

October 3, 2006

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Estate Planning Aspects of the Pension Protection Act of 2006

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (the "Act"). While the Act has an extensive effect on pension plans, it also includes several provisions that impact your estate plan. This memo briefly identifies some of the significant changes in the law.

1) No Changes to Estate Taxes

No changes were made to the estate tax, gift tax or generation-skipping transfer taxes. The estate tax applicable exclusion amount (the "Exemption Amount") remains as follows:

<u>Year</u>	<u>Exemption Amount</u>	<u>Maximum Rate</u>	<u>Year</u>	<u>Exemption Amount</u>	<u>Maximum Rate</u>
2006	\$2,000,000	46%	2009	\$3,500,000	45%
2007	\$2,000,000	45%	2010	No Estate Tax	0%
2008	\$2,000,000	45%	2011	\$1,000,000	55%

2) Charitable Contributions from IRAs.

In 2006 and 2007 only, an individual age 70½ or older can make lifetime charitable gifts directly from an IRA, up to a maximum of \$100,000 per year. These distributions will not be reported as income by the IRA owner. However, they will not generate a charitable deduction either. To qualify for the exclusion from income, the charitable distribution must be made directly from an IRA account to a public charity or conduit private foundation (donor-advised funds and supporting organizations are not qualifying organizations). These distributions will count towards the IRA owner's minimum required distribution for the year.

Example. Mary, age 75, has \$150,000 of adjusted gross income in 2006. In December 2006, instead of taking her usual minimum required distribution, Mary directs the trustee of her IRA to make a direct transfer of \$50,000 to the Red Cross. In this case, Mary is eligible to exclude the \$50,000 distribution from her gross income because: (1) the IRA funds passed directly to charity, (2) the distribution would have otherwise been included in Mary's gross income, and (3) the donation would have otherwise qualified as a charitable deduction on her income tax return under Internal Revenue Code Section 170.

3) Non-spouse Beneficiaries of Retirement Plans

Employer sponsored retirement plans (like 401(k) plans) often require benefits to be paid in a lump sum or within five (5) years of the participant's death to the participant's designated beneficiary. Under current law, if the beneficiary is a spouse, he or she can roll over the distribution to an IRA, but a non-spouse beneficiary could not and was therefore often forced to receive the benefits in a

lump sum and incur an immediate income tax liability. The Act offers non-spouse beneficiaries the ability to transfer these benefits directly to an inherited IRA for their benefit, which enables them to defer distributions and income taxation by taking distributions according to the minimum distribution rules.

Examples. On February 1, 2007, Mary passes away, naming her son, Jim, as sole beneficiary of her 401(k). On June 1, 2007, Jim transfers his mother's 401(k) directly to an inherited IRA for his benefit via a trustee-to-trustee transfer. Under the new tax law, Jim is permitted to make this post-mortem transfer to an inherited IRA for his benefit. (If instead, Mary names a trust for the benefit of Jim as beneficiary of her 401(k), the trustee would be permitted to make a post-mortem trustee-to-trustee transfer of the 401(k) into an inherited IRA for Jim's trust's benefit.)

4) College 529 Saving Plans

The Act makes permanent several 529 college savings plan features that were to expire in 2010. These include keeping distributions from 529 college savings plans income tax-free when paying for college expenses. Thus, 529 college saving plans will grow tax-free and also not be subject to income tax when withdrawn to pay for college expenses.

5) Charitable Contributions of Art

Gifts of undivided fractional interests in tangible personal property (like artwork) will only be deductible at fair market value if the gift is to be used in a manner related to the charity's exempt purposes. Further, all interests owned by the donor must be completely given away no later than the first to occur of (a) the donor's death, or (b) ten years after the first transfer. If the gift is not completed by then, any deductions taken will be recaptured, and a 10% penalty will also be assessed.

6) New Donor Advised Fund Rules

Some people have donor advised funds at a community foundation or with another charitable group. The Act creates a new excise tax on certain distributions from donor advised funds that include distributions to individuals or organizations for non-exempt purposes. Distributions to a public charity, non-charitable organization (if for charitable purposes and if expense responsibility occurs), and a sponsoring organization are permissible distributions. The Act also creates an excise tax on certain prohibited benefits, including any benefits that a distribution provides (directly or indirectly) to the donor, an advisor or related person.

7) Roth Accounts Made Permanent and Direct Rollovers to Roth IRAs Allowed.

Roth 401(k) and 403(b) plans, which just took effect in 2006, are now made permanent. After December 31, 2007, rollovers can be made directly from retirement plans such as 401(k), 457(b) or 403(b) plans to Roth IRAs. This means you will no longer need to rollover your account into an IRA and then roll the IRA into a Roth IRA. Instead, it will be accomplished in one step. However, the present tax law rules that apply to rollovers to Roth IRAs would still apply; i.e., a rollover from a qualified plan to a Roth IRA is includible in gross income (except to the extent that it represents a return of after-tax contributions) and individuals who do not meet the Roth IRA income limits will not be eligible to rollover their retirement account into a Roth IRA.

Example. In 2008, John had \$1,000,000 in his 401(k) plan and adjusted gross income of \$80,000. In December, 2008, John transfers \$200,000 of his 401(k) assets into a newly-created Roth IRA. Under the new tax law, John is permitted to make this direct transfer to his Roth IRA. If John had adjusted gross income of \$110,000, John would be ineligible to convert his 401(k) to a Roth IRA because his adjusted gross income exceeds the \$100,000 limitation.

8) Limits on Certain Charitable Deductions for Income Tax Purposes:

- No more income tax deductions for contributions of clothing and household items to charity, unless items are in good condition or better;
- No deduction is allowed for cash or checks, regardless of the amount, unless the donor substantiates the contribution by cancelled check, bank record or receipt from the charity showing the name of the charity, the date and the amount; and
- Effective for contributions made after September 1, 2006, charitable deductions for contributions of tangible personal property will be reduced or recaptured if the charity sells the property within 3 years of the contribution.

This Estate Planning Alert provides only a brief summary of the changes in the Act of interest to your estate plans. For further information or to confer with one of our estate planning attorneys, please contact us at 317-633-4884.

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