. The Act is a massive tax bill which overhauls the funding and disclosure rules for defined benefit pension plans, changes the rules for conversions of pension plans to cash balance plans and makes many other changes relating to pension plans and their beneficiaries. It also revises some charitable giving rules and makes exempt-organization reforms.

■ **Funding and disclosure provisions**

- Reform of funding rules for single employer and multi-employer defined benefit plans.
- Boost in deduction limits for single and multi-employer plans, under certain circumstances.
- Prohibits companies from making set-asides or setting up reserves to non-qualified deferred compensation plans if they maintain an underfunded or terminated qualified plan.
- Extends the use of a long-term corporate bond interest rate instead of the 30-year Treasury rate.
- Revises the rules for calculating the amount of a lump-sum distribution from a defined benefit plan.
- Increases disclosure rules for qualified plans.
- Creates exceptions from the prohibited transaction rules for certain investment advice provided to qualified plans and IRAs.

■ **Numerous retirement savings provisions made permanent**

The Act makes permanent a number of retirement plan and IRA liberalizations set to sunset after 2010. These include increased contributions to IRAs, larger catch-up contribution limits for those age 50 or older and increased maximum annual contributions to 401(k) plans.

■ **Liberalized payout and rollover rules**

The Pension Protection Act of 2006 liberalizes a number of qualified plan and IRA payout and rollover rules, including the following:

- After 2007, taxpayers would be permitted to make direct rollovers from

qualified plans to Roth IRAs.

- Eased 401(k) hardship distribution rules.
- Nonspouse designated beneficiaries could make rollovers of inherited amounts in qualified plans or IRAs to their own IRAs.
- Defined benefit plans could make in-service distributions to age-62-or-older participants.

■ **Charitable reforms**

The Act includes an exclusion from income tax for certain distributions, of up to \$100,000, from a traditional or Roth IRA if made to a tax-exempt organization to which deductible contributions can be made. The change would be effective for two years through 2007.

- A boost in the charitable deduction limit for qualified conservation contributions, with a special break for farmers and ranchers.
- Deduction rules would be tightened for charitable contributions of clothing and household items.
- Record retention rules are tightened for contributions of money.
- Charities receiving a gift or bequest of a fractional interest in property would have to take complete ownership of the item within 10 years or the death of the donor, whichever is first.

MAJOR OVERHAUL OF PENSION PLAN RULES

The Act, as passed by the House and Senate, overhauls the funding and disclosure rules for defined benefit plans, addresses conversions of pension plans to cash balance plans, carries liberalized payout and rollover rules and makes a host of other changes relating to pension plans and their beneficiaries.

■ **Reform of the single-employer defined benefit rules**

The reform rules for single employer defined benefit plans include:

- providing a permanent interest rate based on a modified “yield curve” for employers to more accurately measure current pension liabilities as they come due;
- requiring employers to make sufficient contributions to plans in order to meet a 100% funding target and erase funding shortfalls over seven years;
- prohibiting employers from using credit balances if their plans are funded at less than 80%;
- triggering accelerated contributions for “at-risk” plans;

- reducing the smoothing of interest rates to two years (instead of five for assets and four for liabilities under current law) to improve funding accuracy and protect plans against market and funding volatility;
- permitting employers to make additional maximum deductible contributions of up to 180% of current liability;
- prohibiting employers and union leaders from increasing benefits if a plan is less than 80% funded, unless the benefits are paid for immediately;
- prohibiting further benefit accruals for lump-sum distributions or shutdown benefits from plans funded at less than 60%. Once a plan is above 60% the employer and the union then decide how to credit past service accruals;
- restricting the use of deferred executive compensation arrangements for employers with severely underfunded plans;
- permanently establishing an employer-paid termination premium of \$1,250 per participant if a plan sponsor terminates its employee pension plan upon entering bankruptcy;
- giving airlines that opt for a “hard freeze” of their pension plans an additional 10 years to meet their funding obligations and avoid defaulting on their plans and turning these obligations over to PBGC. An employer-paid termination premium of \$2,500 per plan participant also must be paid by these airlines if they terminate their employee pension plan upon entering bankruptcy;
- giving airlines that opt for a “soft freeze” of their pension plans an additional three years to meet their funding obligations and avoid defaulting on their plans and turning these obligations over to PBGC. An employer-paid termination premium of \$2,500 per plan participant also must be paid by these airlines if they terminate their employee pension plan upon entering bankruptcy. For these airlines, the bill will also extend the deficit reduction contribution relief that was included in the 2004 Pension Funding Equity Act through 2007.

■ **Reform of the multiemployer pension system**

The Act's changes relating to multi-employer plans include:

- identifying underfunded multiemployer pension plans and establishing quantifiable benchmarks for measuring a plan's funding improvement;
- providing new notice requirements for underfunded plans;
- changing the amortization schedule for any plan benefit amendments from 30 years to 15 years;
- increasing the maximum deductible limit to 140% of current liability, providing additional funding flexibility for plans each year;

- requiring plan trustees to improve the health of the plan by one-third within 10 years if a plan is less than 80% funded or will hit a funding deficiency within seven years;
- prohibiting benefit increases if the increase causes the plan to fall below 65% funded status; and
- establishing new funding standards and possible benefit restrictions for multiemployer plans that are funded at less than 65%.

■ **Legal certainty for hybrid pension plans**

The Act ends the legal uncertainty surrounding cash balance pension plans and establishes a simple age discrimination standard for all defined benefit plans which clarifies pre-Act law with respect to age discrimination requirements under ERISA on a prospective basis.

■ **New disclosure rules for qualified plans**

The Act:

- requires both single and multiemployer plans to include more detailed and specific information on their Form 5500 filings;
- enhances Form 4010 disclosure requirements and making all Form 4010 information filed with PBGC available to the public, except for sensitive corporate proprietary information;
- establishes a 80%, at-risk threshold which determines whether plans pose a threat to PBGC and therefore file 4010 information;
- requires both single and multiemployer pension plans to notify workers and retirees of the funded status of their plan within 120 days after the close of the plan year;
- gives employers the option of allowing workers to sell their company stock three years after receiving it in their 401(k) plan;
- prohibits companies from forcing employees to invest any of their own retirement savings contributions in the stock of the employer;
- makes it clear companies have a fiduciary responsibility for workers' savings during "blackout" periods, when workers are temporarily barred from making changes to their 401(k) investments; and
- requires companies to give workers quarterly benefit statements which 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:

- permits qualified “fiduciary advisers” to offer face-to-face, personally-tailored investment advice to help employees manage their 401(k) and other retirement options;
- puts in place fiduciary and disclosure safeguards to ensure advice provided to employees is solely in their best interest;
- requires fiduciary advisers for employer-sponsored plans to base their recommendations on a computer model which is certified and audited by an independent party; and
- requires fiduciary advisers for non-employer sponsored plans to charge a flat rate fee for one year (with no computer model). During that time, DOL and Treasury will study whether a computer model exists to tailor professional investment advice to an individual's own unique needs based on personal and subjective criteria about their financial and family circumstances. If they cannot certify such a model exists, then the advisers will be free to provide advice free from the prohibited transaction exemption as long as they certify in writing the company has adopted written policies and procedures which ensure the investment advice provided is in the employee's best interest.

QUALIFIED PLAN PAYOUT AND ROLLOVER RULES LIBERALIZED

The Act, as passed by both the House and Senate, liberalizes many qualified plan and IRA payout and rollover rules, including the following:

- After 2007, taxpayers can make direct rollovers from qualified plans to Roth IRAs.
- Effective on the enactment date, for purposes of the 401(k) hardship distribution rules, “hardship” includes hardship of a beneficiary under the plan (even if the beneficiary is not a spouse or dependent). IRS is directed to issue regulations within 180 days after the enactment date to effect this change.
- Effective for post-2006 distributions, nonspouse designated beneficiaries can make rollovers of inherited amounts in qualified plans or IRAs to their own IRAs (treated as inherited IRAs).
- Effective for distributions in plan years beginning after 2006, defined benefit plans can make in-service distributions to age-62-or-older participants.
- Effective for distributions after the enactment date, there's no 10% early withdrawal tax on distributions from governmental defined benefit plans to qualified public safety employees (police, fire, emergency medical services) who separate from service after age 50.

- The Act also OKs direct deposits of tax refunds into an IRA, effective for tax years beginning after 2006.

NUMEROUS RETIREMENT SAVINGS PROVISIONS MADE PERMANENT

The Act, as passed by both the House and Senate, makes permanent a number of retirement plan and IRA liberalizations which were set to sunset after 2010 under the Economic Growth and Tax Reconciliation Act of 2001. These include:

- increased contributions to IRAs;
- boosted contribution limits for those age 50 or older (catch-up contributions);
- increased maximum annual contributions to 401(k) plans;
- the rules relating to deemed IRAs under employer plans;
- the option to treat elective deferrals as after-tax Roth contributions; and
- the tax credit for certain pension startup costs.

The Act also makes permanent the tax credit for lower-income taxpayers who save for retirement.

CHARITABLE REFORMS

The Act, as passed by both the House and Senate, includes many changes for charitable contribution deductions and charitable organizations, including the following:

- An exclusion from income tax for certain distributions, of up to \$100,000, from a traditional or Roth IRA if made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.
- A boost in the charitable deduction limit from 30% to 50% of AGI for qualified conservation contributions, if the contributions do not prevent the use of the donated land for farming or ranching purposes. The charitable deduction limit would be raised to 100% of AGI for eligible farmers and ranchers. The change applies for two years through 2007.
- A recapture rule applies, effective for contributions made after September 1, 2006, if property for which a fair market value deduction was claimed is not used for an exempt purpose of the donee organization.
- Effective for contributions made after the enactment date, no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better. In addition, IRS may deny a deduction for any item with minimal monetary value. These rules 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.

- Effective for contributions made after the enactment date, 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.
- Effective for contributions, bequests and gifts made after the enactment date, charities receiving a fractional interest in an item of tangible personal property must take complete ownership of the item within 10 years or the death of the donor, whichever is first. In addition, the donee would be required to have the following:
 1. taken possession of the item at least once during the 10-year period as long as the donor remains alive, and
 2. used the item for the organization's exempt purpose. Failure to comply with these requirements results in the recapture of all tax benefits plus interest and the imposition of a 10% penalty.

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