

The recently passed Pension Protection Act of 2006 is a massive tax bill that overhauls the funding and disclosure rules for defined benefit plans, addresses conversions of pension plans to cash balance plans, carries liberalized payout and rollover rules, and makes a host of other changes relating to pension plans and their beneficiaries. Here's an overview of the key tax changes in this important new legislation:

### **Reform of the single-employer defined benefit rules**

For single-employer defined benefit plans, the Act:

- requires employers to make contributions to their single-employer defined benefit pension plans over the next seven years in order to make those plans 100% funded. Formerly, a 90% funding level was acceptable;
- specifies that the discount rate used to calculate the present value of current pension liabilities be based on a segmented yield curve of corporate bonds;
- triggers accelerated contributions for "at-risk" plans;
- reduces the smoothing of interest rates to two years (instead of five for assets and four for liabilities under current law);
- permits employers to make additional maximum deductible contributions;
- prohibits further benefit accruals for lump-sum distributions or shutdown benefits from plans funded at less than 60%;
- restricts the use of deferred executive compensation arrangements for employers with severely underfunded plans;
- permanently establishes an employer-paid termination premium of \$1,250 per participant if a plan sponsor terminates its employee pension plan upon entering bankruptcy; and
- establishes special rules for airlines.

### **Reform of the multiemployer pension system**

The Act's changes relating to multiemployer plans include:

- identifying underfunded multiemployer pension plans and establishing quantifiable benchmarks for measuring a plan's funding improvement;
- providing new notice requirements for underfunded plans;
- changing the amortization schedule for any plan benefit amendments from 30 years to 15 years;
- increasing the maximum deductible limit to 140% of current liability;
- requiring plans trustees to improve the health of the plan by one-third within 10 years if a plan is less than 80% funded or will hit a funding deficiency within seven years; and
- prohibiting benefit increases if the increase causes the plan to fall below 65% funded status.

### **New disclosure rules for qualified plans**

One of the overarching themes of the Act is that there should be more pension transparency so that workers, regulators and investors can better keep tabs on the financial health of traditional pension plans. To meet this need, the Act:

- requires both single and multiemployer plans to include more detailed and specific information on their Form 5500 filings;

- enhances Form 4010 disclosure requirements and makes all Form 4010 information filed with PBGC available to the public, save for sensitive corporate proprietary information;
- establishes an 80%, at-risk threshold that determines whether plans pose a threat to PBGC and therefore must file Form 4010 information;
- requires both single and multiemployer pension plans to notify workers and retirees of the funded status of their plan within 120 days after the close of the plan year;
- prohibits companies from forcing employees to invest any of their own retirement savings contributions in the stock of the employer;
- makes it clear that companies have a fiduciary responsibility for workers' savings during "blackout" periods, when workers are temporarily barred from making changes to their 401(k) investments; and
- requires companies to give workers quarterly benefit statements that include information about accounts, including the value of their assets, their rights to diversify, and the importance of maintaining a diversified portfolio.

### **New investment advice rules**

The Act:

- permits qualified "fiduciary advisers" to offer investment advice to help employees manage their 401(k) and other retirement options;
- puts in place fiduciary and disclosure safeguards to ensure that advice provided to employees is solely in their best interest;
- requires fiduciary advisers for employer-sponsored plans to base their recommendations on a computer model that is certified and audited by an independent party; and
- requires fiduciary advisers for non-employer sponsored plans to charge a flat rate fee for one year (with no computer model).

### **Liberalized plan payout and rollover rules**

Provisions in the Act that liberalize plan payout and rollover rules include the following:

- after 2007, taxpayers will be permitted to make direct rollovers from qualified plans to Roth IRAs;
- for purposes of the 401(k) hardship distribution rules, "hardship" includes hardship of a beneficiary under the plan (even if the beneficiary is not a spouse or dependent). This provision is effective on August 17, 2006;
- members of the National Guard and Reserves called to active duty through 2007 can make penalty-free withdrawals from retirement plans. Withdrawn amounts may be repaid to the IRA or pension plan within two years of the distribution;
- the 10% early withdrawal penalty for distributions to public safety employees over age 50 (including police, fire, and emergency medical services) who may retire early is waived;
- effective for post-2006 distributions, nonspouse designated beneficiaries are allowed to make rollovers of inherited amounts in qualified plans, governmental Section 457 plans, or tax-sheltered annuities to their own IRAs (treated as inherited IRAs); and
- effective for distributions in plan years beginning after 2006, defined benefit plans can make in-service distributions to age-62-or-older participants.

## Retirement savings provisions made permanent

The Act makes permanent a number of retirement plan and IRA liberalizations that were added to the tax laws in 2001 but were set to sunset after 2010. By making the 2001 changes permanent, the new law preserves the advantages of higher employee contribution limits for employer plans, higher IRA contribution limits, more flexible plan rules, portability, a catch-up for those over 50, and an increase in employer contribution limits. The new law also makes permanent the saver's credit, which would not have been available after 2006 absent the extension.

## Charitable reforms

The Act also contains a package of provisions to help prevent abuse in the charitable sector and provide additional tax incentives for Americans to give more resources to the charitable community. The incentives include:

- *Tax-free distributions from IRAs for charitable purposes.* Taxpayers can exclude from gross income 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 provision is effective for two years through 2007.
- *Charitable deduction for contributions of food inventory.* An enhanced deduction for donations of food inventory which was formerly available only to C corporations is extended to all trades and businesses, effective for two years through 2007.
- *Basis adjustment to stock of S corporation contributing property.* If an S corporation contributes property to a charity, an S corporation shareholder only has to reduce his basis in stock of the S corporation by his pro rata share of the adjusted basis of the contributed property, rather than by the amount of the charitable contribution that flows through to him. The provision is effective for two years through 2007.
- *Charitable deduction for contributions of book inventory.* The current-law provision that adds public schools to the list of eligible donees for the enhanced deduction for contributions of qualified book inventory by C corporations is extended for two years through 2007.
- *Qualified conservation contributions.* The new law raises the charitable deduction limit—from 30% of adjusted gross income (AGI) to 50%—for qualified conservation contributions, as long as it does not prevent the use of the donated land for farming or ranching purposes. The charitable deduction limit is raised to 100% of AGI for eligible farmers and ranchers. Unused contributions can be carried forward for up to 15 years. The provision is effective for two years through 2007.

On the charitable reform side, the new rules:

- require reports to the Treasury Department on certain life insurance contracts;
- double the fines and penalties applicable to certain activities by charities, social welfare organizations, private foundations and exempt organization managers;
- clarify the terms of facade easements in historic districts, and also clarify that the charitable deduction is reduced if a rehabilitation tax credit has been claimed with respect to the donated property;
- limit the basis for donated taxidermy property and provide that the value of the deduction is equal to the lesser of basis or fair market value;
- require the recapture of any tax benefit derived from the contribution of property with respect to which a fair market value deduction was claimed if the property is

- not used for an exempt purpose of the donee organization, effective for contributions made after September 1, 2006;
- generally prohibit deductions for contributions of clothing and household items unless they are in good used condition or better;
  - require that in the case of a charitable contribution of money, regardless of the amount, the donor must maintain a cancelled check, bank record or receipt from the donee organization showing the name of the donee organization, the date of the contribution, and the amount of the contribution. This is effective for contributions made in tax years beginning after August 17, 2006;
  - lower the threshold for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property for which a qualified appraisal is required;
  - impose certain requirements on tax-exempt organizations that offer credit counseling services;
  - apply an excess benefits transaction tax on any grant, loan, compensation or other similar payments from a donor-advised fund to a person that with respect to such fund is a donor, donor adviser, or a related person, and from a supporting organization to a substantial contributor or a related person; and
  - require that unrelated business income tax returns of 501(c)(3) organizations be made publicly available.