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# TAXLETTER

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## Special Issue: Highlights of The Pension Protection Act of 2006

A new pension act provides some real opportunities for additional retirement planning. As its name indicates, the Pension Protection Act of 2006 targets the nation's retirement savings. However, this extensive piece of legislation covers other areas as well, from college savings to charitable giving.

Some of the bill's major provisions are aimed at large employers, the ones offering traditional defined benefit pension plans. Such plans generally will need more funding by employers, although there are special breaks for airline companies. So-called "cash balance" plans, which have been controversial, received some clarification in the bill.

In addition, several provisions of this new law are particularly important to ~~smaller employers and individual taxpayers.~~

## Automatic-Enrollment 401(k) Plans Get a Green Light

In recent years, 401(k) and 403(b) plans have become widespread. These defined contributions plans allow workers to defer part of their income (and the tax on that income) until retirement. Along the way, the tax on any investment earnings also is deferred.

Many workers, though, decline to participate in these plans, or participate at minimal levels. In response, some employers have implemented "automatic-

enrollment" 401(k)s and 403(b)s, sometimes known as negative-election plans.

### Raising participation

Employees are automatically signed up for these plans. Unless they opt out, a certain percentage of their pay is placed into their accounts on a regular basis. Because of inertia, few workers actually choose to be removed from these plans so participation rates wind up reaching much higher levels.

There have been some clouds over automatic-enrollment plans, though. Some state laws prohibit employers from setting aside employees' earnings without written consent, for example.

These concerns have been overridden by the new law, which expressly permits automatic enrollment in 401(k) and 403(b) plans. Although this portion of the new law won't officially take effect until 2008, there is nothing to prevent employers from acting sooner. Now that Congress is on record as favoring automatic-enrollment plans, there may be little risk in moving ahead.

### Help for the highly-paid

What's more, business owners should be aware that this area of the new law is more than a warm-hearted movement to encourage workers to save for their own retirement. Salary-deferral plans such as 401(k)s are subject to nondiscrimination rules: in order for highly-compensated employees to maximize their own personal contributions, there must be adequate contributions from rank-and-file workers. Implementing an automatic enrollment 401(k) plan may help owner-employees and other key executives enjoy maximum tax deferral that otherwise might not be available.



America Counts on CPAs

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## Running on autopilot

If you're attracted by the idea of an automatic-enrollment 401(k) plan, you should know how they work. As mentioned, all eligible employees are automatically placed in the plan. Unless they sign a form stating that they don't want to be in the plan, they're enrolled. Each year, all participating employees are given an opportunity to drop out of the plan.

Several other details must be determined:

**Amount of salary deferral.** Typically, these plans set a 3% level. Thus, an employee earning \$30,000 will have \$900 (3% of \$30,000) withheld from his paychecks over the year and deposited to his 401(k) account. A higher or lower level of salary deferral can be chosen, up to each year's 401(k) limits.

**Employer match.** As a further incentive to stay in rather than opt out, many employers provide matching contributions. Typically a 25% or a 50% match is provided, up to 6% of the employee's salary. Thus, if the employee described above contributes \$900 to his 401(k), the employer will add another \$225 or \$450 to the employee's account.

Employers might require three to six years of employment before these matching contributions are fully vested. Such conditions can reduce employee turnover, always a key concern. Moreover, if some employees

do leave and forfeit matching contributions, these forfeitures can stay in the 401(k) plan and reduce future company outlays.

**Automatic increases.** If an employee begins with a 3% contribution the first year, the default contribution might go to 4% in Year Two, 5% in Year Three, etc. The new law makes it easier for companies to automatically escalate the percentage of an employee's salary that is directed to the plan. Such an autopilot approach may make a 401(k) plan less intimidating to employees and thereby reduce negative elections. Also, as employees see their nest eggs grow, they may be more willing to participate at higher levels.

**Automatic investing.** Automatic-enrollment 401(k) plans generally have a default investment option. However, if all the money goes into a money market fund, the long-term results may be disappointing.

Therefore, the default investment plan might be a diversified mix of equities and fixed-income holdings, chosen by a financial advisor. Again, employees may be more inclined to participate in an automatic-enrollment 401(k) if a professionally-designed investment portfolio is readily available.

## The new and the old

New employees can be educated about an automatic-enrollment 401(k)

plan while they're being told about company benefits such as insurance. Existing employees can be informed during their year-end review of benefits, when health plans are chosen and cafeteria plan selections are being made (open season).

With the right package and the right presentation, an automatic-enrollment 401(k) plan can provide greater tax-deferral for highly-compensated executives while other workers enjoy retirement savings they might have passed up.

## Tax-Free 529 Withdrawals Are Now Permanent

So-called 529 plans, named after Section 529 of the Internal Revenue Code, have enjoyed a boom since passage of the 2001 tax law. Prior law offered tax-deferred investment buildup inside these plans; the 2001 act also allowed tax-free withdrawals for higher education expenses.

Other portions of the 2001 law, though, may have discouraged potential investors. For example, withdrawals were due to become taxable again, at the student's rate, after 2010.

Now, the new provision in the Pension Protection Act of 2006 removes that uncertainty. Tax-free withdrawals from 529 plans for higher education are permanent, or at least as permanent as anything in the tax code. Unlike other provisions in the tax code, the tax benefits of 529 plans are available to everyone, regardless of income.

## Double major

These plans are offered by most states and by various financial firms. Among 529 plans, there are two main categories.

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### Defined Benefit and Defined Contribution Plans

Percent of workers participating, in private industry

1990-01                      2005

Defined benefit pension plans

35%                              21%

Defined contribution plans [includes 401(k)s]

34%                              42%

Source: U.S. Bureau of Labor Statistics

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**College savings plans.** These plans really are investment plans so your account will grow (or diminish) depending on how specified investments perform.

**Prepaid tuition plans.** Offered by 18 states, these plans guarantee a return that will move in step with tuition increases, regardless of what happens in the stock or bond markets. Thus, prepaid tuition plans seem like a good deal, especially with college costs escalating rapidly.

Prepaid tuition plans look even better now, after a change in federal law ~~earlier this year, allowing them to be~~ considered as parental assets for purposes of determining financial aid, the same as 529 college savings plans.

**Learning the limits**

However, there are disadvantages. In many cases, prepaid tuition plans are open only to residents of the state offering the plan.

As the name suggests, money accumulated in 529 prepaid tuition plans generally can be spent only on tuition (and mandatory fees and/or room and board). They usually don't cover other discretionary costs.

You'll probably pay a premium for the upside-but-no-downside guarantee. Investing, say, \$20,000 might buy you \$16,000 worth of current tuition. After some time, your \$20,000 investment could buy \$25,000 or \$30,000 worth of tuition, depending on how tuition costs escalate. Over a 15-year period, if tuition costs have increased by 8% a year, your annualized return might be around 6.5%, because of the upfront premium you paid.

What's more, you also may lack educational choices if you use a prepaid tuition plan. With many 529 prepaid tuition plans, money can be spent only at the sponsoring state's public universities. In some others, money can be spent at private universities but still within the sponsoring state. If your child decides to go to a college that's not in a covered state, you usually can get your money back,

but with a scant return on your investment, or no return at all.

**Going independent**

One prepaid tuition plan, the Independent 529 Plan, covers more than 250 private colleges around the country, including some of the nation's top institutions. TIAA-CREF administers this plan and manages its investments.



Money you place into this plan can be used at any of the participating schools; there's no need to make a selection in advance. In addition, all of the colleges participating in the Independent 529 Plan are required to discount their tuition by at least 0.5% per year.

Suppose, for example, you make a contribution to the Independent 529 plan for son William when he is eight years old. Ten years later, William enrolls in a private university that

offers a 1% tuition discount through this plan.

If so, William will be entitled to a 10% tuition discount (1% times 10 years) when he applies his Independent 529 Plan certificate to tuition at that university. This discount effectively increases your ultimate return, so that your initial outlay will more than keep up with tuition increases that occur at the college that's eventually selected.

**Combination course**

Considering all the possibilities, one strategy to consider is combining 529 plans. You might put enough money into a prepaid tuition plan (a state plan or one offered by a financial institution) to lock in full payment for some future tuition. In addition, you can contribute to a 529 savings plan for your youngster. Under current law, tax-free withdrawals from a 529 savings plan can be used not only for tuition but also to pay for room and board, books, etc.

**Educated choices**

When choosing a 529 college savings plan, look for those that offer good investment options, managed by first-rate professionals, because your ultimate payoff will depend on the performance of those accounts. Pay attention to the cost side, too. Over the long-term, lower expenses can make a significant difference in your total return. Even within the same state, costs for different 529 plans can vary widely.

**State of the art**

For prepaid tuition or college savings plans, many investors favor their own state's 529 plans because of state tax deductions. Those features should be considered but you shouldn't automatically choose your own state's plan. Find out how much you'll actually save in taxes and see if those savings are worth what you might give up in other features.

Say you pay state income tax of 4%, net of a federal tax deduction, and you

Largest 529 Plans	
Plan	Assets (3/31/06)
Virginia savings	\$15.8 billion
Rhode Island savings	\$6.8 billion
New Hampshire savings	\$5.7 billion
Florida prepaid	\$5.1 billion
New York savings	\$5.0 billion

Source: College Savings Plan Network

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invest \$50,000 in a 529 plan. Going in-state would save you \$2,000 (4% of \$50,000). You have to decide whether another state's plan is inexpensive enough and flexible enough to be worth giving up that \$2,000 in tax savings.

### Un-covered

Although 529 plans received permanent tax breaks, the same treatment was not extended to Coverdell Education

Savings Accounts (ESAs). Thus, Coverdell ESAs are still in jeopardy of regaining their prior tax treatment after 2010.

If this happens, Coverdell ESAs no longer will offer funding for K-12 expenditures and Coverdell ESA withdrawals may put some other education-related tax breaks off-limits for that year. Nevertheless, it's not necessary to give up on Coverdell ESAs because tax-free transfers to 529 plans are permitted.

### Sweet (and Stringent) Charity

The new law both eases and tightens the rules on charitable contributions. On the positive side, from now through 2007, taxpayers over age 70½ can take tax-free distributions of up to \$100,000 per year from a traditional or Roth IRA to make a charitable contribution.

Suppose, for example, you are 72 years old and have pledged \$50,000 to your alma mater's building fund this year. However, you don't have that much ready cash and you're not willing to disrupt your investment portfolio.

One option is to tap your IRA for the money to fulfill your pledge. However, taking \$50,000 from your IRA normally would generate \$50,000 worth of taxable income.

It's true that you'd also get a \$50,000 tax deduction as an offset. However, the offset might not be complete because of various limits on taking charitable deductions and the phaseout of itemized deductions faced by high-bracket taxpayers.

Under the new law, you could simply take \$50,000 from your IRA and give it to your alma mater. You would recognize no income and get no tax deduction.

This tactic may be especially appealing to non-itemizers, who won't be able to get a tax deduction for charitable gifts anyway. You can make your normal charitable contributions, up to \$100,000 a year, and pull untaxed dollars from

your IRA to make those donations.

On the downside, such IRA-to-charity donations must be made directly to a charity. They can't go to a donor-advised fund or a supporting organization.

### Easier easements

The new law also made deductions for conservation easements more available in 2006 and 2007.

You'd get such a deduction if you donate a restriction on future use of land that you own to a charity fostering preservation. The deduction would be for the loss of property value, based on before-and-after appraisals. Even after donating such an easement, you can sell the land or leave it to your heirs.

Under prior law, annual deductions for conservation easements were limited to 30% of your adjusted gross income (AGI); unused deductions can be spread over the next five years. The new law raises this limit (temporarily) to 50% of AGI, provided the easement does not prevent farming or ranching.

### Cash concerns

Although the above provisions open up some charitable planning opportunities, other sections of the new law close down what the IRS perceived as abuses. Going forward, all charitable deductions for cash gifts must be substantiated by a bank record or a letter from the charity. Such a letter must specify the date and amount of the donation.

This may have important implications for churchgoers who make regular cash contributions. Obviously, it's impractical to get receipts or letters of acknowledgment. Instead, make a pledge and write checks, perhaps every month.

Also, charitable donations for household items such as clothing will not be permitted unless the articles are in "good" condition, a quality that is not defined. (Single items appraised at over \$500 are assumed to be "good," so they qualify.) You might want to take photos of items you are donating, to support deductions for non-cash contributions.

These provisions became effective after August 17, 2006, the date of enactment, so they currently apply to charitable contributions of cash and household goods.

IRA Assets	
2001	\$2.619 billion
2002	\$2.533 billion
2003	\$2.991 billion
2004	\$3.336 billion
2005	\$3.667 billion

Source: Board of Governors of the Federal Reserve System

## More...and More to Come

The Pension Protection Act of 2006 is over 900 pages long so it contains many other important provisions. They include:

- Retention of the retirement provisions of the 2001 tax act. The contribution limits and age 50+ "catch-ups" for IRAs, 401(k), etc., are now permanent. So is the existence of Roth 401(k)s.
- Permanent status granted to the saver's tax credit.
- Allowance of direct rollovers from retirement plans to Roth IRAs, starting in 2008. You won't have to roll money to a traditional IRA and then convert to a Roth IRA.
- Direct deposit of tax refunds to IRAs, starting in 2007.
- Penalty-free withdrawals from IRAs and other retirement plans for National Guard and reservists called to active duty for at least 179 days, if the call-up is before 2008. Any amounts withdrawn can be replaced within two years after that active duty expires.
- Investment advice to retirement plan participants by the firms providing those plans, starting in 2007.
- Rollovers from qualified plans to IRAs for non-spouse beneficiaries, starting in 2007.
- DB/k plans. Companies with 500 or fewer employees will be able to create defined benefit pension plans with 401(k) features, starting in 2010.
- Historic preservation deductions. The new law allows for the preservation of entire buildings, not just the facade. Higher standards for appraisals and recordkeeping also are included.
- S corporation donations. The potential capital gain exposure has been reduced, putting S corporation shareholders on level ground with partners in partnerships.

## New legislation offers opportunities for closely-held business owners

Closely-held business provisions that will become effective in 2007 and 2008, involve:

- Reformed funding rules for single employer and multi-employer defined benefit plans.
- The Act's newly created prohibited transaction exemption under ERISA that allows related parties to provide investment advice to plan participants and IRA owners if certain requirements, including detailed disclosure requirements, are satisfied.
- Increases in the maximum value of deductions for single-employer plans.
- New reporting and disclosure requirements for defined benefit plans.
- New diversification conditions for employee contributions, elective deferrals and employer contributions with respect to investing in employer securities.
- Revised vesting requirements for employer contributions to defined contribution plans.
- For policies issued after enactment, new limitations on amounts an employer may receive tax-free from COLI benefit proceeds.

## Still not settled

Despite all the territory covered in this huge bill, some expired provisions of previous tax laws have not been extended. These include the sales tax deduction, the above-the-line deduction for higher education expenses, the research and development tax credit, the work opportunity tax credit, the welfare-to-work tax credit, and the up-to-\$250 above-the-line deduction for teachers' classroom expenses.

## Count Social Security in Your Retirement Portfolio

The average married couple can expect to receive about \$20,000 a year in Social Security retirement benefits. Top earners now can expect to receive around \$25,000 a year, assuming they retire at their full retirement age, between 65 and 67.

If a top earner is married and his or her spouse receives a 50% spousal benefit, the couple's total Social Security benefits would be just over \$38,000 a year. If the earner decides to postpone benefits, the total will be higher still: One gets a greater monthly benefit for waiting, up until age 70.

Those Social Security benefits have two advantages:

1. **Taxes.** Under current law, no more than 85% of benefits will be taxed. The range can be from zero up to 85% of the Social Security benefits being subject to taxation, depending on other income.

Suppose, for example, that you and your spouse have an income that's well into six figures and you receive

\$38,000 per year from Social Security. Of that \$38,000, no more than \$32,300 (85% of \$38,000) will be included in your taxable income.

2. **Inflation adjustments.** Each year, monthly benefits are indexed to inflation. Benefits for 2007, for example, are 3.3% higher than they were in 2006. At that rate, the monthly benefit would just about double in 22 years.

**Part of the picture.** For many people, receiving between \$20,000 and \$40,000 per year in Social Security benefits won't provide their desired retirement lifestyle, even with the tax benefits and inflation adjustments described above.

Therefore, one should invest for one's own retirement and not rely solely on Social Security. At the same time, though, the process of structuring a retirement portfolio should not ignore future Social Security benefits.

Take the hypothetical case of Harry and Janet Black, both aged 60. Their financial adviser suggests that they split their investment portfolio 50-50, between stocks (for growth and inflation protection) and bonds (for current income and stability).

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Further assume that Harry and Janet's Social Security checks, when they begin to arrive in a few years, will be above average but not at the maximum levels. Assume they can expect to receive around \$30,000 per year in combined Social Security retirement benefits.

That's the equivalent of owning a \$540,000 bond portfolio: as of this writing, investment-grade corporate bonds pay around 5.5% interest. If you owned \$540,000 worth of such bonds, yielding 5.5%, you'd receive around \$30,000 in **annual interest, which is what our hypothetical couple will get from Social Security.**

As mentioned, \$30,000 per year from Social Security beats a \$540,000 bond portfolio because your retirement benefits rise every year. With a bond portfolio, interest payments are fixed until the bonds are redeemed. When new bonds are bought, your new interest rates might be higher or lower.

**Balancing act.** Nevertheless, many investment plans for retirement do ignore Social Security benefits, which provide a stream of steadily rising income. As a result, such plans may be overweighted in bonds and underweighted in stocks, a formula likely to deliver underperforming investment returns over the long term.

Going back to Harry and Janet Black, you can see the impact. Their financial adviser estimates that their total portfolio, investments, inside and outside of tax-deferred retirement accounts, will be around \$1.2 million.

Based on the advisor's recommendations, Harry and Janet are aiming to hold 50% in bonds and 50% in stocks. Such a portfolio might look like this:

	Value	Yield	Income
Stocks	\$600,000	2%	\$12,000
Bonds	\$600,000	5.5%	\$33,000
Total	\$1,200,000		\$45,000

Thus, they would have \$45,000 in retirement income from their portfolio, pretax. In addition, \$600,000 of their assets would be in stocks, likely to grow.

However, that's not really an accurate view of their portfolio. As mentioned, they expect to receive \$30,000 per year in Social Security benefits when they retire in six years. Counting those benefits, their retirement portfolio will look like this:

	Value	Yield	Income
Stocks	\$600,000	2%	\$12,000
Bonds	\$600,000	5.5%	\$33,000
Social Security	\$540,000*	5.5%	\$30,000
Total	\$1,740,000*		\$75,000
* Imputed			

By looking at their finances from this perspective, their total portfolio tops \$1.7 million, of which only about 35% is invested in stocks. Because Harry or Janet (or both) could live another 40 years, they might need more growth potential—more stocks—than they have in their current portfolio.

For example, they might restructure their holdings in this manner:

	Value	Yield	Income
Stocks	\$850,000	2%	\$17,000
Bonds	\$350,000	5.5%	\$19,250
Social Security	\$540,000*	5.5%	\$30,000
Total	\$1,740,000*		\$66,250
* Imputed			

With this portfolio, their retirement income drops by \$8,750 because they switched \$250,000 from bonds to stocks. However, the after-tax difference will not be the full \$8,750 because they'll be receiving less fully taxed bond interest and more dividend income, which is lightly taxed under current law. What's more, nearly half of their income will be coming from Social Security, which probably will increase each year.

In this revised allocation, Harry and Janet have added \$250,000 to their equity holdings. Even if they use the dividend income for retirement spending, the stocks or stock funds may increase in value over the long term.

Their dividend income can grow, too, if the companies boost their payouts. In addition, Harry and Janet may be able to cash in some stock market gains to supplement their income. Thanks to Social Security benefits, Harry and Janet can plan on having enough cash flow to allow them to tie up more money in lower-yielding stocks that increase their chances of realizing long-term gains.

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