Client Alert

ARMSTRONG TEASDALE LLP

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HIGHLIGHTS OF THE PENSION PROTECTION ACT OF 2006

The recently passed (August 17 enactment date) Pension Protection Act of 2006 is a massive tax bill that overhauls rules for retirement plans, changes rules that govern charitable giving and charities, and alters the treatment of death benefits from corporate-owned life insurance.

RETIREMENT PLAN PROVISIONS

Reform of the single-employer defined benefit rules

For single-employer defined benefit plans, the Act:

- requires employers to make contributions to their single-employer defined benefit pension plans over the next seven years in order to make them 100% funded. Formerly, a 90% funding level was acceptable;
- specifies that the discount rate used to calculate the present value of current pension liabilities be based on a segmented yield curve of corporate bonds;
- triggers accelerated contributions for "at-risk" plans;
- reduces the smoothing of interest rates to two years (instead of five for assets and four for liabilities under current law);
- permits employers to make additional maximum deductible contributions;
- prohibits further benefit accruals for lump-sum distributions or shutdown benefits from plans funded at less than 60%;
- restricts the use of deferred executive compensation arrangements for employers with severely underfunded plans;
- permanently establishes an employer-paid termination premium of $1,250 per participant if a plan sponsor terminates its employee pension plan upon entering bankruptcy; and
- establishes special rules for airlines.

Reform of the multiemployer pension system

The Act's changes relating to multiemployer 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;
- requiring plans 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; and
- prohibiting benefit increases if the increase causes the plan to fall below 65% funded status.

New disclosure rules for qualified plans

One of the overarching themes of the Act is that there should be more pension transparency so that workers, regulators and investors can better keep tabs on the financial health of traditional pension plans. To meet this need, 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 makes all Form 4010 information filed with PBGC available to the public, save for sensitive corporate proprietary information;

- establishes an 80%, at-risk threshold that determines whether plans pose a threat to PBGC and therefore must 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;
- prohibits companies from forcing employees to invest any of their own retirement savings contributions in the stock of the employer;
- makes it clear that companies have a fiduciary responsibility for workers' savings during "blackout" periods, when workers are temporarily barred from making changes to their 410(k) investments; and
- requires companies to give workers quarterly benefit statements that 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 investment advice to help employees manage their 401(k) and other retirement options;
- puts in place fiduciary and disclosure safeguards to ensure that 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 that 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).

Liberalized plan payout and rollover rules

Provisions in the Act that liberalize plan payout and rollover rules include the following:

- after 2007, taxpayers will be permitted to make direct rollovers from qualified plans to Roth IRAs;
- for purposes of the 401(k) hardship distribution rules, "hardship" includes hardship of any beneficiary under the plan (not just a spouse or dependent);
- members of the National Guard and Reserves called to active duty through 2007 can make penalty-free withdrawals from retirement plans. Withdrawn amounts may be repaid to the IRA or pension plan within two years of the distribution;
- the 10% early withdrawal penalty for distributions to public safety employees over age 50 (including police, fire, and emergency medical services) who may retire early is waived;
- effective for post-2006 distributions, nonspouse designated beneficiaries are allowed to make rollovers of inherited amounts in qualified plans, governmental Sec. 457 plans, or tax-sheltered annuities to their own IRAs (treated as inherited IRAs); and
- effective for distributions in plan years beginning after 2006, defined benefit plans can make in-service distributions to age-62-or-older participants.

Retirement savings provisions made permanent

The Act makes permanent a number of retirement plan and IRA liberalizations that were added to the tax laws in 2001 but were set to sunset after 2010. By making the 2001 changes permanent, the new law preserves the advantages of higher employee contribution limits for employer plans, higher IRA contribution limits, more flexible plan rules, portability, a catch-up for those over 50, and an increase in employer contribution limits. The new law also makes permanent the saver's credit, which would not have been available after 2006 absent the extension.

CHARITABLE GIVING AND CHARITIES

Charitable giving incentives

The Act contains a charitable giving incentives package designed to encourage charitable donations. The incentives include:

- tax-free distributions from IRAs for charitable purposes. The new law permits taxpayers to exclude from gross income certain distributions of up to $100,000 from a traditional individual retirement account (IRA) or Roth IRA which would otherwise be included in income. The charitable distribution must be made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.
- charitable deduction for contributions of food inventory. Under the new law, an enhanced deduction for donations of food inventory which was formerly available only to C corporations is extended to all trades and businesses, effective for two years through 2007.
- basis adjustment to stock of S corporation contributing property. The Act provides that if an S corporation contributes property to a charity, an S corporation shareholder only has to reduce his basis in stock of the S corporation by his pro rata share of the adjusted basis of the contributed property, rather than by the amount of the charitable contribution that flows through to him. For example, if an S corporation with one individual

shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500, the shareholder will be treated as having made a $500 charitable contribution and will reduce the basis of the S corporation stock by $200. The provision is effective for two years through 2007.
- charitable deduction for contributions of book inventory. The provision extends the current-law provision that adds public schools to the list of eligible donees for the enhanced deduction for contributions of qualified book inventory by C corporations. The provision is effective for two years through 2007.
- the tax treatment of certain payments to controlling exempt organizations. Under prior law, rent, royalty, annuity, and interest income paid to a tax-exempt organization by a controlled taxable subsidiary was generally treated as unrelated business income, which was taxable to the tax-exempt parent organization. The new law modifies that rule such that only the portion of such payments which is not regarded as fair market value will be treated as unrelated business taxable income. Exempt organizations are required to report certain amounts received from controlled organizations. The provision is effective for two years through 2007.
- qualified conservation contributions. The new law raises the charitable deduction limit—from 30% of adjusted gross income to 50%—for qualified conservation contributions, as long as it does not prevent the use of the donated land for farming or ranching purposes. The charitable deduction limit is raised to 100% of adjusted gross income for eligible farmers and ranchers. Unused contributions can be carried forward for up to 15 years. The provision is effective for two years through 2007.

Charitable reform

The Act also imposes new requirements and restrictions on exempt organizations. The new rules:

- require reports to the Treasury Department on certain life insurance contracts.
- double the fines and penalties applicable to certain activities by charities, social welfare organizations, private foundations and exempt organization managers.
- clarify the terms of facade easements in historic districts, and also clarify that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property.
- limit the basis for donated taxidermy property to the cost of preparing, stuffing and mounting an animal and provide that the value of the deduction is equal to the lesser of basis or fair market value.
- require the recapture of any tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed if the property is not used for an exempt purpose of the donee organization. The change is effective for contributions made after Sept. 1, 2006.
- prohibit deductions for contributions of clothing and household items unless they are in good used condition or better. In addition, IRS may deny a deduction for any item with minimal monetary value. These rules, which are effective for contributions made after the enactment date, 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.
- require that 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. The change is effective for contributions made after the enactment date.
- require that charities receiving a fractional interest in an item of tangible personal property take complete ownership of the item within 10 years or the death of the donor, whichever occurs first. In addition, the donee must have (i) taken possession of the item at least once during the 10-year period as long as the donor remains alive, and (ii) 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. The change is effective for contributions, bequests, and gifts made after the enactment date.
- lower the threshold for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required.
- impose certain requirements on tax-exempt organizations that offer credit counseling services, subject to a four-year transition rule to limit the allowable amount of debt management plan income to 50% of revenues.
- apply an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that with respect to such fund is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person.
- require that unrelated business income tax returns of section 501(c)(3) organizations be made publicly available.

REVISED RULES FOR CORPORATE-OWNED LIFE INSURANCE (COLI)

Treatment of death benefits from corporate-owned life insurance (COLI)

Under pre-Act law, payments of life insurance after the covered party's death are generally not taxable to the recipient.

For contracts issued after enactment date, the Act requires businesses to treat proceeds from COLI as income unless the insured was an employee within 12 months of death, proceeds are paid to the insured's beneficiary used to buy back any equity interest owned by the insured at the time of death; or the insured was a "highly compensated employee." Highly compensated employees are more then 5% owners, directors and anyone else in the top 35% of employees ranked by pay. The new COLI provision also includes notice and consent requirements, and reporting requirements.

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