

Pension ANALYST

Important Information

Legislation

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Pension Protection Act of 2006 Makes Changes To Defined Benefit Governmental and Church Plans

This is one of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined benefit plans. This publication focuses on those changes that are effective in 2006 and 2007 for defined benefit governmental plans and church plans that do not elect to be covered by ERISA (“non-electing church plans”). A later publication will discuss the provisions effective in 2008 and beyond.

WHO'S AFFECTED These developments affect sponsors of and participants in defined benefit governmental plans and church plans that do not elect to be covered by ERISA (“non-electing church 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 major provisions for comprehensive pension reform and introduce substantial changes to enhance retirement security of American workers and their families.

PPA makes permanent the provisions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) that were scheduled to expire in 2010. In addition, the new law extends the maximum pre-distribution notice period and allows non-spouse beneficiaries to directly rollover death benefits to IRAs. The new law also permits public safety officers to take certain tax-free distributions from retirement plans for the payment of qualified health insurance premiums. In addition, the new law contains provisions that significantly impact hybrid plans, such as cash balance plans, that were in existence as of June 29, 2005. Prospective conversions of defined benefit plans to hybrid plans are deemed to be non-discriminatory, provided certain requirements are satisfied.

This *Pension Analyst* discusses the PPA provisions that apply immediately (e.g., in 2006, 2007 and retroactively) to defined benefit governmental and church 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 The provisions of PPA impact plan design and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* to identify required and desired plan 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.

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Provisions Effective Immediately

EGTRRA Provisions Made Permanent

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

- The increased annual compensation limits applied when determining qualified plan contributions.
- The increased limits on the maximum annual benefit limit.
- The revised rules for notification of benefit accrual reductions.
- The simplification of the top-heavy rules, including the definition of key employee.
- The requirement to automatically rollover to an IRA small distributions exceeding \$1,000.
- Multiple rollover rules, including the ability: to make rollovers to and from various types of plans; for a surviving spouse to rollover a death benefit distribution.

EGTRRA permanence is especially welcome news for many plan administrators, who are only just beginning to amend plan documents to fully reflect EGTRRA provisions.

Determination of Average Compensation for Benefit Limits

In general, a participant's annual benefit under a defined benefit plan is limited to the lesser of (1) the participant's highest three years of average compensation, or (2) \$175,000 (for 2006). PPA clarifies that compensation received during years that the individual was not a plan participant may be taken into consideration in determining the three-year average compensation. This provision applies to limitation years beginning after December 31, 2005.

Hybrid Plan Rules

PPA now provides guidance that will enable certain hybrid plans, such as cash balance plans, to satisfy the ERISA, Internal Revenue Code (Code) and Age Discrimination in Employment Act (ADEA) rules

prohibiting age discrimination. To satisfy these rules, a participant's accrued benefit must be equal to or greater than that of any similarly situated younger individual (i.e., an individual who is identical in every respect, including period of service, compensation, position, date of hire, work history, but not age) who is or could be a participant in the plan.

PPA also requires a defined benefit plan that is converted into a hybrid plan after June 29, 2005, to protect the accrued benefit of any participant who was a participant immediately before the date the conversion amendment was adopted. The participant's total accrued benefit *cannot be less than* the participant's accrued benefit for years of service before the effective date of the amendment *plus* the participant's accrued benefit for years of service after the effective date of the amendment.

Finally, PPA requires hybrid plans to satisfy specific requirements with respect to vesting, interest crediting and the payment of lump sums.

For hybrid plans in existence on June 29, 2005, the interest rate and vesting requirements apply to plan years beginning after December 31, 2007. However, a plan sponsor may elect to have these requirements apply for any period beginning after June 29, 2005, and before the first day of the plan year beginning after December 31, 2007. A delayed effective date applies to plans maintained pursuant to collective bargaining agreements.

The plan conversion rules apply to plan amendments that are adopted and effective after June 29, 2005. However, a plan sponsor may elect to have these rules apply to plan amendments adopted before June 29, 2005, but effective after that date.

A detailed explanation of the impact of PPA on hybrid plans is discussed in our September 2006 *Pension Analyst*, titled "[Pension Protection Act of 2006 and Other Recent Developments Provide Guidance on Hybrid Plans.](#)"

Purchase of Permissive Service Credits

Many defined benefit plans sponsored by state or local governments let participants make voluntary after-tax employee contributions in order to purchase additional service credits. Under the Taxpayer Relief Act of 1997, these purchases may be counted toward either the defined contribution annual additions limit for the year of purchase or as part of the participant's overall accrued benefit subject to the defined benefit plan limit on accruals. However, participants were not permitted to purchase service credits to provide enhanced retirement benefits for a period of service already credited under the plan.

In addition, under EGTRRA, a direct trustee-to-trustee transfer from a section 403(b) arrangement or a governmental section 457(b) plan to a governmental defined benefit plan was not considered taxable income if the transferred amount was used to purchase a service credit under the defined benefit plan.

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

Plans are not required to permit the purchase of service credits or accept the transfer of such credits from other plans but plan sponsors that want to make this feature available may need to amend their plans.

Waiver of 10% Penalty on Certain Distributions

Effective for distributions made after August 17, 2006, the 10% early withdrawal penalty tax does not apply to distributions made from a governmental defined benefit pension plan to a public safety employee (i.e., police officer, firefighter or emergency medical services employee) who separates from service after reaching age 50.

Treatment of Indian Tribal Plans as Governmental Plans

The new law expands the ERISA and 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, which could now offer 414(h) pick-up contributions. 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.

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 the last day of the 2011 plan year for governmental plans), 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.

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 notice to a participant describing available optional forms of payment, including the right to defer distribution 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 rules requiring the notice that describes an employee's right to defer distribution to also describe the tax and retirement savings consequences of not deferring a 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). Indirect 60-day rollovers are not permitted.

Rollover 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 have to be amended to reflect the new provisions.

Pension Plans May Make Limited In-Service Distributions

Generally, defined benefit plans do not allow in-service payments to a participant who has not terminated employment, although plans are permitted to allow payments once a participant reaches his normal retirement date, even if still employed. The IRS had previously proposed phased retirement rules in 2004 that permitted a pension plan to pay participants a portion of their accrued benefit before normal retirement age, provided the participant's work schedule was reduced.

However, effective for plan years beginning on or after January 1, 2007, defined benefit plans will be able to make distributions to active employees who have reached age 62, even if the employee has not reduced his work schedule. Plans are not required to permit in-service distributions. If a plan sponsor chooses to offer in-service distributions, the plan would have to be amended. 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.

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 retirement 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.

Church Plan Benefit Limits

PPA provides that, for limitation years beginning on or after January 1, 2007, the 100% of the highest three years of average compensation limit on a participant's annual benefit does not apply to non-highly compensated employees (NHCEs) covered under a church plan. NHCEs will only be subject to the dollar limit on annual benefits (\$180,000 for 2007). However, highly compensated employees (HCEs) will be subject to the lesser of the compensation limit or the dollar limit. In addition, PPA clarifies that the compensation limit applies to all of an HCE's accrued benefit, including benefits accrued before the individual became an HCE.

Next Steps

Prudential Retirement will continue to monitor the IRS 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 are looking for additional clarification about plan amendment requirements. In general, PPA provides that required plan amendments may be effective retroactively, 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 supercedes the standard interim and discretionary amendments deadlines.

In the interim, plan sponsors must operationally comply with the provisions of PPA, based on the various effective dates. Sponsors should review the contents of this publication to assess the impact of PPA on their plan document and administration. Sponsors of hybrid plans should examine their plan provisions to determine if design changes may be needed.

If you have questions about the information discussed in this *Pension Analyst* and how the PPA changes affect your plan design or administration, please contact your Prudential Retirement representative.

**Summary of Pension Protection Act Provisions
Effective Before January 1, 2008
For Non-ERISA Single Employer Defined Benefit Plans**

Changes Effective Retroactively

- EGTRRA permanence
- Increased ability to purchase additional service credits (transfers made on or after January 1, 1998)
- Elimination of limitation on certain civil service credit purchases (transfers made on or after January 1, 2002)
- Hybrid plan conversion rules (conversions made after June 29, 2005)
- Revised calculation of average compensation for benefit limit purposes (limitation years beginning on or after January 1, 2006)

Changes Effective upon Enactment (August 17, 2006)

- Waiver of 10% early distribution penalty tax on certain distribution made to public safety officers
- Ability to treat certain Indian tribal plans as governmental plans

Changes Effective in 2007

- Extension of maximum pre-distribution notice period to 180 days
- Ability for non-spouse beneficiaries to make direct rollovers to IRAs
- Expanded ability to make direct rollovers of after-tax amounts
- Ability for public safety officers to take certain tax-free distributions
- Ability to make in-service distributions at age 62
- Revised annual benefit limits for participants in church plans

Pension Analyst by Prudential Retirement

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