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TAX & TRANSACTIONS BULLETIN

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- On August 17, 2006, President Bush signed the Pension Protection Act of 2006 ("Act").
- The Act's main purpose is to strengthen and reform U.S. Pension Plans by requiring companies to make larger contributions to their defined benefit plans. Businesses which fail to make required contributions to their defined benefit plans will pay higher premiums to the Pension Benefit Guarantee Corporation (PBGC).
- The Act permits an individual age $70^{1}/_{2}$ or older to distribute up to $100,000 from her IRA Account to Charity <u>tax-free</u> in 2006 and again in 2007. The individual does not recognize income and does not receive a charitable deduction.
- The Act allows a Non-Spouse Beneficiary of a deceased employee's Eligible Retirement Plan to rollover Plan distributions tax-free to an Inherited IRA. The Inherited IRA is established in the decedent's name f/b/o the Non-Spouse Beneficiary. The Inherited IRA generally may make payments to the Non-Spouse Beneficiary over her remaining life expectancy.

SUMMARY OF "PENSION PROTECTION ACT OF 2006" ("ACT"), SIGNED BY PRESIDENT GEORGE W. BUSH ON AUGUST 17, 2006

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 ("Act"). The Act's main purpose is to strengthen and reform U.S. Pension Plans by requiring companies to make larger contributions to their defined benefit plans. Businesses which fail to make required contributions to their defined benefit plans will pay higher premiums to the Pension Benefit Guarantee Corporation (PBGC). The Act also contains numerous provisions affecting individual taxpayers, several of which are summarized below.

INDIVIDUALS

1. Tax-Free IRA Distributions to Charity up to $100,000 in 2006 and Again in 2007

The Act permits an individual age $70^{1}/_{2}$ or older[1] to distribute up to $100,000 from her IRA[2] Account to Charity <u>tax-free</u> in 2006 and again in 2007.[3] The individual does not recognize income and does not receive a charitable deduction. Due to a favorable Allocation Rule, the charitable distribution is treated as first made out of taxable IRA income,[4] meaning the IRA owner <u>preserves</u> her non-deductible contributions (i.e. basis) within the IRA for later

[1] The distribution must be made: (i) directly from the IRA Account <u>to</u> the Charity; <u>and</u> (ii) on or after the date on which the IRA owner has attained age $70^{1}/_{2}$. See new Code Section 408(d)(8).

[2] The charitable distribution may be made from either a Traditional IRA <u>or</u> a Roth IRA. The IRA owner may <u>exclude</u> from gross income "qualified charitable distributions" <u>not</u> exceeding $100,000. Carryovers are not permitted, and therefore an individual with "qualified charitable distributions" of $115,000 must include $15,000 in income currently. The $100,000 exclusion from income does not apply to distributions from Simplified Employee Pensions or 408(p) Simple IRAs. [Note: charitable gifts from a Roth IRA have <u>few</u> tax advantages, since qualified distributions from a Roth IRA are received tax-free, and Roth IRAs are <u>not</u> subject to Required Minimum Distributions during the original owner's lifetime.]

[3] The recipient must be a 50-percent Charity described in Code Section 170(b)(1)(A) (i.e. a "Public Charity"). IRA transfers to a Supporting Organization or a Donor Advised Fund <u>fail</u> to qualify. <u>Note</u>: the distribution to charity must <u>otherwise be entirely deductible</u> as a charitable gift. Thus, the IRA owner: (i) cannot receive any benefit from the Charity; <u>and</u> (ii) must obtain adequate substantiation of the transfer. If the IRA owner (i) receives a benefit from the Charity, <u>or</u> (ii) fails to obtain adequate substantiation, then the exclusion from income is not available for <u>any part</u> of the distribution.

[4] <u>Caution</u>: the favorable Allocation Rule only applies to IRAs that have received both deductible <u>and</u> non-deductible contributions. Recall that nondeductible contributions to a traditional IRA may be withdrawn tax free (see IRS Form 8606 and Code Section 408(o)). In a typical IRA distribution to the owner, a portion of each dollar distributed is a non-taxable return of nondeductible contributions (i.e. return of basis), and the balance is a taxable payment of deductible contributions and earnings. <u>However</u>, the new charitable distribution rules permit the owner to "<u>front load</u>" the payment of taxable amounts (i.e. deductible contributions and earnings) to Charity. Thus, the owner <u>preserves</u> her nondeductible contributions (i.e. her non-taxable basis) within the IRA, for later tax-free distribution to herself.

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tax-free distribution to herself. Also, charitable distributions are counted as Required Minimum Distributions ("RMDs"). Thus, an IRA owner may make a charitable distribution in an amount equal to his Required Minimum Distribution, and thereby satisfy his required payout for that year under the RMD rules without incurring tax.

Example 1: *Dad has a Traditional IRA with a balance of $100,000. He has no other IRA. Of that amount, $80,000 represents deductible contributions and earnings, and $20,000 represents nondeductible contributions (i.e. basis) which Dad may withdraw tax-free. Assume Dad distributes $80,000 from the IRA directly to Charity. Ordinarily, 20 percent of the $80,000 distribution (i.e. $16,000) would be treated as a payout of nondeductible contributions (i.e. basis). However, due to the favorable Allocation Rule, all $80,000 is treated as a payout of deductible contributions and earnings. For purposes of subsequent distributions to Dad, $20,000 of IRA will be treated as nondeductible contributions (i.e. basis) which may be paid to Dad tax-free.*

2. Tax-Free Rollover of Qualified Plan Distributions by Non-Spouse Beneficiary

The Act allows a Non-Spouse Beneficiary of a deceased employee's Eligible Retirement Plan[5] to rollover Plan distributions tax-free to an Inherited IRA.[6] The Inherited IRA is established in the decedent's name f/b/o the Non-Spouse Beneficiary. The following rules apply to that Inherited IRA: (a) the Non-Spouse Beneficiary will not be treated as the owner of the rollover assets; (b) assets transferred to the Inherited IRA cannot be rolled over again; and (c) assets rolled over to the Inherited IRA must be distributed to the Non-Spouse Beneficiary according to the Required Minimum Distribution rules (i.e. generally over the remaining life expectancy of the Non-Spouse Beneficiary). The Non-Spouse Beneficiary may name a successor beneficiary, provided that the Inherited IRA continues to make RMD distributions based on the remaining life expectancy of the original Non-Spouse Beneficiary.

The key dynamic of the Non-Spouse rollover rule is the ability to transfer Qualified Plan assets (e.g. 401k assets) to an Inherited IRA. For example, where a parent died leaving a large pension plan to a child, the Plan's rules may force the child to withdraw all funds within 5 years (or even immediately), creating a significant tax liability. Under the Act, the child now has the ability to rollover the Plan assets to an Inherited IRA in the parent's name f/b/o child, thus allowing the child to withdraw funds over his remaining life expectancy and defer tax.[7] The Act applies to distributions after December 31, 2006. The Act appears to permit rollovers from Plans inherited prior to the Act's effective date.

Example 2: *Mom died leaving a large pension plan to Child whereby Child was forced, under the qualified plan's rules, to take funds out of the plan within five years. Under the Act, Child can now transfer the funds via a trustee-to-trustee transfer to an IRA in Mom's name f/b/o Child, allowing Child to withdraw dollars over his life expectancy.*

[5]Eligible Retirement Plans include: (1) a 408(a) Individual Retirement Account; (2) a 408(b) Individual Retirement Annuity (other than an endowment contract); (3) a Qualified Trust (e.g. a 401k Plan); (4) a 403(a) Annuity Plan; (5) a 457(b) Eligible Nonqualified Deferred Compensation Plan; and (6) a 403(b) Annuity Contract. See Code Section 402(c)(8)(B).

[6]Plan distributions may be rolled over tax-free to either (i) a 408(a) Individual Retirement Accounts or (ii) a 408(b) Individual Retirement Annuity (other than an endowment contract). The recipient IRA must receive the Plan distributions in a direct trustee-to-trustee transfer. See new Code Section 402(c)(ii).

[7]A Trustee of a Trust that is named as beneficiary of a Qualified Plan is also permitted to rollover Plan assets to an Inherited IRA.

Edited by William B. Fox, B.A., J.D., LL.M. Tax