

The Pension Protection Act of 2006

On August 17, 2006, President Bush signed the Pension Protection Act of 2006. The law attempts to shore up the nation's pension system and the Pension Benefit Guaranty Corporation (PBGC), by making sweeping changes to the funding rules that apply to defined benefit pension plans. The law also encourages retirement saving, and ends uncertainty by making permanent the IRA and pension provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which had been scheduled to expire at the end of 2010.

Key provisions of the Act are summarized below.

CHANGES EFFECTIVE UPON ENACTMENT (EXCEPT AS NOTED)

1. Repeal of Sunset Provisions: EGTRRA contained numerous pension and IRA-related provisions that were scheduled to expire after 2010. The Act makes these changes permanent. These include:
 - a. Increased contributions to IRAs;
 - b. Boosted contribution limits for those age 50 or older (catch-up contributions);
 - c. Increased maximum annual contributions to 401(k) plans;
 - d. The rules relating to deemed IRAs under employer plans;
 - e. The option to treat elective deferrals as after-tax Roth contributions;
 - f. The tax credit for certain pension startup costs; and
 - g. The Code Sec. 25B tax credit for lower-income taxpayers who save for retirement ("Savers Credit").
2. "At Risk" Plans and NQDC Funding: The Act restricts set-asides to nonqualified deferred compensation arrangements while a defined benefit plan is in trouble. If an employer with an underfunded ("at risk") defined benefit plan sets aside assets in a "rabbi trust" or other arrangement to fund nonqualified deferred compensation benefits for the company's top five executive officers, those officers will be subject to income tax and a 20% penalty on the amount set aside. (This rule also applies if an employer is bankrupt--or a member of the employer's controlled group is bankrupt--and to certain employers who have previously terminated underfunded defined benefit plans.)
3. Cash Balance and Other Hybrid Plans: The Act protects hybrid plans (like cash balance plans) from age discrimination charges if a plan's design satisfies statutory requirements. (In general effective for periods beginning on or after June 29, 2005. Certain provisions effective later.)
4. Hardship Withdrawals Expanded: The Act allows a participant to request a hardship withdrawal from a 401(k), 403(b), 457, or nonqualified deferred

compensation plan if the participant's plan beneficiary (even if the beneficiary is not a spouse or dependent) incurs the hardship. The Treasury Department is instructed to issue new rules within 180 days of enactment.

5. Reservist Retirement Distributions: The Act provides that the 10% early distribution penalty tax will not apply to IRA and retirement plan withdrawals made by a reservist called to active duty for at least 179 days. The Act also amends the distribution rules to make this a distributable event under 401(k) and 403(b) plans. Reservists will have two years from the end of active duty (or, if later, until two years from the date of enactment) to re-contribute the amount received to an IRA on a nondeductible basis. This provision applies to individuals ordered or called to active duty after September 11, 2001 and before December 31, 2007, for distributions after September 11, 2001.
6. Public Safety Employees: There is no 10% early withdrawal penalty on distributions from governmental defined benefit plans to qualified public safety employees (police, fire, emergency medical services) who separate from service after age 50.
7. Enron Catch-up Contributions: The Act allows certain Enron 401(k) plan participants to make additional IRA contributions of up to \$3,000 per year for 2006-2009. Individuals who take advantage of this provision cannot also make age-50 catch-up contributions.
8. Charitable Contributions From IRAs: The Act provides an exclusion from gross income for otherwise taxable traditional or Roth IRA distributions (up to \$100,000 per year) that are paid directly from the IRA to a qualified charity, if the IRA owner is 70 ½ and certain other conditions are satisfied at the time of distribution. (Effective in 2006 and 2007 only.)
9. Corporate Owned Life Insurance (COLI): The Act generally limits the amount an employer can receive as a tax-free death benefit from a life insurance policy to the amount of premiums the employer has paid. There are, however, significant exceptions. Death benefits remain tax free if the deceased was an employee at any time during the 12-month period before death, or was a director or highly compensated employee at the time the contract was issued, or where the death benefits are payable to the deceased's family or designated beneficiary (or to a trust established for them), or the proceeds are used by the employer to repurchase an equity interest from the family member, beneficiary, or trust. Effective for contracts issued or (in certain cases) materially modified after enactment.
10. Section 529 Plans. The Act makes permanent all of the provisions of present-law section 529 that were scheduled to expire in 2011. These include: (1) the provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax; (2) the repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational

purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes; (3) a provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under section 529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries; (4) certain provisions permitting rollovers from one account to another account; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope and Lifetime Learning Credit provisions; (7) the provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules; and (8) certain provisions regarding the education expenses of special needs beneficiaries.

CHANGES EFFECTIVE IN 2007

11. Investment Advice: The Act gives workers new access to personalized professional retirement advice. It creates a new prohibited transaction exemption under ERISA that allows related parties to provide investment advice (including, for example, recommendation of the advisor's own funds) to plan participants and IRA owners if either (a) the advisor's fees don't vary based on the investment selected by the participant, or (b) (for employer-sponsored retirement plans, but not IRAs) the advice is based on a computer model certified by an independent expert, and certain other requirements, including detailed disclosure requirements, are satisfied.
12. Fiduciary Protection for Default Investments: The Act provides protection to retirement plan fiduciaries where an employee's account is placed in a default investment because the participant failed to make an affirmative investment election. The DOL is instructed to issue regulations within 6 months of enactment that will implement the provision.
13. Non-spouse Rollovers: The Act lets a non-spouse beneficiary make a direct rollover from a qualified plan, 403(b), or 457 plan to an IRA. The IRA is treated as an inherited IRA of the non-spouse beneficiary.
14. After-tax Rollovers: The Act allows the direct rollover of after-tax contributions between qualified plans (including defined benefit plans), and between qualified plans and 403(b) plans.
15. Deposit of Tax Refund to IRA: The Act allows taxpayers to have their tax refund checks deposited directly to an IRA (subject to the normal IRA contribution rules).
16. IRA Limits Indexed: The Act adjusts the income limits that apply to IRA contributions and the Saver's Credit for inflation.
17. Diversification Requirements for Defined Contribution Plans: The Act requires

that participants in defined contribution plans (such as 401(k) plans) be allowed to invest their own pre-tax and after-tax contributions in investments other than employer stock. Participants must also be allowed to invest employer contributions in investments other than employer stock after three years of service. (This provision does not apply to most ESOPs.) A transition rule applies to amounts invested prior to the effective date of the Act.

18. Faster Vesting: The Act requires faster vesting of employer contributions to defined contribution plans (like 401(k) plans). All employer contributions must vest either 100% after three years of service, or on a graded basis, 20% per year beginning with the participant's second year of service. The new law applies to all employees with an hour of service after the effective date. (A later effective date applies to collectively bargained plans.)
19. "Phased" Retirement: The Act encourages "phased" retirement by allowing distribution of benefits from pension (defined benefit) plans to employees who have attained age 62, but who haven't yet separated from service ("in-service distributions").
20. Single Participant Plans: The Act provides that one-participant qualified plans aren't required to file a Form 5500 if plan assets are \$250,000 or less (increased from \$100,000).

CHANGES EFFECTIVE IN 2008 (OR LATER WHERE NOTED)

21. New Funding Rules: The Act tightens qualified defined benefit plan funding rules, generally requiring funding of a plan's current year liabilities and, if the plan is less than 100% funded, funding of the shortfall over 7 years. Special accelerated funding rules apply to "at risk" plans. The Act restricts plans that don't meet specified funding levels from taking actions that might place the plan at further risk--for example, increasing benefits or paying benefits in the form of a lump sum. (Certain provisions effective sooner.)
22. Rollovers From Qualified Plans to Roth IRAs: The Act permits direct rollovers from qualified plans to Roth IRAs. Previously, a taxpayer could accomplish this only indirectly by making a rollover from a qualified plan to a traditional IRA, and then converting that traditional IRA to a Roth.
23. Increased Deductions: The Act modifies the deduction rules applicable to defined benefit plans to reflect the new funding rules. The Act also increases the deduction available to employers who maintain both a defined benefit and a defined contribution plan.
24. Automatic Enrollment: The Act encourages the use of automatic enrollment in 401(k) and 403(b) plans by creating a new safe harbor for "qualified automatic contribution arrangements." Plans that satisfy certain design requirements (including minimum contributions and faster vesting) aren't required to perform

ADP/ACP or top-heavy testing. The Act also confirms that ERISA preempts any state law that would directly or indirectly restrict the inclusion of an automatic enrollment provision in a plan (effective upon enactment).

25. ERISA Bonding: The Act increases the maximum bond required under ERISA from \$500,000 to \$1 million for plans that hold employer securities.
26. 401(k)/DB Plan: The Act allows employers with 500 or fewer employees to adopt a combined defined benefit/401(k) plan. The defined benefit portion of the plan must meet minimum accrual requirements, and the 401(k) portion must have automatic enrollment and meet minimum matching contribution requirements. These plans would be exempt from ADP/ACP and top-heavy testing, and employers will have the convenience of a single plan document and single Form 5500 filing. This provision is effective for plan years beginning after December 31, 2009.

For additional details, see the [Joint Committee on Taxation](#) summary.

CHARITABLE REFORMS

27. IRA Contribution. An exclusion for certain distributions of up to \$100,000 from a traditional or Roth IRA if made to a tax-exempt organization to which deductible contributions can be made. The change is effective for two years through 2007.
28. Personal Property Contribution. For contributions made after September 1, 2006, there is a “recovery” of the tax benefit for charitable contributions of tangible personal property for which an FMV deduction is claimed and which is not used for exempt purposes. Under the Act, if a donee organization disposes of “applicable property” within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit arising from the contribution. However, there is no adjustment if the donee organization makes a proper certification regarding the property to IRS.
29. Clothing/Household Items. For contributions made after the enactment date, no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better. In addition, IRS may deny a deduction for any item with minimal monetary value. These rules don’t apply to any contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer includes with his return a qualified appraisal for the donated property.
30. Monetary Gifts. For contributions made after the enactment date, the Act disallows a deduction for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

31. Fractional Interests. For contributions, bequests, and gifts made after the enactment date, charities receiving a fractional interest in an item of tangible personal property must take complete ownership of the item within 10 years or the death of the donor, whichever is first. In addition, the donee would be required to have (i) taken possession of the item at least once during the 10-year period as long as the donor remains alive, and (ii) used the item for the organization's exempt purpose. Failure to comply with these requirements results in the recapture of all tax benefits plus interest and the imposition of a 10% penalty.

For more information on charitable reforms, see the [Ways and Means Summary](#).