

## **Pension Protection Act of 2006: Maybe Unintended...But Positive Changes for Unmarried Persons**

By Deb L. Kinney

It's not unusual for people's eyes to glaze over when the topic of retirement plans comes up. But this is one time when you might want to pay attention because the Pension Protection Act of 2006 (the Act) includes provisions that really are great news for same-sex partners and other unmarried persons. The first important modification is that a non-spouse may now be the designated beneficiary for an eligible retirement plan. The second change is that an employee who designates a non-spouse beneficiary may now tap into the employee's retirement funds in certain "hardship" situations to help the beneficiary. Each of these provisions is discussed in more detail below. However, in recognition of those glazed looks, some basic information about pension plans will probably be helpful.

There are generally two kinds of pension plans, *defined contribution* and *defined benefit* plans. *Defined contribution plans* are the most common type of plan. They are accounts into which an employee will make periodic contributions of a specified amount of pre-tax dollars or a defined percentage of her/his salary and, usually, an employer will match those contributions up to a predetermined amount. The total assets ultimately available for distribution to the employee or the designated beneficiary will vary depending on income, expenses, and gains or losses experienced by the plan's investments. Examples of defined contribution plans include 401(k), 403(b), or 404(c) plans, stock options, and profit-sharing plans. Typically, the employee "owns" the plan and may choose the plan beneficiary who will receive the plan assets if the employee dies before the assets are exhausted. *Defined benefit plans*, on the other hand, are more like a contract between an employer and employee in which the employer agrees to provide a specific benefit amount at some future date, usually after a certain age or after the employee retires. Traditional public employee retirement plans that provide a retirement benefit based only the age of the employee, the employee's final salary, and her/his years of service are the most common example of a defined benefit plan. In this case, the plan itself controls the funds and may restrict how and to whom the funds may be distributed. When a plan is approved by the IRS, it is called a "qualified" plan and, as such, is subject to the Employee Retirement Income Security Act (ERISA) regulations.

Historically, when a surviving spouse (as defined by the Internal Revenue Code) inherited retirement assets from a defined benefit or defined contribution plan as the designated beneficiary, the beneficiary could roll the assets into her/his own IRA without any tax liabilities and would only be taxed later when the assets were withdrawn from the IRA. Moreover, if a surviving spouse did not have an immediate need for the assets, she/he could wait to take the distributions until she/he reached the age of 59 ½. The distributions could also be "stretched" or withdrawn in small portions over the expected lifetime of the beneficiary (as determined by the IRS), thereby reducing the tax liabilities and increasing the amount of money actually available to the beneficiary.

In contrast, a non-spouse beneficiary was compelled to withdraw the entire amount of the retirement assets from most all pension plans in a lump sum or, in the best case, take the distributions over a 5 year period. Because the majority of contributions to retirement plans are made with "pre-tax" dollars, the deferred income tax is collected by the government when distributions are made. The rate applied is the marginal income tax rate of the person who actually receives the distributions. The infusion of income in a short period of time that occurs when a retirement asset is distributed in these circumstances will often force the beneficiary into a much higher tax bracket than she/he would otherwise be in during that time. The result is that she/he will receive significantly less than she/he would have if she/he had been able to absorb the additional income over a longer period or if she/he had taken the distribution during retirement.

The first important change created by the Act is that designated non-spouse beneficiaries of a defined benefit plan such as an unmarried partner, parent, sibling, or adult child are now provided with the same options as a surviving spouse with regard to asset distribution. A non-spouse beneficiary may now take a distribution in a lump sum, or roll the assets into an inherited IRA in the name of the deceased partner and stretch the distribution over 5 years or even over the life expectancy of the beneficiary. This is likely to result in significant tax savings for non-spouse beneficiaries. It is important to note that while the Act provides a non-spouse beneficiary with additional distribution options, the beneficiary is not permitted to merge the assets with her/his own retirement assets.

Of course, there are a few caveats. First, this new provision does not require a pension plan to allow distributions to non-spouse beneficiaries. The provision is applicable only if the plan currently permits non-spousal beneficiaries. Some plans, such as the Federal Employee Pension plan, allow distribution to spousal beneficiaries only. This amendment will not change that allowance.

Second, even if a plan is covered by the Act, each plan participant must name her/his beneficiary(ies) on the form provided by the plan administrator in order to insure that a non-spouse beneficiary will be eligible to receive the distribution. Since the Federal government does not recognize a legal relationship other than marriage, registered domestic partners or other non-spouse parties will have no claim to the benefits unless they are specifically designated, in writing, as the beneficiary. These assets cannot be directed by your estate documents, but only by a beneficiary designation.

Finally, because the Act does not specifically address Roth IRAs, for now it is safest to assume that they are not covered. Future Treasury Department regulations may clarify this situation.

The second significant provision of the Act is that a plan participant may now make withdrawals from her/his 401(k) in case of certain medical or financial emergencies experienced by the designated beneficiary, irrespective of the parties' marital status. In the past, a plan participant was only allowed to make such withdrawals for her/his legally recognized spouse or dependent(s). This modification insures that a plan participant has a source of emergency funds for her/his same-sex partner or any other previously designated plan beneficiary.

This new provision directs the Secretary of the Treasury to issue rules for purposes of determining whether a hardship or unforeseen financial emergency has occurred, so the criteria are not absolutely clear at this point. However, Internal Revenue Code Section 409A(a)(2)(B)(ii) provides that an "unforeseen financial emergency" is "a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant."

Furthermore, it is not clear whether a plan participant will be permitted to take a *hardship distribution* for the dependent of a non-spouse, such as the child of a same-sex partner, even if that non-spouse is a designated beneficiary. If the dependent meets the criteria for designation as a qualifying child (IRC §152(c)) or a qualifying relative (IRC §152(d)), it is possible that a hardship distribution would be permitted. This is likely to be determined on a case by case basis, although future Treasury Department regulations may clarify who else will be eligible.

The Act does not specifically address or include any Government or Union pensions unless the plan itself addresses non-spousal distributions. It does not affect military or social security benefits. The Act also does not change the requirement that a beneficiary have a valid social security number or tax identification number to be eligible to receive benefits, nor does the Act require or compel employers to provide pension benefits to domestic partners.

The Pension Protection Act of 2006 was signed into law by President Bush in August 2006 and is applicable to pension distributions made after December 31, 2006.

Additional information about the Pension Protection Act of 2006 can be found at:

<http://www.irs.gov/retirement/article/0,,id=165131,00.html>

<http://www.hrc.org>