

Pension ANALYST

Important Information

New Legislation

October 2006



Pension Protection Act of 2006 Requires Immediate Action by Defined Contribution Plan Sponsors

This is one of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined contribution plans. This publication focuses on those changes that are effective in 2006 and 2007. A later publication will discuss the provisions effective in 2008 and beyond.

WHO'S AFFECTED These developments affect sponsors of and participants in qualified defined contribution plans, 403(b) arrangements and section 457(b) plans.

BACKGROUND AND SUMMARY On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The 1000 pages of this new law contain numerous provisions affecting defined contribution plans. Some of these provisions will make it easier to administer these plans. For example, the law makes permanent the provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) that were scheduled to expire in 2010. Other provisions, such as the many new participant notice requirements, may add complexity. In addition, some provisions are required (e.g., faster vesting of non-matching employer contributions), while others are optional (e.g., the [automatic enrollment safe harbor design](#)). Finally, the effective dates of these changes generally range from the date of enactment through 2010, with some provisions effective before August 17, 2006.

This *Pension Analyst* discusses the PPA provisions that apply immediately (e.g., in 2006, 2007 and retroactively) to all types of defined contribution plans, in an effort to help plan sponsors determine the immediate actions needed to keep their plans in compliance with ERISA and the Internal Revenue Code.

ACTION AND NEXT STEPS Plan sponsors should carefully review this information and the attached checklist to identify required and desired plan design changes. If Prudential Retirement provides document services for your plan, we will work with you to ensure that appropriate changes are made during the required timeframes. We will also work with you to ensure that these changes are properly and timely reflected in your plan's recordkeeping procedures.

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RELATED DOCUMENTS

[Pension Protection Act of 2006: Immediate Action Items for Plans Subject to ERISA](#)

[Pension Protection Act of 2006: Immediate Action Items for Plans Not Subject to ERISA](#)

Provisions Effective Immediately

EGTRRA Provisions Made Permanent

Many important [changes made by EGTRRA](#) were scheduled to expire, or sunset, after December 31, 2010. Some of the more notable defined contribution plan provisions that PPA has now made permanent include:

- The increased annual elective deferral limit for 401(k), 403(b) and section 457(b) plans, which is currently \$15,000 and will be adjusted for inflation in \$500 increments beginning in 2007.
- The repeal of the coordination of the section 457(b) deferral limit with elective deferral contributions made to other types of plans.
- The ability for employees age 50 or older to make "catch-up" contributions to 401(k), 403(b) and governmental section 457(b) plans (currently \$5,000, to be adjusted for inflation in \$500 increments beginning in 2007).
- The increased dollar and compensation annual addition limitations.
- The repeal of the maximum exclusion allowance applicable to section 403(b) arrangements.
- The 100% of compensation limit applicable to contributions under a section 457(b) plan.
- The increased annual compensation limit applied when determining qualified plan contributions.
- The ability for participants in 401(k) plans and 403(b) arrangements to make "designated Roth contributions."
- More rapid minimum vesting for employer matching contributions (three-year cliff or two- to six-year graded).
- The ineligibility of all hardship withdrawals for rollover.

- The required six-month suspension from making elective deferrals and employee post-tax contributions following a hardship withdrawal under the 401(k) “safe harbor” hardship withdrawal rules.
- Changes to employer deduction limits.
- Simplification of the top-heavy testing rules, including the definition of key employee.
- The prohibited transaction exemption for loans made to owner-employees.
- Multiple rollover rules, including the ability: to make rollovers to and from various types of plans; to rollover after-tax employee contribution to another qualified plan or IRA; for a surviving spouse to rollover a death benefit distribution.
- The requirement to automatically rollover to an IRA involuntary small distributions exceeding \$1,000.
- The repeal of the “same desk rule.”
- The repeal of the “multiple use test” that had applied to 401(k) plans that also accept employee post-tax or employer matching contributions.

EGTRRA permanence is welcome news for both sponsors of qualified plans, who are only just beginning to amend plan documents to fully reflect EGTRRA provisions, and service-providers, who were facing the prospect of having to un-wind system changes made as a result of the EGTRRA changes.

In addition, PPA makes permanent the Saver’s Credit that was due to expire on December 31, 2006. The maximum credit amount remains \$2,000, but the income limits that determine the amount of credit available to a taxpayer will be indexed for inflation beginning in 2007.

Qualified Reservist Distributions

The new law provides special rules for qualified reservist distributions. A “qualified reservist distribution” is a distribution:

- Of elective deferrals from a 401(k) plan or 403(b) arrangement;
- Made to an individual who was ordered or called to active duty in the Reserves or National Guard
 - After September 11, 2001, and before December 31, 2007,
 - For a period exceeding 179 days, or an indefinite period; and
- Made during the period beginning on the date of the call-up order and ending at the close of the active duty period.

These distributions are exempt from the 10% early withdrawal penalty tax. In addition, an individual may re-contribute all or part of his qualified reservist distributions to an IRA at any time during the two-year period beginning on the day after the end of his active duty period. Multiple repayments may be made, but repayments may be made only to IRAs, even if the distributions came from a 401(k) plan or 403(b) arrangement. In no event will the two-year repayment period end before August 17, 2008.

Even though this provision was effective on August 17, 2006, additional IRS guidance will be needed to administer it. For example, it appears that some standard distributions (such as in-service withdrawals, hardship withdrawals or termination distributions) may simply require special tax reporting on the part of the individual taking the distribution, similar to the treatment of certain [qualified hurricane distributions](#), but no plan amendment. On the other hand, plan amendments may be necessary if a sponsor wishes to offer qualified reservist distributions as a special type of in-service distribution. On September 28, 2006, an [IRS News Release](#) provided guidance to qualifying individuals who want to obtain refunds of previously-paid early withdrawal penalty taxes.

New Deduction Rules for Multiple Plans

A special combined plan contribution deduction limit applies when an employer sponsors both a defined contribution plan and a defined benefit plan covering one or more of the same employees. This limit is the greater of: (1) 25% of compensation paid or accrued during the plan year, or (2) the contribution needed to meet minimum funding requirements. Effective for contributions made for tax years beginning on or after January 1, 2006, this combined plan limit does not apply if the defined contribution plan contributions do not exceed 6% of compensation for beneficiaries under the plans.

Expanded Ability to Purchase Defined Benefit Service Credits via Asset Transfers

The new law clarifies that state and local governmental employees may use amounts transferred from 403(b) arrangements or governmental section 457(b) plans to purchase benefit credits under a defined benefit plan for periods that they did not actually perform service. This clarification is effective for transfers made in years beginning on or after January 1, 1998.

In addition, PPA clarifies that the limits on nonqualified service credits do not apply to assets transferred from a 403(b) arrangement or governmental section 457(b) plan to purchase service credits. Once transferred, these assets are subject to the defined benefit plan distribution rules. These provisions apply to transfers made on or after January 1, 2002.

Sponsors of governmental defined benefit plans that allow participants to purchase additional service credits may want to consider amending those plans to permit these additional purchases. If a governmental 403(b) arrangement or section 457(b) plan permits such transfers to be made, contracts or plan documents may need to be amended to allow the transfers to be made in additional situations.

ERISA Preemption of State Wage Withholding Laws

PPA adds a provision to ERISA that preempts any state law that would directly or indirectly prohibit or restrict the use of an automatic contribution (i.e., automatic enrollment) arrangement. This provision is directed at state laws that prohibit involuntary wage withholding. To qualify for this preemption, a 401(k) plan or 403(b) plan must: provide for automatic deferral contributions to be made if a participant takes no action; invest those automatic deferrals in accordance with default investment regulations; and provide advance notice of the automatic deferrals to participants. This exemption became effective on August 17, 2006, but will be difficult to apply until the Department of Labor's (DOL's) recently-proposed default investment regulations are finalized and participant notice guidance is provided. Of course, the preemption does not apply to non-ERISA plans such as governmental plans, non-electing church plans, and 403(b) programs not covered by ERISA.

Expanded Availability of Hardship and Unforeseeable Emergency Distributions

The new law expands the availability of hardship and unforeseeable emergency distributions from deferral contributions made to 401(k) plans, 403(b) arrangements, and section 457 plans. The IRS is directed to issue regulations allowing distributions to be made if a participant's beneficiary incurs an event that would qualify as a hardship if it occurred with respect to the participant's spouse or dependent. While this provision, which will bring some parity to the treatment of domestic partners, is effective August 17, 2006, it will be difficult to put it into practice until the IRS issues guidance. Plans and arrangements that currently permit hardship and unforeseeable emergency distributions are not required to adopt this new provision, but may do so if they desire.

Expanded Participation in Section 457(b) Plans

Effective August 17, 2006, PPA allows certain individuals who have previously received distributions from a section 457(b) plan due to termination of employment to again participate in that plan. An individual is eligible to make section 457(b) plan deferrals if he received a single sum payment of \$3,500 or less before January 1, 1997. Sponsors of plans that had denied plan re-entry to these individuals may want to modify their plan provisions to permit participation by these individuals.

Exemption from “Safest Available Annuity” Standards

Existing ERISA guidance requires a plan fiduciary that is choosing an annuity provider for purposes of making plan distributions to obtain the “safest available annuity.” The new law now directs the DOL to issue regulations by August 17, 2007, clarifying that the selection of an annuity contract as an optional form of distribution from a defined contribution plan is not subject to this safest available annuity standard but is subject to otherwise applicable standards. Even without this regulatory guidance, the exemption applies as of August 17, 2006.

Clarification of QDRO Rules

Effective August 17, 2006, and subject to regulations that the DOL must issue by August 17, 2007, PPA clarifies that the mere fact that a domestic relations order issued after another domestic relations order or revising another domestic relations order does not cause the order to fail to meet the requirements of a qualified domestic relations order (QDRO). Plan sponsors should be aware of the pending DOL regulations, just in case they receive domestic relations orders that may subject to those rules.

Treatment of Indian Tribal Plans as Governmental Plans

The new law expands the ERISA and Internal Revenue Code definitions of “governmental plan” to include certain Indian tribal government plans. To be eligible for treatment as a governmental plan, all plan participants must be tribal government employees and substantially all of these employees must perform noncommercial, essential government functions. As a result, a plan covering only teachers in tribal schools could qualify as a governmental plan. However, a plan covering tribal employees of a casino, hotel or similar venture could not be considered a governmental plan and would therefore be subject to ERISA reporting and disclosure rules, as well as all standard qualified plan rules (e.g., minimum vesting rules). This provision applies to plan years beginning on or after August 17, 2006.

However, [IRS Notice 2006-89](#) provides transitional relief for plans affected by this change. Under this relief, a plan will be treated as satisfying the new definition of “governmental plan” if it complies with the new rules based on a reasonable, good faith interpretation of those rules. In general, to comply with this requirement, employees employed by a hotel, casino, service station, convenience store, or marina operated by the tribal government cannot continue to make contributions and earn benefits under the plan after the last day of the last plan year beginning before August 17, 2006. Plans that cover both governmental tribal employees and commercial tribal employees may allow all employees to continue to make contributions and earn benefits, as long as the tribal government adopts a separate plan for the commercial employees no later than September 30, 2007.

Prohibited Transaction Exemption for Certain Securities Transactions

PPA provides a new prohibited transaction exemption for inadvertent prohibited transactions involving the purchase or sale of a security or commodity between a plan and a party in interest. The exemption applies to any transaction a fiduciary discovers (or should have discovered) is a prohibited transaction after August 17, 2006, if the transaction is corrected with 14 days of the date it was (or should have reasonably been) discovered. A transaction is corrected if it is undone and the plan is made whole for any resulting losses. In addition, any profits made through the use of plan assets must be restored to the plan. This exemption does not apply to any transaction between a plan and the plan sponsor involving employer securities or real property, or to any transaction that the party in interest knew or should have known was prohibited at the time it occurred.

Increased Penalties for Coercive Interference with ERISA Rights

Coercive interference with ERISA rights occurs when a person uses fraud, force or violence (or the threat of force or violence) to restrain, coerce or intimidate any plan participant or beneficiary to interfere with or prevent the exercise of his ERISA rights. A willful act of coercive interference is a criminal offense, subject to fine and/or imprisonment. Effective for violations occurring on or after August 17, 2006, the maximum fine amount is increased from \$10,000 to \$100,000, and the maximum prison term is increased from one year to ten years.

Provisions Effective in 2007

Several important PPA provisions are effective in 2007. Some of these provisions are purely operational in nature, while others will require plan amendments. While formal plan amendments may not be needed until 2009 or 2011, plan sponsors will need to keep track of when and how each new provision was put into place, to be able to adopt the appropriate amendments. In addition, many of these provisions will require new or revised participant communications, in some cases, before January 1, 2007.

Extension of Participant Notification Period to 180 Days

Qualified plans must provide certain notices to participants and their spouses before distributions may be made. These notices include: the Qualified Joint and Survivor Annuity (QJSA) notice, which must be provided to a participant and his spouse if the plan is subject to the QJSA rules and an optional form of payment may be elected; the notice to a participant describing available optional forms of payment, including the right to defer distribution, if QJSA notices are not required; and the notice explaining tax and rollover rules. Effective for distributions made on or after January 1, 2007, the time period for providing any or all of these notices is expanded. The notices will have to be provided no more than 180 days and no less than 30 days before the distribution or annuity starting date.

In addition, PPA directs the IRS to issue regulations requiring that a description of the tax and retirement savings consequences of not deferring a distribution be included in the notice that describes an employee's right to defer distribution. Until those regulations are issued, plan sponsors must make a "reasonable attempt" to comply with the new rules.

Non-Spouse Beneficiary Rollovers

Effective for distributions made on or after January 1, 2007, non-spouse beneficiaries will be able to directly rollover death benefit distributions to IRAs. These IRAs will be treated as inherited IRAs and later

distributions will be subject to the minimum required distribution rules that apply to IRA beneficiaries (rather than those that apply to owners). This expanded direct rollover rule applies to distributions from qualified plans, 403(b) arrangements and governmental section 457(b) plans. Indirect 60-day rollovers are not permitted. Most plan documents will have to be amended to reflect this revision to the rollover distribution rules. Since this is a required change, plan sponsors may need to make “interim amendments” to their plans before the actual 2009 plan amendment deadline.

Rollovers of After-Tax Amounts

PPA expands the rollover options available for the distribution of employee after-tax contributions. Effective for distributions made on or after January 1, 2007, after-tax amounts may be directly rolled over from a qualified plan to any other qualified plan, including a defined benefit plan, or to a section 403(b) arrangement or IRA. The receiving plan must separately account for the nontaxable after-tax amounts and the taxable related earnings, if both amounts are rolled over. Indirect 60-day rollovers are not permitted and after-tax amounts may not be rolled-over from section 403(b) arrangements to qualified plans. While plans must permit these rollover distributions, and may have to be amended to reflect these new rules, plans will not have to accept rollover contributions of these amounts. Plans that choose to accept such contributions will need to be amended to reflect the new provisions.

Pension Plans May Make Limited In-Service Distributions

Effective for plan years beginning on or after January 1, 2007, money purchase pension plans (including target benefit plans) will be able to make distributions to active employees who have reached age 62. Plans are not required to permit these in-service distributions but plan sponsors that have significant employee populations working past early retirement age may want to consider amending their plans to permit these distributions. This amendment would be considered a “discretionary amendment” that would have to be adopted by the last day of the plan year that it is effective. Of course, pension plans have long been permitted to make in-service distributions to employees working past normal retirement. If a plan’s normal retirement age is younger than age 62 (say, age 60), these distributions would still be permitted.

Tax-Free Distributions to Public Safety Officers

Effective for distributions made on or after January 1, 2007, eligible retired public safety officers may receive tax-free distributions from qualified plans, section 403(b) arrangements, and governmental section 457(b) plans for the payment of qualified health insurance premiums. The maximum annual amount of these tax-free distributions is \$3,000, which is not indexed for inflation. To qualify for the special tax treatment, the premium payments must be made directly from the retirement plan to the insurer. Premiums may be for accident or health insurance or for long-term care insurance for the retired public safety officer, his spouse, or his dependents. An individual is eligible for this special tax treatment if he separated from service as a public safety officer with the employer maintaining the plan making the premium payments, due to disability or after reaching normal retirement age. Plans are not required to make direct premium payments but plan sponsors that want to make this feature available may need to amend their plans to permit such payments.

ERISA 404(c) Protection for Default Investment Arrangements

Effective for plan years beginning on or after January 1, 2007, a default investment arrangement provided when a participant does not provide investment direction (for example, under plans that use the automatic enrollment design) will be eligible for ERISA section 404(c) protection if it meets the following requirements:

- The investment satisfies the requirements specified in DOL regulations;
- Each participant receives a notice explaining his right to designate investments and how his contributions and earnings will be invested if he does not make any investment elections; and
- The participant has a reasonable period of time after receiving the notice and before the beginning of the plan year to make investment elections.

PPA requires the DOL to issue guidance regarding default investment arrangements no later than February 13, 2007. On September 27, 2006, the DOL issued proposed regulations and requested comments by November 13, 2006. At this point, plan sponsors cannot rely on the guidance provided in these regulations, which appear to require a minimum 30-day advance notice about the plan's default investment provisions. Hopefully, the DOL will provide some transitional rules for plans with plan years beginning before the effective date of the final regulations.

Investment Diversification

Effective for plan years beginning on or after January 1, 2007 ([later, for certain collectively-bargained plans](#)), a defined contribution plan that holds publicly-traded securities must provide diversification rights with respect to amounts invested in these securities. Participants and beneficiaries holding accounts under the plan must be able to immediately direct that elective deferrals and employee post-tax contributions be invested in alternative investments. Participants must be able to redirect the investment of employer contributions once they have completed three years of vesting service. Beneficiaries of deceased participants must always be able to redirect the investment of employer contributions.

Employer contributions invested in employer securities before the effective date of these new rules are subject to a transition rule. Under this special rule, 33% of the employer securities must be eligible for diversification in 2007, 66% must be eligible in 2008 and the entire amount must be eligible for diversification in 2009. This transition rules does not apply to participants who have completed three years of service and reached age 55 by the beginning of the 2006 plan year. These participants must be able to redirect all of their employer stock investments as of the first day of the first plan year beginning on or after January 1, 2007.

Plans that are subject to these new rules must also provide participants and beneficiaries with a choice of at least three investment options other than employer securities. These other investment options must be diversified and have materially different risk and return characteristics. In addition, participants and beneficiaries must have the same opportunity to request changes with respect to their employer stock investments as they have to make other investment changes.

These rules do not apply to an ESOP that does not hold elective deferrals, employee after-tax contributions or employer matching contributions. However, an ESOP that is subject to these new rules is exempt from the standard ESOP diversification rules.

Notice of Freedom to Divest Employer Securities

A plan sponsor must provide an individual with a notice explaining his right to diversify employer security investments no less than 30 days before the first date the individual has this right. If an individual is eligible to exercise diversification rights at different times, the plan must provide multiple notices. These notices must be written in a manner that can be understood by the average plan participant and must describe the participant's right to divest employer securities, as well as the importance of diversifying retirement plan assets.

PPA directs the DOL to provide a model notice by February 13, 2007. However, this notice requirement applies to plan years beginning on or after January 1, 2007, so some plans may have to provide notices before the DOL's model notice is available. Any notice that would have to be provided before November 15, 2006, does not have to be provided until November 15, 2006.

Prohibited Transaction Exemption for Investment Advice Provided to Participants

PPA provides a new prohibited transaction exemption for fiduciary advisers that provide investment advice to participants for a fee. "Fiduciary advisers" include banks, insurance companies, broker dealers, and registered investment advisors, as well as all of their affiliates, employees, representatives and agents.

To be eligible for the exemption, the advice must be provided through an eligible investment advice arrangement. An "eligible investment advice arrangement" is an arrangement that either pays level fees to the investment adviser (i.e., any fees received by the adviser must not vary on the basis of investment options selected) or uses an objective, certified computer model to provide the advice. In addition, the adviser must provide a comprehensive disclosure of fees and affiliations before providing any advice. An independent auditor must perform annual audits to verify that the adviser satisfies the requirements for this exemption. If a computer model is used, it must be certified by an independent investment expert at the time it is initially created and then again if later modified.

A plan sponsor that prudently selects and periodically reviews a fiduciary adviser will not be held liable for the specific advice provided by the adviser.

This exemption applies to investment advice provided on or after January 1, 2007, but DOL guidance is needed to clarify many of its conditions.

Quarterly Benefit Statements Required

Effective for plan years beginning on or after January 1, 2007 ([later, for certain collectively-bargained plans](#)), defined contribution plans that are subject to ERISA's disclosure rules must provide quarterly statements to participants and beneficiaries who have the right to direct their account investments. Annual statements must be provided to participants who do not have the right to direct investments. Statements must be provided on request to beneficiaries who do not have the right to direct investments, but no more than one statement must be provided in any 12-month period.

Along with these new timing requirements, PPA requires benefit statements to provide specific information regarding a participant or beneficiary's account. Statements must be written in a manner that can be understood by the average plan participant and indicate, on the basis of the most recent information available:

- The total account balance;
- The vested account balance, or the earliest date that non-vested amounts will become vested;
- The value of each investment to which assets have been allocated; and
- The value of any assets invested in employer securities.

In addition, quarterly statements must include:

- An explanation of any limitations or restrictions on the participant or beneficiary's right to direct investments;
- An explanation of the importance of having a well-balanced and diversified investment portfolio for

long-term retirement security;

- A statement of the risk that holding more than 20% of a portfolio in the securities of one entity (including employer stock) may not result in adequate diversification; and
- Directions to the DOL's Website for information on individual investing and diversification.

The new law directs the DOL to provide model benefit statements, meeting these requirements, by August 17, 2007.

Accelerated Minimum Vesting for Employer Contributions

Under PPA, all employer contributions are subject to the more rapid minimum vesting requirements that have applied to employer matching contributions since 2002. Nonelective contributions, profit-sharing contributions and money purchase pension contributions must now vest at least as rapidly as they would under either a three-year cliff vesting schedule or a six-year graded schedule that provides for vesting in 20% increments beginning with the employee's second year of service. In general, plans are only required to apply the more rapid vesting schedule to contributions made for plan years beginning on or after January 1, 2007 ([later, for certain collectively-bargained plans](#)). These faster vesting requirements do not apply to contributions made to plans that are not subject to ERISA.

Next Steps

Prudential Retirement will continue to monitor the IRS and DOL's published guidance regarding these new rules. As guidance is provided, we will make changes to the services that we provide to assist plan sponsors with their plan administration responsibilities.

At this time, service providers who offer plan documents (e.g., IRS pre-approved plans) are looking for additional clarification about plan amendment requirements. In general, PPA provides that required plan amendments may be effective retroactively and will not violate the anti-cutback rule, as long as the plan is operated in compliance with the new provisions as of the appropriate effective dates and the amendments are adopted on or before the last day of the first plan year beginning on or after January 1, 2009. For governmental plans, this amendment adoption deadline is the last day of the 2011 plan year. While [recent IRS guidance](#) sets forth adoption deadlines for "interim amendments" (reflecting statutory or regulatory changes) and "discretionary amendments" (reflecting voluntary plan design changes), this guidance also provides an exception to these deadlines when a new law provides a different amendment deadline. IRS representatives have recently indicated that the PPA amendment deadline supersedes the standard interim and discretionary amendments deadlines.

If you have questions about the application of these PPA rules to your plan or program, please contact your Prudential Retirement representative for guidance.

Pension Analyst by Prudential Retirement

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