

## *New Pension Law —*

# Tax Changes Affect Individuals and Businesses

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In August Congress passed and President George W. Bush signed the Pension Protection Act of 2006 (the Pension Act), which is more than 900 pages in length. Although the Pension Act has not received 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 supposedly is to shore up traditionally defined benefit pension plans with the intention of avoiding the need for future taxpayer-funded bailouts.

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

### **Retirement plans**

*The Pension Act made favorable retirement plan rules permanent.*

The Economic Growth and Tax Relief Reconciliation Act of 2001 made many favorable changes to help retirement savers. The most important provisions allow for larger annual IRA and retirement plan contributions, additional contributions for those who are age 50 years 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" (disap-

pear) after 2010. In other words, the less favorable old law rules were scheduled to reappear for 2011 and subsequent 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**

*Phaseout ranges for deductible IRA and Roth IRA contributions will be indexed for inflation.*

For 2007 and the years that follow, 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**

*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 a nonspousal beneficiary's IRA.

Under prior law, only surviving spouses were able to take advantage of the tax-free rollover privilege.

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*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. These funds should not be commingled with an existing IRA, as the new account will have different distribution rules.

Please give us a call if this situation affects you and you would like our help.

## Direct deposits

*Direct deposits of tax refunds can be made into IRAs.*

Starting in 2007, you will be able to arrange to have all or part of your federal income tax refund deposited

directly into your IRA (or your spouse's IRA if you file jointly).

## Direct rollovers

*Direct rollovers will be 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.

## Permanent rules

*Favorable rules for Section 529 plans are now permanent.*

The Pension Act makes permanent

the current, ultrafavorable 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.

## Tax-exempt changes

*Some changes affect charitable donations and charities.*

The Pension Act also includes numerous changes affecting the tax deductions for 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 of less than \$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 canceled check) or a written communication from the charity that adequately documents your donation. This change is effective for 2007.

*Note:* Basically this means no more deductions 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 disal-

## Small Exempt Organizations – IRS to Require Annual Notices

An organization with gross receipts that normally are \$25,000 or less for the year (determined in accordance with special rules) is not required to file Form 990 or 990-EZ. This filing exemption doesn't apply to private foundations.

The purpose of this exemption is to avoid imposing an administrative burden on small organizations.

However, in the absence of an annual information return, the IRS cannot monitor an organization's continuing existence, and often the public has difficulty obtaining basic information about it.

The IRS has made a timely announcement in regards to an article in the last issue of our newsletter. For tax years beginning in 2007, an organization that is exempt from filing an

annual return under the gross receipts test must file an annual notice with the IRS.

This notice should include the organization's legal name; assumed or "doing business as" name; mailing address; Internet Web site address, if any; taxpayer identification number; name and address of a principal officer and evidence that it continues to satisfy the gross receipts exemption.

This annual notice must be filed electronically at the time and in the manner prescribed in future regulations.

There will be no monetary penalty for the failure to submit an annual notice.

However, an organization's exemption will be revoked for such a failure for three consecutive years.

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lows 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 August 17, 2006, so some 2006 donations will be affected.

**Important:** Exactly what “good” means is a mystery, and the IRS is expected to issue some guidance.

You will probably see charities begin to add a box or redesign their receipts to document their assessment of the donated goods. In the meantime, consider taking photos and keep a detailed inventory of what you donate.

You can still deduct the value of an item that isn’t in good condition if the amount claimed is more than \$500 and you attach a qualified appraisal with your return.

- *Temporary allowance of donations directly out of IRAs.*

The Pension Act allows those who are age 70 1/2 years 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. These direct charitable distributions can take the place of otherwise required minimum distributions.

Because a qualified charitable distribution is federal income tax free, you do not get any federal income tax deduction for that contribution. But tax-free treatment for the distribution is effectively the same as a 100 percent 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 chari-

table contribution deductions.

- *Temporary liberalization 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 benefit rules

*New rules shore up defined benefit plans, and there are 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 are 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 years or older and still working. Currently, defined benefit plans are prohibited from making such distributions before employees reach normal retirement age.

- Faster vesting is provided 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 diversify more quickly 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. While this article 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.

## Numerous changes affect tax deductions for donations





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The man who blows his own trumpet is usually a soloist.

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## Happy Holidays

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