

Highlights of the Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA 2006) was signed into law by President George W. Bush on August 17, 2006. During the signing ceremony, President Bush described the act as the “most sweeping reform of America’s pension laws in over 30 years.”

Over 900 pages in length, the new legislation reflects the move by many employers away from traditional defined benefit (DB) pension plans and toward defined contribution (DC) plans. Its provisions also highlight governmental concern over the shaky financial condition of many DB plans and the potential adverse effect that any future defaults by plan sponsors may have on the federal government and the American taxpayer.

Defined contribution plans are also affected, in a myriad of ways. The act makes permanent many of the provisions of EGTRRA 2001 which encouraged individuals to establish and contribute to both IRAs and employer-sponsored DC plans. PPA 2006 also impacts distributions from qualified plans, with both temporary and permanent changes.

Further, PPA 2006 includes many “miscellaneous” provisions, including those affecting employer-owned life insurance, charitable giving, IRC Sec. 529 plans, and long-term care.

The following is a brief summary of a few notable provisions of this new legislation. Individual taxpayers are strongly encouraged to consult with their own financial and tax advisors to review in detail how the act may impact their own personal situations.

Traditional Defined Benefit (DB) Pension Plans

Much of PPA 2006 is devoted to bolstering traditional DB plans, as well as strengthening the government’s “safety net”, the Pension Benefit Guaranty Corporation (PBGC).

Item	Prior Law	2006 Legislation
Minimum plan funding	Employer generally required to fund up to 90% of plan’s liabilities. Current law applies in 2006 and 2007.	Generally requires employers to fund 100% of plan’s liabilities. Underfunded plans have seven years to reach 100%. Minimum annual contribution must cover the value of benefits earned during the years. Effective for plan years beginning in 2008.
Employer deduction limits	Contributions deductible up to 100% of current plan liability.	For new plans, in 2006 and 2007, maximum deduction limited to 150% of current liabilities. In 2008 and later, the maximum deduction will generally be the amount necessary to bring the plan assets up to 150% of the applicable funding target. Some restrictions on this 50% “cushion” apply for small plans recently amended to increase benefits.

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Traditional Defined Benefit (DB) Pension Plans (continued)

Item	Prior Law	2006 Legislation
“At risk” plans	Lump-sum distributions limited for certain highly compensated employees if less than 110% of current liability funded.	Employer generally subject to funding requirements greater than the normal 100%. Restrictions on certain benefits may apply. Extremely underfunded plans would be automatically frozen. Notices are required to participants in certain events. For plan years beginning in 2008 and later.
Valuing plan liabilities	Valued using investment grade corporate bonds. Prior law applies in 2006 and 2007.	Beginning in 2008, a three-segmented yield curve will be used. May include updated mortality tables or tables based on a plan’s experience and trends.
Maximum plan benefit	EGTRRA 2001 increased the maximum annual dollar limit to the lesser of \$160,000 (indexed for inflation) or 100% of compensation (maximum of \$200,000). Benefits were reduced if begun before age 62 and increased if begun after age 65. The provision was originally set to “sunset” on 12/31/2010.	Makes permanent the increased benefit allowed under EGTRRA 2001. ¹
Cash balance plans	Prior legislation left employers who switched to a “cash balance” hybrid plan open to lawsuits over age discrimination.	If a plan meets certain requirements, new cash balance plans are not considered discriminatory. Conversions of existing DB plans to cash balance plans will be permissible, subject to certain requirements. ²
Fully insured DB plans	Currently described in IRC Sec. 412(i).	Moved to new IRC Sec. 412(e)(3). ¹

¹ Effective August 17, 2006, the date of enactment.

² Generally effective for periods beginning after June 29, 2005.

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IRAs and Defined Contribution (DC) Plans

PPA 2006 includes many provisions designed to encourage individuals to participate in IRAs and employer-sponsored DC plans. The law makes permanent¹ a number of EGTRRA 2001 provisions that originally were to “sunset” after 2010, including:

- **Increased IRA contribution limits:** In 2006 and 2007, \$4,000; in 2008, \$5,000; adjusted for inflation in later years.
- **Increased limits for defined contribution plans:** In 2006, a total maximum contribution of \$44,000; elective deferrals limited to \$15,000 (401(k) and 457 plans) and \$10,000 for SIMPLE plans; compensation that may be taken into account (\$220,000); all adjusted for inflation in later years.
- **“Catch-up” contributions for workers age 50 and older:** For IRAs, in 2006, \$1,000. In 2006 for 401(k) plans, \$5,000; for SIMPLE plans, \$2,500; adjusted for inflation in later years.
- **Vesting of employer contributions:** 100% vesting under either a three-year cliff or six-year graded schedule.
- **Increased employer deduction for qualified plan contributions:** EGTRRA generally increased the deduction limit from 15% to 25% of compensation and modified the definition of compensation for certain types of plans.
- **Roth 401(k) and 403(b) contributions:** Under EGTRRA 2001, Roth contributions to 401(k) and 403(b) plans were allowed only during 2006-2010.
- **“Deemed” IRAs:** Established under an employer plan which provided for separate employee contributions.
- **“Solo” 401(k) plans:** Elective deferrals are not taken into account for purposes of the limit on deductible plan contributions.

PPA 2006 also included a number of notable new items:

Item	Prior Law	2006 Legislation
Automatic 401(k) plan enrollment	Permitted by IRS and DOL regulations, but restricted by law in many states.	Beginning with enactment, preempts state laws prohibiting automatic enrollment and withholding of employee wages. Employees must opt-out if they do not wish to participate.
Automatic enrollment safe harbor 401(k) plan	No comparable provision.	Beginning in 2008, allows a new safe harbor 401(k) plan with automatic enrollment features. Must meet special employee notice, matching contribution, and vesting requirements.

¹ Effective August 17, 2006, the date of enactment.

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IRAs and Defined Contribution (DC) Plans (continued)

Item	Prior Law	2006 Legislation
Custom investment advice for employee-participants	Considered a “prohibited transaction” under prior law.	Beginning in 2007, allows for an “eligible investment advice arrangement.” Any fees or commissions must not vary with the investment option chosen or else a computer model meeting certain requirement must be used.
Direct deposit of federal income tax refunds into an IRA	Allows refunds of federal income taxes to be directly deposited into a checking or savings account.	Beginning in 2007, allows refunds of federal income taxes to also be directly deposited into an IRA.

Distributions from IRAs and Qualified Retirement Plans

Item	Prior Law	2006 Legislation
Qualified reservist distribution	No comparable provision. IRC Sec. 72(t) generally applies a 10% tax penalty to withdrawals from IRAs and other qualified retirement plans made by owners or participants under age 59½, unless certain exceptions apply.	Waives the 10% early withdrawal penalty for withdrawals from an IRA or other retirement plan by qualifying military reservists called to active duty between 09/11/2001 and 12/31/2007. Allows for re-contribution of withdrawn amounts during the two years after active duty ends.
Public safety employees – distributions from defined benefit plans after age 50	No comparable provision. IRC Sec. 72(t) generally applies a 10% tax penalty to withdrawals from IRAs and other qualified retirement plans made by owners and participants under age 59½, unless certain exceptions apply. One exception applies to employees who separate from service after age 55.	The 10% tax penalty for early withdrawals does not apply to distributions from a qualified governmental defined benefit plan to a qualified public safety employee who separates from service after age 50. ¹

¹ Effective for distributions made after the date of enactment, August 17, 2006.

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Distributions from IRAs and Qualified Retirement Plans (continued)

Item	Prior Law	2006 Legislation
Public safety employees – tax free distributions to pay for health and long-term care insurance	No comparable provision. Distributions from IRAs and qualified retirement plans are generally taxable to the extent the distribution represent a return of before-tax contributions. A 10% penalty tax may also apply to distributions made before the participant reaches age 59½, unless certain exceptions apply.	Beginning in 2007, provides an exclusion from income of up to \$3,000 for distributions from qualifying retirement plans for retired public safety officers to pay for qualified accident, health, or long-term care insurance. Premium payments must be made directly from the retirement plan to the insurer.
Rollovers by nonspouse beneficiaries	No comparable provision. Only a surviving spouse could roll over a distribution from a deceased spouse's qualified plan to his or her own IRA.	Beginning in 2007, beneficiaries other than a surviving spouse may roll over benefits received from a qualified retirement plan, a 457 plan, or a tax sheltered annuity to an inherited IRA.
Direct rollover from a qualified plan to a Roth IRA	No comparable provision. Under prior law, a distribution from a qualified retirement plan, 457 plan, or tax-sheltered annuity had to first be rolled over to a traditional IRA before it could be transferred to a Roth IRA.	Beginning in 2008, distributions from qualified retirement plans, 457 plans, and tax-sheltered annuities may be rolled directly into a Roth IRA. These distributions are subject to the same requirements as a Roth conversion.
Phased retirement	No comparable provision. Prior law generally prohibited a qualified plan from making retirement distributions to a participant who had not reached normal retirement age and who had not separated from service. Proposed regulations would permit plans to pay a portion of benefits to employees who are at least age 59½ and reduce their work time by at least 20%.	Beginning in 2007, allows retirement distributions to employees who are at least age 62 even if they have not separated from employment at the time of the distribution.

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Charitable Giving

Although the vast majority of the act concerns pensions and retirement plans, there are a number of provisions affecting charitable giving. Among these are:

Item	Prior Law	2006 Legislation
Qualified charitable distributions from IRAs	No comparable provision. Withdrawals from IRAs are generally subject to tax, to the extent that they represent a return of before-tax contributions. Contributions to charitable organizations are subject to a number of limitations on the deductibility of such contributions.	For 2006 and 2007, provides an exclusion from gross income of up to \$100,000 for distributions made from a Roth or Traditional IRA directly to a qualified charitable organization. The IRA owner must be at least age 70½ when the distribution is made. No charitable deduction is allowed for such qualified charitable distributions.
Charitable contributions of clothing and household items	Generally, taxpayers are permitted to deduct the fair market value of tangible personal property donated to charity. Certain substantiation requirements apply.	Prohibits a charitable deduction for contributions of used clothing or household items unless the items donated are in good used condition or better. A deduction may be allowed for donations of property that is not in good used condition or better if the value exceeds \$500 and a qualified appraisal accompanies the taxpayer's return. ¹
Cash contributions to charities	Generally requires a donor to substantiate a charitable donation of cash through written records such as a cancelled check, a receipt, or a letter of acknowledgement from the charitable donee showing the donee's name, the amount and date of the contribution, or other reliable written records.	Requires the donor to substantiate a charitable donation of cash through either a bank record or a written communication from the charitable donee showing the donee's name and the amount, and date of the contribution. ²
Charitable contributions of food inventory and book inventory	Under the Katrina Emergency Tax Relief Act of 2005 (KETRA), allowed an expanded business charitable deduction for donations of food items from inventory or donations of books to a public school. Applicable to donations made on or after 08/25/05 and before 01/01/06.	Extends the effective date of these provisions for one year to donations made after 12/31/05 and before 01/01/08.

¹ Effective for contributions made after August 17, 2006.

² Effective for contributions made in tax years beginning after August 17, 2006.

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Charitable Giving (continued)

Item	Prior Law	2006 Legislation
Qualified conservation easement	Generally allows an income tax deduction for the value of a qualified conservation easement. The deduction is limited to 30% of the donor's adjusted gross income in the year the contribution is made; any excess may be carried forward and deducted for up to five years.	For 2006 and 2007, generally increases the allowable deduction to 50% of the donor's adjusted gross income, with any excess being carried forward for up to 15 years. For qualified farmers and ranchers, the allowable deduction is 100% of the donor's adjusted gross income.

Miscellaneous Provisions

As with many major legislative acts, there are always a few "miscellaneous" provisions:

Item	Prior Law	2006 Legislation
IRC Sec. 529 plans	Many of the key provisions concerning qualified tuition plans came into being with the EGTRRA 2001. Under that act, these provisions were originally set to "sunset" on 12/31/10.	Makes the "temporary" provisions of EGTRRA that apply to qualified tuition plans permanent. ¹
Saver's credit	Provides for a nonrefundable tax credit for lower-income taxpayers for contributions to IRAs and certain qualified retirement plans. The credit amount varies with the adjusted gross income of the taxpayer. The provision was originally set to "sunset" on 12/31/06.	Makes the credit permanent. Beginning in 2007, indexes for inflation the income limits applicable to the credit, in multiples of \$500. ¹
Start-Up tax credit for small employer-sponsored plans	Allowed small employers a credit of up to \$500 per year for the costs of establishing a new qualified retirement plan. The provision was originally set to "sunset" on 12/31/10.	Makes the credit permanent. ¹
1035 exchanges and LTC	No comparable provisions.	Expands the scope of IRC Sec. 1035 to include tax-free exchanges of qualified long-term care (LTC) contracts. The provision also covers LTC provided as a part of, or a rider to, a life or annuity contract. ²

¹ Effective August 17, 2006, the date of enactment.

² Applicable to exchanges occurring after December 31, 2009.

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Miscellaneous Provisions (continued)

Item	Prior Law	2006 Legislation
Tax treatment of LTC as a rider to life or annuity contracts	Some provision for LTC coverage as a part of a life insurance contract.	Establishes new, complex tax rules for long-term care insurance (LTC) which is provided by a rider on, or a part of, either a life insurance contract or annuity contract. A withdrawal from the life or annuity contract used to pay for LTC is generally not includable in income. ¹ No itemized medical expense deduction is allowed for charges against the life or annuity contract for LTC coverage.
Employer-owned life insurance	Generally, amounts received under a life insurance contract paid by reason of the death of the insured are excluded from gross income for federal income tax purposes.	Generally provides that in the case of an employer-owned life insurance contract, the amount excluded from the policyholder's income cannot exceed the premiums and other amounts paid for the contract. ² Death benefit above these payment amounts is included in income. The new law adds certain notice and consent requirements and provides for specified exceptions to the income inclusion rules.
Restrictions on executive deferred compensation	No comparable provisions.	Generally provides that during periods in which a qualified retirement plan is "at-risk", any funds set aside in a nonqualified deferred compensation plan for high-level executives will become taxable in the year of transfer. An underpayment interest penalty and a 20% penalty tax also apply. Further, the employer is denied a deduction for such transfers. ³

¹ Generally effective for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009.

² Effective for contracts issued after August 17, 2006 (the date of enactment) except for contracts acquired under a IRC Sec. 1035 exchange.

³ Effective for funds transferred or set aside after August 17, 2006, the date of enactment.