Summary of the Pension Protection Act of 2006

Provided by:

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The Pension Protection Act of 2006 was signed into law by President Bush on August 17, 2006.

The Pension Protection Act is an attempt to strengthen the nation's traditional private pension system, as well as to better ensure the long-term solvency of the Pension Benefit Guaranty Corporation (PBGC), the government agency that assumes responsibility for failed defined benefit pension plans.

In addition, the Act extends and, in some instances, improves a variety of plans designed to encourage retirement savings. Uncertainty in regard to future planning is also eliminated by the Pension Protection Act making permanent many of the provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 that were scheduled to expire after 2010. Finally, the Act adds new rules regarding charities and charitable donations.

As you review the attached summary, pay particular attention to any provisions you feel may impact on your situation. If you would like additional information on the Pension Protection Act of 2006 or to discuss the impact of specific provisions on your planning, please call my office.

The Pension Protection Act of 2006

The Pension Protection Act of 2006 (the Act) was passed by Congress on August 3, 2006 and signed into law by President Bush on August 17, 2006. This bill represents the first comprehensive pension legislation since the Employee Retirement Income Security Act (ERISA) was signed into law more than 30 years ago in 1974.

Traditional Pension Plans:

The Act seeks to strengthen the system of traditional pension plans by allowing a higher deductible limit on employer contributions while, at the same time, requiring higher funding levels in order for plans to continue their qualified plan tax status. This discussion deals with single-employer pension plans. Multiemployer plans are subject to a different set of rules. In addition, the funding rules discussed below apply to plan years starting in 2008.

Funded Status

The objective of the Act is to require that most pension plans become fully funded over a seven-year period. Prior law required only a 90% funding level and the transition to 100% funding under the Pension Protection Act is gradual, beginning in 2008.

The funded status of a plan is determined by comparing the value of the plan's assets on the valuation date to the present value of the plan's benefit obligations.

Plan assets are generally valued at fair market value as of the valuation date, although some averaging to reduce the impact of market fluctuations is allowed.

The present value of the plan's benefit obligations is determined by the plan's actuary based on interest and mortality assumptions provided in the Act.

The ratio of plan assets to benefit obligations then determines the plan's funded status…whether the plan is fully funded, underfunded, overfunded or at risk. The funded status is important because it determines the amount of the required contribution.

Required Contributions

For each plan year, the employer must generally contribute a minimum of the plan's "target normal cost" plus a "shortfall amortization installment."

The "target normal cost" is the present value of the benefits expected to accrue during the plan year, assuming the actuarial assumptions required by the Act.

A "shortfall amortization installment" is required if a funding shortfall exists (i.e., if the ratio of plan assets to benefit obligations is less than a specified percentage). For plans established prior to 2008, a funding shortfall exists if the ratio of plan assets to benefit obligations is less than 92% in 2008, 94% in 2009, 96% in 2010 and 100% thereafter. If a funding shortfall exists, it is amortized in level annual installments over seven years and that amortized amount is added to the target normal cost to arrive at a plan's required minimum contribution for that plan year.

NOTE: Pension plans of commercial passenger airlines and airline catering companies benefit from special funding rules that allow funding shortfalls to be amortized either over 10 years (instead of seven years) or amortized over 17 years if special rules are followed.

At-Risk Plans

"At-risk" plans are subject to stricter funding requirements, resulting in higher contribution requirements.

A plan will be considered at risk if (1) it is less than 80% funded without regard to the at-risk rule, or (2) it is less than 70% funded with regard to the at-risk rule. The 80% threshold is, however, reduced to 65% for 2008, 70% for 2009 and 75% for 2010.

Liabilities under the at-risk rule are determined by assuming that all employees who are eligible to retire in the next 10 years will retire as early as possible and elect the retirement benefit with the highest present value.

Additional funding will be required from at-risk plans in order to bring the plan out of at-risk status more rapidly.

Benefit Limitations

If a plan's funded status falls below specified levels, the Act imposes several limitations on benefits.

If less than 80% of a plan's benefit obligations are funded, the forms of accelerated distributions (e.g., lump sum distributions) are limited and the plan cannot be amended to increase benefits.

If less than 60% of a plan's benefit obligations are funded, there can be no accelerated distributions (e.g., lump sum distributions), benefit accruals are frozen and the plan cannot be amended to increase benefits.

Executive Compensation Benefits

Starting immediately on the date of enactment, the Pension Protection Act restricts the funding of and payouts from executive compensation plans if the employer's pension plan is at risk.

Higher Deduction Limits

Under previous law, an employer generally could deduct contributions up to 100% of a plan's current liability. Any contributions above that amount were subject to a 10% excise tax.

For 2006 and 2007, the Pension Protection Act increases the maximum deductible contribution from 100% to 150% of a plan's current unfunded liability, as calculated under prior law.

Beginning in 2008, deductible contributions may be made up to an amount equal to the normal cost for the year, plus (1) the amount necessary to fully fund the plan as of the beginning of the year, plus (2) 50% of the unfunded liability as of the beginning of the year, plus (3) a "cushion" based on anticipated benefit increases in future years.

PBGC Premiums

The annual flat-rate PBGC premium of $30 per participant remains unchanged, with annual indexing for inflation starting in 2007. The variable-rate PBGC premium, however, will be subject to new rules based on yield curve segment rates beginning in 2008. In addition, the Act subjects pension plan sponsors who "dump" pension liabilities on the PBGC and then emerge from bankruptcy to termination premiums of $1,250 per participant.

Other Qualified Plan Changes:

Hybrid Plans

In order to encourage cash balance "hybrid plans," the Act protects them against age discrimination challenges, so long as the plans meet specified standards, generally from June 29, 2005 and later.

Phased Retirement

In order to facilitate phased retirement, the Act allows for "in-service" pension plan distributions to plan participants who are age 62 or older, enabling them to become part-time employees and still receive pension benefits.

Automatic 401(k) Enrollment

The Act makes it easier for companies to automatically enroll employees into their 401(k) plans by explicitly protecting automatic enrollment against state interference. With automatic enrollment, employees' salary is automatically reduced to fund their 401(k) contributions unless or until an employee takes steps to opt-out of participating.

Diversification Requirements

It has not been uncommon for 401(k) plans to require that employer contributions to the plan be invested in employer stock. With the collapse of Enron illustrating the risks that employees run by being substantially invested in their employer's stock, the Act requires that any defined contribution plan holding publicly-traded employer securities allow plan participants to diversify their account balances invested in those securities. At least three materially different investment alternatives must be available to plan participants.

Investment Advice

In the past, ERISA rules inhibited the investment information that employers could provide to plan participants. By creating a new prohibited transaction exemption, beginning in 2007 the Act permits plan fiduciaries to be compensated for providing plan participants with investment advice. Generally speaking, an investment advice arrangement must either provide that any compensation received by the fiduciary advisor does not vary based on the investment option selected or the recommendations are based on a computer model certified by an independent third party.

In the case of IRAs, advice based on a computer model will qualify for the prohibited transaction exemption only if the model complies with guidelines to be developed by the Labor Department.

Combined Defined Benefit/401(k) Plans for Small Employers

Beginning in 2010, companies with up to 500 employees can establish a combined defined benefit plan and automatic enrollment 401(k) plan with a single plan document and trust fund.

Vesting

Under the new law, defined contribution plan employer contributions other than matching contributions are subject to the faster vesting rules that currently apply to employer matching contributions only. After 2006, all employer contributions to a defined contribution plan will have to vest under either a 3-year cliff vesting schedule or a 6-year graded vesting schedule.

Survivor Annuity Requirements

For plan years beginning after 2007, the Act requires that defined benefit and money purchase pension plans offer a 75% survivor annuity, in addition to a lesser option equaling at least a 50% survivor annuity.

Simplified Rollovers

Currently, certain rollovers are either prohibited or require use of a conduit traditional IRA. The Act simplifies rollovers in these situations:

- Currently, a spouse beneficiary may roll over his or her spouse's interest in a qualified retirement plan, government plan or 403(b) plan into an IRA and not be taxed until distributions are actually taken. Beginning in 2007, the Act extends this special rollover treatment to non-spouse beneficiaries as well.

- A temporary rule allowing after-tax contributions to employer plans to be rolled over into IRAs has been made permanent.

- Direct rollovers will be allowed from retirement plans to Roth IRAs, beginning in 2008, assuming all conversion qualifications are met (e.g., income requirements).

- The IRS is granted the permanent authority to extend the 60-day rollover period when failure to roll funds over within 60 days is due to events beyond the reasonable control of the individual.

Roth 401(k) and 403(b) Plans

Originally set to expire after 2010, the availability of a Roth feature in 401(k) and 403(b) plans, which first became available in 2006, has been made permanent.

401(k) and 403(b) Hardship Withdrawals

Within six months of enactment, the Treasury Department is to issue regulations allowing 401(k) and 403(b) plan hardship withdrawals with respect to any person named as a beneficiary of the plan participant. Current rules limit hardship withdrawals to a participant's spouse and dependents only.

Military and Public Service Personnel

Reservists who are called to active military duty for at least 179 days between September 12, 2001 and December 30, 2007 are allowed to make penalty-free withdrawals from retirement plans and IRAs. Service personnel are also given up to two years following the end of their active duty to avoid income tax on distributions by re-contributing the amounts they withdrew.

Public service personnel participating in a governmental pension plan may make penalty-free withdrawals following separation from service if they are age 50 or greater (previously age 55).

Adding Certainty to Retirement Planning:

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) introduced a wide variety of retirement savings opportunities. These provisions, however, were scheduled to expire at the end of 2010. The Pension Protection Act of 2006 makes permanent these changes to retirement planning rules:

Higher IRA Contributions

The higher dollar contributions to IRAs have been made permanent ($4,000 in 2006 - 2007, $5,000 in 2008 and inflation adjusted thereafter). In addition, the additional $1,000 "catch-up" IRA contribution available to older workers (over age 50) is made permanent.

Also, beginning in 2007, taxpayers will be allowed to direct the IRS to deposit all or a portion of their tax refund into an IRA.

Finally, the income limits used for determining eligibility for Roth IRA contributions and deductions for contributions to traditional IRAs made by active participants in an employer's qualified plan will be indexed for inflation beginning in 2007.

Permanent Saver's Credit

The Saver's Credit, which allows lower- and middle-income taxpayers to claim a tax credit of up to $1,000 for contributions or deferrals to retirement plans and IRAs, was scheduled to expire at the end of 2006. The Saver's Credit has been made permanent and, in addition, starting in 2007 the adjusted gross income limits used to calculate the amount of the credit will be adjusted for inflation. The amount of the credit itself, however, is not indexed for inflation.

Higher Defined Benefit Plan Limits

The maximum annual benefit a participant can receive from a defined benefit plan has been made permanent ($175,000 for 2006, as adjusted for inflation).

In addition, defined benefit plan benefits will be reduced only if payments begin prior to age 62. Prior to EGTRRA, benefits that began prior to Social Security retirement age were subject to reduction.

Higher Defined Contribution Plan Limits

The higher dollar contributions to defined contribution plans, 401(k)/403(b) plan elective deferrals, 457 plan deferrals and SIMPLE plans, as well as the catch-up contributions that can be made by older workers, have been made permanent.

Maximum Contributions	
Plan Type	**2006 Contribution Limit (as adjusted for inflation)**
Defined Contribution	$44,000
401(k)/403(b)/457 Deferrals	$15,000
401(k) Catch-Up Contributions (age 50+)	$5,000
SIMPLE (IRA and 401(k))	$10,000
SIMPLE Catch-Up Contributions (age 50+)	$2,500

The higher maximum compensation on which defined contribution plan contributions can be based has been made permanent ($220,000 in 2006, as adjusted for inflation). In addition:

- Rather than reverting to the pre-EGTRRA 25% limit, the limit on total contributions for a participant in a defined contribution plan will remain at 100% of compensation.
- The deduction limit for contributions to defined contribution plans remains at 25% of aggregate compensation, rather than reverting to the pre-EGTRRA limit of 15% for profit-sharing plans and 25% for money-purchase pension plans.
- The rule that makes 401(k) elective deferrals deductible in full, without any regard to deduction limitations, is made permanent.

Saving for College:

The Pension Protection Act permanently extends the rules allowing state-sponsored Section 529 qualified tuition programs and federal income tax free treatment for qualified distributions from those plans. In addition, the operation of Section 529 plans will be subject to new rules intended to prevent abuse.

Giving to Charity:

The Pension Protection Act giveth and it taketh away:

- **IRAs:** In 2006 and 2007 only, taxpayers who are at least age 70-1/2 can make tax-free distributions of up to $100,000 from traditional or Roth IRAs directly to charities. The charitable donation must be made directly by the IRA trustee to a qualified public charity. Distributions, however, cannot be made to donor-advised funds or to supporting private foundations.

- **Donations of Clothing and Household Goods:** Effective for donations after August 17, 2006, clothing and household goods to charity must be in "good condition" or better for the donor to receive a tax deduction. The Act, however, does not define what "good condition" is. A limited exception allows a deduction for single items in "less than good" condition if the item is appraised at more than $500. It's interesting to note that individuals claimed $36.9 billion in noncash donations on Form 8283 in 2003, some 48% of which was represented by clothing.

- **Cash Contributions:** Beginning in the 2007 tax year, cash contributions regardless of amount are not deductible unless the donor can substantiate the contribution, either through a bank record, cancelled check or a statement from the charity showing the name of the charity, the amount of the contribution and the date the contribution was made.

- **Conservation Easements:** In 2006 and 2007 only, contributions of qualified conservation easements can offset 50% of adjusted gross income, up from 30%.

- **Food and Book Donation Extension:** Two provisions of the Katrina Emergency Tax Relief Act of 2005 (KETRA) have been extended. The enhanced food inventory donation rules applying to partnerships, S corporations and other business entities have been extended to December 31, 2007, as has the enhanced deduction for books donated to public schools by C corporations. In neither case do the recipients of the donations have to be hurricane victims (Katrina or otherwise).

- **Gifts of Fractional Interests:** Beginning on August 18, 2006, gifts of fractional interests are restricted. Unless the donor gives away the entire interest within 10 years or the date of the donor's death, whichever is sooner, or if the donee never takes possession of the item during that period, the donor's tax deduction is recaptured with interest and penalty.

One provision that **did not** make it into the Act is permitting non-itemizers to deduct their charitable contributions.

In addition, the Pension Protection Act steps up federal oversight of charitable organizations in these ways:

- Requires that charitable organizations report certain acquisitions of life insurance contracts beginning on August 17, 2006 to the Treasury Secretary, who must then issue a report indicating if the acquisition of these life insurance contracts is consistent with the tax-exempt purposes of the charitable organizations. The intention is to rein in the potentially abusive use of life insurance by charitable organizations.

- Increases reporting responsibilities for donor advised funds and supporting organizations.

- Provides for the recovery of the tax benefits derived from contributions of property if the property is not used for an exempt purpose by the charity.

- Encourages a greater sharing of information on charities between the states and the IRS.

- Expands the definition of charitable foundation gross investment income to include capital gains, annuities and other substantially similar investment income.

- Imposes new information reporting requirements on charitable entities that were previously not required to file because their gross receipts were less than $25,000.

- Extends public disclosure requirements to the unrelated business income of charitable organizations.

- Applies an excess benefits transaction tax on any payments from a donor advised fund to a donor, donor adviser or related person, and on any payments from a supporting organization to a substantial contributor or related person.

- Instructs the Treasury Secretary to undertake a study on the organization and operation of donor advised funds and of supporting organizations to determine if such organizations are operating in a manner consistent with their tax-exempt status.

Insurance-Related Provisions:

- **Employer-Owned Life Insurance:** In general, life insurance proceeds are exempt from the gross income of the beneficiary. In order to retain this favorable tax treatment, however, employers purchasing insurance issued after August 17, 2006 on the life of employees must provide those employees with a notice and receive their consent to be insured **before the issue date** of the policy. Failure to comply with the notice and consent requirements of the Pension Protection Act could result in the death benefit being taxable income to the employer to the extent the proceeds at death exceed the total premiums and any other amounts paid by the policyholder for the contract.

- **Long-Term Care Insurance:** The Act allows qualified long-term care insurance to be offered as part of an annuity or life insurance contract. The cost of the long-term care coverage charged against the cash value of the annuity or life insurance contract will not be includible in gross income, but will reduce the policyowner's investment in the contract. In addition, the rules related to tax-free exchanges of insurance and annuity contracts have been broadened to include combination products, as well as exchanges of standalone qualified long-term care insurance contracts.

- **Annuities:** The Act directs the Labor Department to clarify the regulations allowing annuities in 401(k) plans, giving employers clearer guidelines on selecting annuities to be offered as part of their 401(k) plans.

- **Public Safety Officers and Tax-Free Health and Long-Term Care Insurance Premiums:** Beginning in 2007, a retired public safety officer can direct that up to $3,000 per year be paid tax-free from a governmental retirement plan for health or long-term care insurance premiums for the plan participant, the participant's spouse or a dependent. The governmental retirement plan must pay the premiums directly to the insurer, meaning that individuals cannot be reimbursed for having paid the premiums and receive tax-free treatment.