

2006 TAX LEGISLATION UPDATE

What You Need to Know About the Pension Protection Act of 2006

As you might expect from its name, the Pension Protection Act of 2006 (PPA) attempts to protect workers by imposing new regulations on employer pension plans. It tightens minimum funding requirements and places restrictions on employers that don't, or can't, comply with the funding rules for defined benefit plans. Most of these new pension rules won't take effect until 2008.

However, the PPA also provides new benefits for savers, more flexible withdrawals and rollovers, and makes permanent some savings incentives that were previously scheduled to expire. Some of these provisions take effect immediately. Here's a summary of some upcoming changes.

Provisions Taking Effect in 2006

Tax-Free Direct Gifts to Charities

In 2006 and 2007 only, IRA owners 70½ and older can make tax-free direct gifts of up to \$100,000 each year from an IRA to qualifying charitable organizations. Distributions to qualifying organizations can be used to satisfy minimum distribution requirements. These charitable distributions are **not** deductible; however, they are also not considered taxable income.

Penalty-Free Withdrawals for Reservists and Guardsmen

Premature withdrawals from certain qualified retirement plans and IRAs will be penalty-free for reservists and members of the National Guard who are called to active duty for at least 180 days. Distributions made while called to active duty may be redeposited within two years after the end of the active duty period. This provision applies to anyone ordered or called to active duty after Sept. 11, 2001, and before Dec. 31, 2007. Affected personnel have up to a year to request a tax refund for previous tax overpayments related to premature withdrawals.

Saver's Credit

The Saver's Credit — a retirement savings income tax credit for lower-income workers — is now available indefinitely rather than expiring after 2006. The adjusted gross income (AGI) limit for eligibility is \$50,000 for joint filers (\$25,000 for singles), but beginning in 2007 it will be indexed for inflation in \$500 increments.

KEY POINTS

- Funding rules for defined benefit pension plans are tightened.
- Taxpayers can have tax refunds deposited directly into their IRAs.
- Income limits for eligibility to contribute to a Roth IRA or deduct traditional IRA contributions will be indexed for inflation.
- Direct rollovers of 401(k) plan assets into Roth IRAs will be allowed (starting in 2008).
- The following were scheduled to expire after 2010 but are extended indefinitely:
 - Higher contribution limits that were first available in 2002 for IRAs and qualified retirement plans
 - Catch-up contributions to IRAs and qualified retirement plans for those 50 and older
 - Roth 401(k) plan availability
 - Tax-free qualified withdrawals from 529 plans
 - The Saver's Credit for lower-income workers (was scheduled to expire in 2006)

Penalty-Free Withdrawals for Public Safety Employees

Police officers, firefighters and emergency medical technicians can now take penalty-free retirement plan withdrawals as early as age 50 (down from age 55) if the employee separates from service and he or she participates in a government pension plan with a Deferred Retirement Option Plan (DROP) benefit feature.

IRAs and Qualified Retirement Plans

- The law extends availability of the higher contribution limits and catch-up contributions introduced in 2001 for traditional and Roth IRAs and qualified retirement plans (see tables below) and indexes them for inflation. Without Congressional action, the higher limits and the ability to make catch-up contributions would have expired after 2010.

As a result, Congress has preserved your ability to invest substantial amounts for your retirement. Keep in mind that based on these higher contribution limits plus catch-up contributions beginning at age 50, a 30-year-old making the maximum IRA contributions annually could accumulate more than \$1 million in his or her IRA by age 65.

- The definition of a hardship withdrawal now includes hardships suffered by the beneficiary of a 401(k). The beneficiary does not have to be a spouse or dependent. (This rule is effective when the IRS writes the regulations but no later than 180 days after PPA's enactment.)

IRA CONTRIBUTION LIMITS	
Years	Contribution Limits
2006 – 2007	\$4,000
2008 and thereafter <i>(indexed in \$500 increments)</i>	5,000

IRA CATCH-UP CONTRIBUTION LIMIT*	
Years	Contribution Limit
2006 and thereafter	\$1,000

401(k) AND OTHER SALARY REDUCTION PLAN CONTRIBUTION LIMITS		
Years	Contribution Limit	Catch-Up Contribution Limit*
2006 and thereafter <i>(indexed in \$500 increments)</i>	\$15,000	\$5,000

SIMPLE IRA CONTRIBUTION LIMITS		
Years	Contribution Limit	Catch-Up Contribution Limit*
2006 and thereafter <i>(indexed in \$500 increments)</i>	\$10,000	\$2,500

*You must be 50 or older to make catch-up contributions.

WHAT YOU AND YOUR FINANCIAL CONSULTANT SHOULD DISCUSS NOW

Now is the time to meet with your financial consultant to revisit your education savings and retirement plans because you now know, for example, that qualified 529 plan withdrawals will be tax-free and how much you'll be able to contribute to your IRA and your 401(k), 403(b) or other qualified plan for years to come.

It's especially important to meet if you had education and retirement contingency plans in place to help protect you in case these opportunities disappeared after 2010, as scheduled. Those contingencies may need to be adjusted to help achieve your long-term objectives.

529 Plans

Qualified higher education withdrawals from Section 529 plans will continue to be tax-exempt. Under previous law, qualified withdrawals after 2010 would have been taxed at the beneficiary's rate. Qualified withdrawals must be used for tuition, fees, room and board, books, supplies, and equipment required by a higher educational institution.

Provisions Taking Effect in 2007

Individual Retirement Accounts (IRAs)

- The law will make it easier for workers to save for retirement by letting taxpayers have all or part of their income tax refunds deposited directly into their IRAs.
- Rollovers from qualified retirement plans into inherited IRAs (also known as "for-benefit-of" or "FBO" IRAs) by nonspouse beneficiaries will be allowed. For example, children who are beneficiaries of a parent's 401(k) will be able to roll the deceased parent's retirement plan assets into an FBO IRA and stretch out distributions over the beneficiary's life expectancy.
- Eligibility for Roth IRAs and deductibility of traditional IRA contributions are subject to limits based on a taxpayer's modified adjusted gross income (MAGI). These MAGI limits will be indexed for inflation in \$1,000 increments.

Investment Advice Rule

Qualified fiduciary advisors will be permitted to offer personal investment advice to participants in employer-sponsored retirement plans. The investment advice arrangement must provide that advisors' pay will not vary depending on investment alternatives selected or that an

unbiased computer model — certified by an independent expert — will be used to generate recommended portfolios. The bill also directs the Department of Labor to determine the feasibility of applying computer models to IRAs.

Defined Benefit and Defined Contribution Plans

- Defined benefit plans will be able to provide in-service withdrawals to employees who are at least age 62. Plan sponsors will also be required to periodically provide participants with benefit statements.
- All employer contributions to defined contribution plans (including nonmatching contributions) will be required to vest either 100% after three years or at a rate of 20% per year from years two through six.
- For plan years beginning on or after Jan. 1, 2007, simplified annual filing requirements will be available for retirement plans with fewer than 25 participants. One-participant plans with less than \$250,000 in assets will be exempt from annual filing requirements.
- Any defined contribution plan holding publicly traded employer securities will be required to permit participants to diversify out of employer stock beginning in 2007. The plan will also be obligated to offer at least three additional materially different investment alternatives. And the employer will need to provide participants with 30-days' advance notice of their diversification right.

FOR EMPLOYEES OF BANKRUPT EMPLOYERS

Individuals who fit specific criteria will be allowed to make up to \$3,000 (three times the normal amount) in IRA catch-up contributions for 2007, 2008 and 2009. An individual can take advantage of this limit only if all of the following apply:

- He or she worked for a now-bankrupt employer and was a participant in the plan six months before the bankruptcy proceedings
- The employer or its officers were indicted for items related to the bankruptcy
- The employer had at least a 50% match in employer stock in its 401(k) plan

This section appears to have been written with former Enron employees in mind, but it may apply to a few other employers as well.

Provisions Taking Effect in 2008

401(k) and Other Deferred Compensation Retirement Plans

- PPA clarifies how employers may automatically enroll their employees in 401(k) plans. This rule is expected to dramatically increase participation in these retirement savings vehicles.
- Direct rollovers of 401(k) plans and other qualified plans into Roth IRAs will be allowed. This change will eliminate the need to roll qualified plan assets into a traditional IRA first. Eligibility requirements (for example, MAGI cannot exceed \$100,000) and tax consequences when executing a Roth conversion remain unchanged.

Defined Benefit Plans

- The minimum funding standards will be revamped by replacing the minimum funding standard accounting rule and the deficit reduction contribution (DRC) for certain plans with a single minimum funding calculation.
- Disclosure requirements will be enhanced, including new required notices to plan participants highlighting detailed information on plan funding.
- Interest rate assumptions used in calculating lump sum distributions from defined benefit plans will change. Current rules, which will remain in effect for 2006 and 2007, use 30-year Treasury rates. From 2008 through 2011, a participant's lump sum will be determined based on a mixture of the corporate bond yield curve and the 30-year Treasury rate. Full implementation of the corporate bond yield curve will begin in 2012.
- Defined benefit plans that are less than 60% funded will not be able to pay lump sum distributions. In years in which plans are at least 60% but less than 80% funded, limited lump sum distributions will be allowed.

Conclusion

As with other far-reaching pieces of legislation, additional guidance and further details regarding implementation and oversight of these provisions is expected. Be sure to consult your personal or business tax and legal advisory team as you take advantage of these new investment opportunities. Most important, take steps now to benefit from the new resources, vehicles and tools available to help build your nest egg.

THE A.G. EDWARDS DIFFERENCE

Since our founding in 1887, A.G. Edwards has pursued a simple philosophy: Treat people the way we'd like to be treated. It's a philosophy that has served us well. Through our nearly 7,000 financial consultants and a network of 700 offices nationwide and in Europe, we translate this philosophy into meaningful practices that benefit our clients.

When we say we're fully invested in our clients, we mean it. We never forget that it's your money, not ours, and that we're here to help you work toward your goals. We've been doing business this way for nearly 120 years, and we plan to continue on our mission for another 120.

Our Relationship With You

In serving you, we generally act as a broker-dealer but may act as an investment advisor for certain accounts for which we are appointed as investment advisor, and our obligations will vary with the role we play. Unless we otherwise specifically indicate in writing, we are acting only as a broker-dealer. Please consult "Important Information About Your Relationship With A.G. Edwards" on agedwards.com/disclosures for a discussion of the differences between our brokerage and advisory services.



agedwards.com

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is made available with the understanding that A.G. Edwards is not engaged in rendering legal, accounting or tax-preparation services. If tax or legal advice is required, the services of a competent professional should be sought. A.G. Edwards' view is that investment decisions should be based on investment merit, not solely on tax considerations. However, the effects of taxes are a critical factor in achieving a desired after-tax return on your investment. The information provided is based on internal and external sources that are considered reliable; however, the accuracy of the information is not guaranteed. Specific questions on taxes as they relate to your situation should be directed to your tax advisor.