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The Pension Protection Act of 2006

In August, President Bush signed the landmark Pension Protection Act of 2006 into law. The Act, a response by Congress to a rash of major corporate bankruptcies and a negative national savings rate, seeks to protect and promote retirement savings in a number of ways.

Defined benefit plan funding rules

The Pension Benefit Guaranty Corporation (PBGC), the quasi-governmental agency that insures defined benefit plans, is currently running a deficit of almost $26 billion.

The Act completely replaces the current defined benefit plan funding rules, beginning in 2008. The new rules significantly increase the annual contributions employers must make to meet their pension promises. Plans that are "at risk" are subject to even stricter funding requirements, and are prohibited from increasing benefits or paying out benefits in the form of a lump sum. New disclosure rules will keep employees informed of the funded status of their plans.

It's hoped that these new rules will help protect employee pension benefits in the event of employer bankruptcies, and avoid the need for a government bailout of the financially troubled Pension Benefit Guaranty Corporation (PBGC).

401(k) and other defined contribution plans

Congress was also concerned about retirement plans that require participating employees to invest in employer stock. As companies like Enron, WorldCom, and Tyco faltered, their stock prices plummeted and years of retirement savings for many employees disappeared seemingly overnight. The Act addresses this problem by generally requiring that defined contribution plans (other than certain ESOPs) offer at least three investment options other than employer stock, beginning in 2007.

Repeal of sunset provisions

The Act makes permanent a number of important provisions that had been scheduled to expire after 2010, reducing uncertainty and further encouraging retirement savings. The provisions that had been scheduled to expire include those relating to Section 529 tax-free qualified withdrawals, Roth 401(k)s, increased IRA and retirement plan contribution limits, increased deduction limits, rollover rules, faster vesting of matching contributions, and catch-up contributions, among others. The saver's tax credit, which had been scheduled to expire in 2008, is also made permanent.

More flexibility for nonspouse beneficiaries

The Act contains two provisions affecting 401(k), 403(b), and 457 plans that are important for domestic partners and other nonspouse beneficiaries. First, when a participant in one of these plans dies, only the participant's spouse can currently roll the death benefits over to an IRA. Nonspouse beneficiaries must leave the funds in the employer plan. And while current law generally lets nonspouse beneficiaries take distributions over their lifetimes, employer plans aren't required to offer that option. Nonspouse beneficiaries are often forced to take a distribution from a plan sooner than they'd like, and sooner than the law requires. Starting in 2007, the Act fixes this problem by letting nonspouse beneficiaries make a direct rollover to an "inherited" IRA, allowing them to defer taxes by spreading distributions from the IRA over the maximum period the law allows.

Select provisions made permanent by the Pension Protection Act:

- *Section 529 tax-free qualified withdrawals*
- *Roth 401(k)s*
- *Increased IRA and retirement plan contribution limits*
- *Catch-up contributions*
- *Saver's credit*
- *Credit for pension plan start-up costs*
- *Faster vesting of matching contributions*
- *Enhanced rollover rules*
- *Increased deduction limits*

Second, participants in 401(k), 403(b), 457, or nonqualified deferred compensation plans can (if the plan permits) currently make an in-service withdrawal if they, their spouse, or their dependents incur a financial hardship. The Act liberalizes this rule so that an employer can also allow a withdrawal if a participant's plan beneficiary incurs a hardship, even if the beneficiary isn't related to the participant.

Direct rollovers to Roth IRAs

Currently, a participant who receives a distribution from a qualified plan, 403(b), or 457 plan can't roll those funds over to a Roth IRA. He or she can, however, accomplish this indirectly by first rolling the funds over to a traditional IRA, and then (if eligible) converting the traditional IRA to a Roth IRA.

Starting in 2008, the Act streamlines this two-step process, allowing direct rollovers from 403(b), 457, and qualified plans to Roth IRAs. A participant will still need to meet the eligibility requirements for a conversion (in general, adjusted gross income can't exceed $100,000). However, the Tax Increase Prevention and Reconciliation Act repeals the eligibility rules effective in 2010, allowing any taxpayer to convert a traditional IRA to a Roth IRA regardless of income or filing status.

Automatic enrollment

The Act encourages employers with 401(k) and 403(b) plans to use automatic enrollment to increase employee participation. Automatic enrollment applies to employees who, for one reason or another, fail to make an affirmative election about participating in a plan. Beginning in 2008, the Act provides an incentive for employers to adopt automatic enrollment by allowing them to forgo discrimination testing and top-heavy testing if minimum contribution and notice requirements are satisfied. The Act also contains a new rule that lets employees request a refund of contributions made during the first 90 days after automatic contributions begin.

Phased retirement distributions

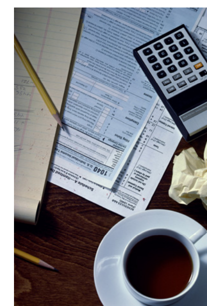
As baby boomers begin to retire, some experts warn that employers may begin facing a shortage of skilled workers. To address this issue, some employers have established "phased retirement" programs that encourage workers who are eligible to retire to continue working on a part-time basis. Employees benefit by having a smoother transition from full-time employment to retirement, and employers benefit by retaining the services of talented employees.

One impediment to these programs, however, is the fact that pension plans generally can't begin paying benefits to active employees until they've reached the plan's normal retirement age (typically age 65). This means that employees who want to transition from full-time to part-time employment can't supplement their reduced income with their pension benefit until they've reached age 65. Starting in 2007, the Act supports phased retirement arrangements by allowing pension plans to begin paying benefits after an employee reaches age 62, even though the employee is still working part-time.

Miscellaneous changes

Effective in 2007, except as noted, the Act also:

- Allows taxpayers age 70½ or older to make charitable contributions of up to $100,000 per year directly from an IRA to a qualified charity in 2006 and 2007. These IRA distributions are tax free, don't increase adjusted gross income (AGI), and satisfy minimum distribution requirements.



- Adjusts the income limits that apply to IRA contributions and the saver's credit for inflation.
- Allows the direct deposit of tax refunds to IRAs.
- Allows advisors who provide services to a retirement plan to also provide investment advice to plan participants if certain requirements are met.
- Requires that 401(k) and other defined contribution plans use three-year cliff or six-year graded vesting for all employer contributions (currently this faster vesting requirement applies only to employer matching contributions).
- Removes the legal uncertainty that has surrounded cash balance plans in recent years by clarifying that a cash balance plan will not be considered to discriminate on the basis of age (generally retroactive to 2005) if certain requirements are met.

Consult your financial professional for more information about this major pension legislation.

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