

Tax Letter

October 2006, Vol 13 - Pension Protection Act

Dear clients and friends:

Early August 2006, Congress passed the Pension protection Act of 2006 (H.R.# 4). Shortly after, the ACT was signed into Law by President Bush. By its name the ACT was enacted to provide protection to the pension benefits of the American workers, particularly workers in the private sector. It covers both the traditional “defined benefit” plans and the more recent “defined contribution” plans.

The so called “defined benefit” plans are pension plans traditionally offered by most of the traditional industries. Thru this type of plans, the private sector employers promised their employees that upon their retirement, they will receive \$xx per month retirement benefits for life. In order to honor this “promise”, the employer must have been fully funding a certain “Required Minimum Reserve” (for short RMR). According to a Federally controlled Corporation – Pension Benefit Guaranty Corporation (PBGC), the private sector overall “defined benefit” RMR is awfully insufficient. Combined total under funding is currently estimated to be about \$4,500 Billions. Additionally, PBGC is currently operating in a deficit, and is expected to reach \$230 Billions. The situation, therefore, is definitely alarming. It shocked Congress into action.

To attack the “defined benefit” front, Congress mandated the US Treasury and IRS to prescribe new method or methods to calculate RMR for each sponsoring employer. Subsequently, the private sector employers who are the sponsors of “defined benefit” plans must bring their individual RMR to a 100% level. They are allowed a total of 7 years to comply. However, the airline industry has 10 years to achieve their 100% RMR level. Further, for purpose of encouraging private sector employers as well as employees to go along with a so called “Hybrid” cash method of settling all their prior and past under funding problems. This “Hybrid” method was first employed by IBM with mixed results and litigation. Thru provisions in the Pension Protection Act of 2006, Congress legalized this “Hybrid” method, and put the legal concerns to rest, once and for all..

Next is the “defined contribution” plans. Among all, the most popular “defined contribution” plans are the 401K plans. These types of plan do not come with any “promise” to pay a certain amount of retirement benefit. They relied primarily on the “contribution” made to each individual employee's 401K account. At the time when an employee participant retires, his or her retirement income from the plan 100% depends upon the total accumulation of fund in his or her 401K account. There will not be any guarantee as to how much can one get. The contributions into an individual's 401K account usually is made in the form of payroll deduction from the employee's pay and certain level of employer “matching”, if any. According to available Federal statistics, the participation rate by all eligible employees working for employers sponsoring these types of plan is very low, much lower than 75%. There are, at least, two major reasons

for such a low participation rate. Firstly, an eligible employee must actively enroll in the plan. If he or she failed to do so, he or she is not participating. Secondly, employer "contribution" is voluntary, not mandatory. Therefore, only some employers not all employers choose to make employer "matching contribution". As a whole, you may say that the 401K plan is not being encouraged and/or promoted by most of the employers who are sponsors of such plans.

To address the issue, Congress made the participation of 401K plan 100% "automatic". This means that all eligible employees of sponsoring employers are automatically enrolled. Second, there are mandatory minimum employee contribution of 3% from qualified payroll, and a mandatory employer "matching" contribution. For the 1st percent of payroll contribution from the employee, the employer must match it dollar-for-dollar. Then, for the 2nd percent on up to the maximum as prescribed by current income tax law, the employer must match 50 cents for every dollar of employee payroll deduction. In short, if an employee only wish to be withheld the mandatory minimum 3%, he or she will have an employer matching of at least 2%, together 5% into his or her 401K account. Of course, employees are allowed to get out of participation. If so wishes, the employee must actively, explicitly opt out in writing.

In addition to provisions aimed at both the traditional pension plans and the 401K plans, the ACT also covers other areas such as easier roll over from qualified plans into individual retirement accounts (IRA), or direct roll over to ROTH IRA. Before the ACT, any none wishes to roll over from qualified plans to his or her ROTH, must first roll over to IRA. Also, non spousal pension plan beneficiaries may roll over their inherited pension money in a lump sum into his or her "inherited IRA" account. Caution, the non spousal beneficiary can not co-mingle his or her IRA with the "inherited IRA". They must be segregated at all times. Finally, the non spousal beneficiary must choose either to withdrawn all funds (100%) from the inherited IRA" within 5 years, or within his or her life time. There will be no penalties associated with any of these required withdrawals.

Last, but not least, the ACT also tightens the requirements for certain charitable deductions. For example, used clothing, household items, furniture and appliances can be deducted only if the taxpayer donor can provide acceptable proof of condition, of course, they must be in good condition. Another example is cash donation. Before the ACT, for small amount of cash donation to churches in Sundays can be deducted without written proof, as long as the deduction claimed is usual and reasonable. Now, the ACT requires written proof, including small amount of cash donation to churches in Sundays. Yes, there are abuses in the past, however, by requiring written proof of small donations is too over bearing and eventually will hurt churches and charities.

Any question, please give us a call at 415-381-0681, or visit our website at www.chochan.com.

Sincerely,

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