



The Pension Protection Act of 2006

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On August 17, 2006, President Bush signed The Pension Protection Act of 2006 (PPA), a 1,300-page monstrosity which should create opportunities for financial planners for decades to come. What opportunities does it create for you and your practice? We have summarized below the most salient points which should serve as your crib notes to understanding the legislation's most compelling parts.

The PPA is the first meaningful pension legislation in over 30 years. It was intended to address the significant under-funding of traditional retirement plans. Congress believed it to be the best solution to prevent the potential insolvency of many defined benefit plans. Although it is unclear to us whether the PPA will "save" these types of plans, it ultimately will be identified as the defining pension legislation of our time.

The PPA contains several parts that address the under-funding of defined-benefit plans (we have chosen to leave the aspects of this part of the Bill to the pension specialists; we focus here on the portion of the PPA applicable to planners who are advising individuals). However, we believe the added expense created by the fixes may have the unintended consequence of causing companies to collapse or freeze their existing plans. Hewlett Packard provides an excellent example of what we feel is the future of retirement plans. During the past year, HP imposed a freeze on its defined-benefit plan; however it did increase the matching contribution to the employees' 401 (k) plans.

On the positive side, Congress has expanded many of the rules relating to pension and retirement plans from the 2001 Tax Act and the tax treatment of 529 Plans. The PPA also changes the provisions relating to charitable giving with a focus on the perceived loopholes in this area. These changes should give employers a strong incentive to start/expand their defined-contribution plans, which in turn will create greater planning opportunities to expand your revenue base. Discussed below is what you need to know.

Automatic 401k Enrollment

An individual's apathy will no longer keep him from saving for retirement or choosing a proper asset allocation. The PPA includes two major changes that address these issues. Starting in 2007, employers can automatically enroll their employees in their defined-contribution plans. The PPA also enables employers to choose default investment options on behalf of plan participants who do not make an election. In the past, if an individual did not make an election, funds were often transferred to the money-market

option. However, with the alleviation of the fiduciary duty restriction on employers, an employer is now free to choose a wider array of default investment options. Of course, employees can still choose to opt out of the plan. These changes will likely result in an increase in the use of lifestyle and lifecycle-type funds because of their broad applicability.

Investment Advice

Another much-anticipated and long-overdue feature of the PPA permits individuals to receive personalized investment advice from plan sponsors, albeit with a few limitations. For example, the advisor cannot receive additional compensation for recommending different funds; therefore a flat-fee arrangement would be the most likely result. In addition, for any computer-model-generated portfolio recommendations, a certification and audit must be performed by an independent third party.

Personalized investment advice could be a big win for inexperienced investors who, in the past, would have made a bad choice. However, this rule opens up the door for potential conflicts of interest. The PPA attempts to limit the impact of this problem and has requested that the Treasury Department issue rules clarifying the issue further.

The PPA has also attempted to address the problems associated with employees' being overly concentrated in their company's stock. They have legislated that defined-contribution plans must meet certain diversification requirements with regard to employer securities. The individual must be permitted to instruct the plan to sell employer securities and allocate the proceeds to other investment options.

Roth 401k

The PPA has eliminated the "temporary" status of Roth's (IRAs and 401 (k)s), which will create the largest changes in our retirement system. Employers can now commit to offering these plans to their employees. Most planners agree that a Roth investment option makes great sense under the right circumstances (see example below). However, because it was scheduled to sunset in 2010, most employers and large fund administrators were reluctant to incur the time and expense needed to add them to their offerings. Permanency will create explosive growth in this area, and financial planners will need to bone up on the different profiles of people who would use a Roth 401 (k) plan in favor of a traditional 401 (k) so that we can make thoughtful recommendations to our clients.

Certainly, everyone is aware of the income-tax issues regarding Roth accounts, including tax-free distributions during retirement in exchange for foregoing a present income tax deduction. However, there is an additional estate-tax benefit to a Roth. Under current law, there are no required minimum-distribution rules for a Roth IRA, further enhancing the potential benefit of using a Roth.

The old rules in evaluating a Roth versus a traditional retirement-plan contribution continue to apply; if someone believes that he will be in the same tax bracket in retirement as he is while working, then a contribution to a Roth will usually be beneficial (assuming he has cash outside the plan to pay current taxes due). However, if he will be in a lower tax bracket in retirement, then you need to do a more thorough analysis.

Quite often in practice we face the question of Roth vs. traditional IRAs. We have created a model to analyze this issue. The following assumptions are factored in to our decision-making process:

- The investor's current marginal income-tax rate; here 35%
- Future marginal income-tax rate of 25% (in retirement)
- Investment growth rate of 10%
- The individual has cash outside the Roth 401 (k) to pay current income tax due.
- The individual would re-invest the tax savings from the 401 (k) contribution at a 6.5% after-tax rate of return.

Our conclusion under this scenario (see chart above) is if he is below the age of 55, then contribute to the Roth 401 (k). If he is 55 or older, then contribute to a traditional 401 (k).

You should also note that direct rollovers from retirement plans to Roth IRAs will not be permitted until 2008. This is a significant change. Until 2008, any retirement-plan transfer would need to be made first into a traditional IRA and then transferred to the Roth IRA. Keep in mind that the direct rollover feature will not relieve the individual of any other restrictions inherent in making contributions to a Roth IRA. For example, the AGI limitations would still apply, as would the obligation to pay any income tax due when initiating the rollover.

The PPA has also made permanent the rule giving the IRS additional flexibility in waiving the 60-day requirement on rollovers from qualified plans and IRAs.

In addition, the PPA made permanent the increased contribution limits to a 401 (k). The \$15,000 annual contribution limit that was set to expire in 2010 has now been permanently extended. The additional \$5,000 "catch-up" provision has also been extended for those over age 50. Post 2010, the annual contributions limits will be indexed for inflation in increments of \$500.

"Inherited IRA"

The PPA also changes the options for a non-spouse beneficiary of a qualified retirement plan. The non-spouse may continue to get the benefits of tax deferral by rolling over the assets to an "inherited IRA". In the past, only a spouse could benefit from a tax-free rollover and, if the beneficiary was someone other than a spouse, the assets would be distributed in a lump sum with income tax being due almost immediately. Now, a non-

spouse beneficiary can roll the IRA into an “inherited IRA” to continue the benefits of deferral. Once in the “inherited IRA,” which must be a direct trustee-to-trustee rollover, distributions do not have to be taken within five years and they can be stretched over the beneficiary’s life expectancy. This law takes effect in 2007.

One additional requirement is that the assets in the “inherited IRA” cannot be commingled with a beneficiary’s other IRA accounts because the beneficiary must start taking distributions from the “inherited IRA,” whereas if it is an IRA created by that individual, he would not be required to start taking distributions until reaching age 70 ½.

Charitable Contributions

During 2006 and 2007, individuals over age 70 ½ can make tax-free distributions from their IRAs, meaning, there would be no reportable income and no income-tax deduction to worry about. This was a pleasant surprise in the PPA and many charities are using this as a call to their donor base to try to raise money. However, there are some restrictions: The charitable contribution must be 100% deductible; it cannot be a split-interest trust (charitable-remainder trust, pooled income fund or gift annuity). The gift must be made directly to the charity. The charity cannot be a donor-advised fund, supporting organization or most private foundations.

Keep in mind that the distribution is limited to \$100,000 per year. On the plus side, the distribution can be used to satisfy an individual’s required minimum distribution.

The PPA also included a few other rules relating to the perceived abuses in the not-for-profit sector. Contributions of clothing and household items will only be permissible if the items are in “good used condition or better”. There are more stringent substantiation requirements for charitable contributions of cash. Congress seems to be concerned about the potential abuse in the donor-advised fund area and has given the Treasury one year to evaluate and study the organization and operation of donor advised funds. Contributions of partial interests in tangible personal property have been limited (e.g., Artwork). The new rules have expanded charitable-contribution limits for farmers and ranchers who wish to make a charitable deduction using a qualified conservation easement.

Interestingly the most coveted relief that was being lobbied for by the not-for-profit sector was not included in the PPA; it does not provide for a charitable deduction for those taxpayers who do not itemize on their personal returns.

College Savings Plans

Section 529-qualified tuition plans were another planning technique which was underutilized due to the sun-setting provisions. Most planners were not comfortable recommending a tax-advantaged vehicle that may not be there in the future. The

permanency of 529 plans should create an explosion of the popularity of these vehicles as a means to help save for a child's or grandchild's education.

Conclusion

Great change leads to great opportunity for those who are prepared. This is especially true when it comes to changes in our retirement system. The PPA has opened many doors for financial planners; those who are most familiar with the pros and cons of the new legislation will walk right through.