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Dear Clients and Friends:

On August 3, Congress passed the Pension Protection Act of 2006 (“the Pension Act”). President Bush has said he will sign the massive bill into law (it’s over 900 pages long). Although the Pension Act has not received very much media attention, it includes many important tax changes that will affect individuals, employers, businesses in general, and charitable organizations. Many of the changes have nothing to do with retirement plans, even though the Act’s main purpose is supposedly to shore up traditional defined benefit pension plans so as to avoid the need for future taxpayer-funded bailouts.

This letter summarizes what we think are the key points in the new law, starting with the ones most likely to affect small businesses and individuals.

Favorable Retirement Plan Rules Made Permanent

The Economic Growth and Tax Relief Reconciliation Act of 2001 made many favorable changes to help out retirement savers. The most important provisions allow for bigger annual IRA and retirement plan contributions, additional contributions for those who are age 50 and older, and expanded opportunities to arrange for tax-free rollovers between retirement plans and accounts. However, all the favorable changes were scheduled to “sunset” (disappear) after 2010. In other words, the less-favorable “old-law” rules were scheduled to reappear for 2011 and later years.

The Pension Act makes all the taxpayer-friendly changes in the 2001 legislation permanent by repealing the sunset provisions. So you no longer have to worry about rules from the “bad old days” kicking back in for 2011 and beyond. Therefore, it’s basically “business as usual” with no need for adjustments on your part.

Phaseout Ranges for Deductible IRA and Roth IRA Contributions Will Be Indexed for Inflation

For 2007 and later years, the new law mandates inflation adjustments to the income-based phaseout ranges that limit contributions to traditional IRAs and Roth IRAs. The new inflation-adjusted phaseout ranges will allow more individuals to contribute to these accounts.

Nonspouse Beneficiaries Can Roll Over Distributions from Deceased Person's Retirement Plan

Starting in 2007, the Act permits tax-free rollovers of direct trustee-to-trustee transfers from a deceased person's IRA or retirement plan to a nonspousal beneficiary's IRA. The same tax-free rollover privilege will be available for trustee-to-trustee transfers from tax-sheltered annuity arrangements and governmental Section 457 plans to nonspousal a beneficiary's IRA. Under prior law, only surviving spouses were able to take advantage of the tax-free rollover privilege.

Note: This new rule doesn't kick in until 2007. So, if you're due some funds from an inherited retirement account and you'd like to roll them over to an IRA, you'll want to wait until 2007. Also, cash distributions apparently will not qualify for this new rule. Therefore, it will be important to arrange for a trustee-to-trustee transfer of funds. Finally, a new IRA will need to be established to receive the funds—they should not be commingled with an existing IRA as the new account will have different distribution rules. Please give us a call if you have this situation and would like our help.

Direct Deposits of Tax Refunds into IRAs

Starting in 2007, you will be able to arrange to have all or part of your federal income tax refund direct deposited into your IRA (or your spouse's IRA if you file jointly).

More Opportunities to Roll Over After-tax Contributions

Starting in 2007, you will be able to roll over after-tax contributions from a qualified retirement plan into a receiving defined benefit plan or a receiving tax-sheltered annuity arrangement.

Direct Rollovers Allowed from Retirement Plans into Roth IRAs after 2007

Starting in 2008, eligible individuals will be able to arrange for direct rollovers of distributions from qualified retirement plans, tax-sheltered annuities, and governmental Section 457 plans into Roth IRAs. These are so-called Roth IRA conversion transactions. For 2008 and 2009, only individuals with modified adjusted gross incomes of \$100,000 or less are eligible for Roth IRA conversions. For 2010 and beyond, however, the \$100,000 limitation is scheduled to disappear.

Special Breaks for Certain Retirement Account Distributions to Military Reservists

The Pension Act includes favorable new rules for early retirement account withdrawals taken by qualified military reservists. These beneficial new rules potentially apply to amounts withdrawn after 9/11/01 by reservists who were under

age 59½. If taking advantage of these provisions would reduce your tax bill from a prior year, you may need to take quick action to obtain a refund.

Favorable Rules for Section 529 Plans Are Now Permanent

The Pension Act makes permanent the current ultra-favorable federal income tax treatment of Section 529 plans used to finance college education costs. Of particular importance, qualified Section 529 plan distributions (distributions used for qualified higher education expenses) will continue to be federal-income-tax-free, even after 2010. Previously, these distributions would have been taxable if made after 2010.

Note: This eliminates the concern that funds distributed after 2010, when many 529 plan beneficiaries would be in college and withdrawing the plan assets for educational expenses, could be taxed. If you haven't previously taken advantage of these plans, it may be time to reconsider them.

Changes Affecting Charitable Donations and Charities

The Pension Act also includes numerous changes affecting the tax treatment of donations to tax-exempt charitable organizations as well as other provisions that affect charities themselves. Here are highlights of the most important changes.

- *Tighter Rules for Cash Donations under \$250.* The Pension Act completely disallows any deduction for a charitable donation of cash, a check, or any other monetary gift unless you have either a bank record (such as a cancelled check) or a written communication from the charity that adequately documents your donation. This unfavorable change is effective for tax years beginning after the new law's date of enactment, so most individuals won't be affected until 2007.

Note: Basically this means no more deduction for estimated amounts of cash put in the collection plate. Starting in 2007, you'll need to write a check, charge it, or get some sort of documentation from the charity.

- *Tighter Rules for Donations of Used Clothing and Household Items.* The Pension Act completely disallows deductions for most donations of used clothing and household items that are not in "good" condition or better. This unfavorable change is effective for donations after the new law's date of enactment, so 2006 donations may be affected.
- *Temporary Allowance of Donations Directly out of IRAs.* The Pension Act allows those who are age 70½ or older to claim tax-free treatment for otherwise taxable distributions from traditional or Roth IRAs, when the IRA money is paid out directly to a tax-exempt charity. This favorable new rule for "qualified charitable distributions" applies for 2006 and 2007. However, there is a \$100,000 annual cap on the privilege. Because a qualified charitable distribution is federal-income-tax-free, you don't get any federal income tax deduction. But, tax-free treatment for the distribution is effectively the same as a 100% write-off. The new rule benefits seniors

who don't itemize as well as seniors who would be adversely affected by the "normal" restrictions on itemized charitable contribution deductions.

- *Extension of Enhanced Deduction for Donated Food Inventories and Book Donations by C Corporations.* The Katrina Emergency Tax Relief Act of 2005 (Katrina Act) established a temporary enhanced charitable deduction for non-C-corporation businesses that made charitable contributions of food inventories on or after 8/28/05 and not later than 12/31/05. The Katrina Act also created an enhanced deduction for contributions of books by C corporations for qualified donations made on or after 8/28/05 and no later than 12/31/05. The Pension Act extends both of these favorable provisions for two more years—through 12/31/07.
- *Temporary Liberalizations for Qualified Conservation Contributions.* The Pension Act liberalizes the rules for "qualified conservation contributions" made in 2006 and 2007 by individuals and private corporations to charitable organizations. Qualified conservation contributions in excess of what can be currently deducted can be carried forward for up to 15 years.
- *Numerous Other Rules Affecting Donors and Charities.* The Pension Act also includes a laundry list of other new rules intended to combat perceived abuses involving charities. Please call us if you want more information on these.

New Rules That Shore Up Defined Benefit Plans and Other Technical Retirement Plan Changes

Shoring up the financial strength of existing defined benefit pension plans of large employers was the main reason for enacting the new law. Provisions intended to help accomplish this goal are painted below with an extremely broad brush, along with miscellaneous other retirement plan changes.

- Various measures intended to encourage employers to fully fund promised benefits under defined benefit pension plans and to discourage them from promising or delivering additional or accelerated benefits for which adequate funding appears doubtful. Underfunded plans generally have seven years to become fully funded. Special rules apply in some cases. Also, stricter rules apply to keep employees fully informed about troubled plans.
- For plan years beginning after 2006, defined benefit plans will be allowed to make distributions to employees who are age 62 or older and still working. Currently, defined benefit plans are prohibited from making such distributions before employees reach normal retirement age.
- Faster vesting for employer contributions to defined contribution plans.
- Employers are given legal encouragement to automatically enroll their workers for 401(k) elective deferral contributions (i.e., by using negative confirmations that require the employee to affirmatively opt out of making automatic contributions via salary withholding).

- Defined contribution plans must allow employees to more quickly diversify out of employer stock acquired with both employee elective deferral contributions and employer contributions.
- And much, much more that we don't have space to cover here.

Conclusions

The Pension Protection Act of 2006 is a truly massive piece of legislation. Over the coming months, professional advisers will be spending lots of time digesting the new provisions. While this letter only scratches the surface of all the changes, we hope you find it helpful. Please contact us if you have questions or want more information about the new law.

Sincerely,



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