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New Tax Benefit for Reservists

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On Aug. 17, 2006, President Bush signed into law the Pension Protection Act of 2006. The act provides a tax benefit to reservists, strengthens pension funds, and provides important tax law changes.

Reservists. The act creates an exception for reservists called to active-duty service — for more than 180 days or an indefinite period between Sept. 11, 2001 and Dec. 31, 2007 — to make early withdrawals (prior to age 59 ½) from certain retirement plans without triggering the 10-percent penalty tax imposed on such withdrawals under IRS Code Sec. 72(t). The withdrawal exception specifically applies to Individual Retirement Accounts (regular and Roth), 401(k) plans, and 403(b) tax-sheltered annuities. It is important to recognize that the withdrawals will constitute taxable income to the account owner.

Any reservist, who previously received an early retirement plan withdrawal and paid any applicable tax, may apply for relief under the act. The tax relief should be claimed using IRS Form 1040X (Amended U.S. Individual Income Tax Return). When filing for the tax refund a reservist should write "active-duty reservist" on the top of Form 1040X and in Part II (Explanation of Changes) provide the following information: the date he or she was called to active duty; amount of the retirement distribution; and amount of early-distribution tax paid.

A reservist has two years, after the end of his or her active- duty period, to re-contribute part or all of the early retirement plan withdrawal. However, a reservist whose duty period ended before Aug. 17, 2006 has only until Aug. 17, 2008 to re-contribute the early retirement plan withdrawal. A reservist will not be entitled to an income tax deduction for making a re-contribution.

Pension Provisions. The act requires most employers, with under-funded pensions, to become fully funded over a seven-year period beginning in 2008. Employers are permitted to deduct the cost of making any additional contributions required to fund the pensions. The act also provides new strict funding guidelines, and imposes a 10 percent excise tax on companies that fail to correct their pension deficiencies.

IRA, 401(k), and Other Retirement Plans. The act permits employers to automatically enroll their employees into a company 401(k) plan with default contribution levels. Employees who are automatically enrolled will be required to opt-out of the 401(k) plan to terminate their enrollment.

The act allows non-spouse beneficiaries to roll over inherited qualified retirement plan assets into an IRA. The beneficiary will avoid tax on the roll-over. Prior tax law only permitted this tax treatment to a spouse who inherited retirement plan assets from a deceased spouse.

The act establishes the following retirement account benefits: (i) A $4,000 IRA contribution amount limit in 2006 and 2007; (ii) Increased to $5,000 in 2008, and adjusted for inflation after 2008; and (iii) Catch-up contributions (individuals age 50 or older) of $1,000 for IRAs, $2,500 for simple-IRAs, and $5,000 for 401(k) plans.

In addition the act: (i) Permanently removes the 2010 sunset provision for Roth 401(k) and Roth 403(b) plans; (ii) Permits a direct roll-over from a 401(k) to a Roth IRA, with the roll-over treated as a Roth conversion; (iii) Permanently extends the Retirement Savings Tax Credit (was set to expire on Dec. 31, 2006); and (iv) provides for hardship withdrawals "with respect to any person listed as a beneficiary under the 401(k) plan."

Charitable Donations. The act requires individuals to maintain a record (receipt, canceled check, or credit card statement) of all cash donations. In the case of an IRS audit, no tax deduction will be allowed if the taxpayer cannot provide the supporting documentation. The Act also toughens the rules for non-cash donations (cars, clothing, and household goods) by requiring them to be in “good condition.”

In addition, the act permits taxpayers to donate money to charitable organizations directly from their IRA account. The account distributions will be tax-free and avoid any early withdrawal penalty. The maximum annual donation is limited to $100,000, will not be included in the account owners’ taxable income, and will not qualify as a tax deductible charitable contribution.