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Your Bottom Line

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Navigating a clear course toward your financial security.

Pension Protection Act

Warren Mackensen

President Bush signed the Pension Protection Act ("PPA") of 2006 into law on August 17, 2006. The 900-page Act affects both the classic pension plan and many other retirement plans. Here are the major provisions that may have an impact on your bottom line.

College savings plans: The Act establishes permanent federal tax-free treatment of distributions from Section 529 college savings plans.

Donations of clothing and household goods: Items donated after August 17, 2006, must be in "good" used condition or better to be deductible. *Exception:* A deduction may be taken for donations of single items appraised at more than $500 regardless of condition.

Transferring tax refunds to IRAs: For taxable years beginning after December 31, 2006, the Act allows taxpayers to transfer any portion of a tax refund directly to an IRA. This will help people fund their IRAs each year.

Non-spousal heirs: Starting in 2007, non-spousal heirs can, for the first time, roll over qualified retirement plan balances, such as 401(k)s, 403(b)s and 457 plans, to inherited IRAs. Previously, non-spousal beneficiaries had to take payouts immediately (if the plan document required it), or at least within a five-year period if the plan did not require an immediate distribution. The new law allows heirs to use a longer withdrawal schedule and stretch out the tax deferral to avoid large income tax bills on their inheritances. *Caution:* The "inherited IRA" account must contain the decedent's name in the account title, as well as the beneficiary's name. Also, the rollover must go directly from the qualified retirement plan custodian to the inherited IRA custodian. In other words, you cannot take possession of the rollover in between custodians. *Small catch:* The non-spousal beneficiary must commence required minimum distributions immediately, even if the beneficiary is under age 70 $^{1}/_{2}$.

IRA donations to charities: During 2006 and 2007 only, direct payments of up to $100,000 per year from IRAs to charities are allowed. The charitable donation counts towards the annual required minimum distribution. The distributions are tax-free. *Restrictions:* The donor must be 70 $^{1}/_{2}$ or older when the donation is made. Distributions cannot be made to charitable remainder trusts or donor-advised funds. Donors may not receive anything of value from the charity. Receipts from the charities are required. No additional charitable deduction can be claimed on these distributions. Distributions from 401(k)s, 403(b)s, 457s, SEPs or SIMPLEs are not included under these new rules. *Caution:* The receipts may be problematic because the donations must go directly from the IRA administrators to the charities. It is incumbent on the donors to ensure the charities know that the donations are coming, and from whom they were derived. *IRAs with nondeductible contributions:* Distributions to charities are considered to have come first from deductible contributions and earnings on the account, and then from nondeductible contributions. This generates a future tax savings on later withdrawals.

Portability: The Act enhanced the portability of rollovers among qualified retirement plans, such as 401(k) plans, 403(b) plans, governmental 457 plans, and IRAs.

Automatic enrollment: The Act provides for automatic enrollment of employees in 401(k) plans at work. Employees have to affirmatively opt out of enrollment if they do not want to save for their future. This will help America's workforce increase their retirement savings by dramatically improving retirement plan participation.

continued

Pension Protection Act (continued from front)

David A. Batchelder

Retirement Savers Credit: Individuals with modest incomes (up to $25,000 of adjusted gross income [AGI] for single people, and up to $50,000 on a joint return) can double dip. They may enjoy the tax deferral in their 401(k) or IRA, and also get a tax credit, which may be as much as $1,000 for a married couple with AGI up to $30,000.

Direct rollovers to Roth IRAs: Effective for distributions after December 31, 2007, direct rollovers of distributions from qualified plans, such as 401(k)s, 403(b)s, and governmental 457(b) plans, to Roth IRAs will be allowed. This means that a participant no longer needs to roll assets into a traditional IRA first, and then convert the traditional IRA to a Roth IRA. This reduces paperwork hassles. *Limitation:* The current household AGI limit of $100,000 still applies.

Cash donations: Starting in 2007, *all* cash or credit card contributions to charities must be substantiated with a cancelled check, bank record, credit card record, or a receipt from the charity, including the date of the contribution and the amount. Previously, donations less than $250 did not require a receipt.

Faster Vesting: After December 31, 2006, the Act requires that all employer contributions become 100% vested on either a three-year *cliff vesting* schedule or a six-year *graded vesting* schedule. If the cliff vesting schedule is used by the employer, all employer contributions must be 100% vested by the end of the three-year period. If the six-year graded vesting schedule is used, employer contributions must vest at the rate of 20% per year for each year of service, beginning with the second year.

IRAs and Tax Refunds: The Act provides taxpayers with more choice and flexibility for direct deposits of their 2006 federal income tax refunds. They can split their refunds among up to three U.S. financial institutions by using Form 8888. Allowable accounts include checking, savings and IRA accounts. This new option will be available for tax returns filed either on paper or electronically. Taxpayers can continue to use the direct deposit line on Form 1040 to electronically send their refunds to one checking or savings account.

We are apprising you of this new benefit with a fair amount of trepidation, especially with regard to IRA direct deposits. The IRS (draft) instructions for the new Form 8888 require you to notify the IRA custodian (presumably *in advance* of the custodian receiving the deposit) as to which tax year the IRA should be applied. For example, when you file your return in the spring of 2007 and use the IRA direct deposit feature, the IRA custodian is likely to automatically apply the deposit to your account as a 2007 IRA contribution. If you have notified the IRA custodian in advance that the deposit should be applied to 2006, but it is misapplied to the 2007 tax year, and the due date (without extensions) for making the contribution has passed (April 16, 2007), you will be required to file an amended return.

What to do: Avoid using the IRA direct deposit feature on Form 8888. The process is fraught with problems and potential additional (amended return) paperwork. Always try to make your full annual IRA contribution by the end of the current calendar year. When a new year begins, start to fund your IRA for the new year so that you are never contributing money to an IRA in the spring of the new year, to be applied as a prior-year contribution. ❖

Business Continuity Planning

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