

Washington Tax Report

The Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA or the Act) was enacted on August 17, 2006. The massive reform legislation was intended to improve pension funding, clarify many defined benefit obligations, and assist individuals to prepare and save for retirement. The PPA is the most significant pension legislation in almost 30 years. The Act addresses minimum funding requirements and accelerates funding obligations for defined benefit plans, creates new prohibited transaction exemptions, produces incentives for automatic enrollment for 401(k) plans, clarifies rules for defined contribution plans, allows employees to diversify their pensions, and makes many of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provisions permanent. In addition, charitable giving, healthcare related provisions, and tariff reforms are part of the PPA.

IRAs and Charitable Contributions

Prior to the PPA, only spouses were allowed to rollover their deceased spouse's interest in qualified retirement plans, government plans, or tax sheltered annuities into their own IRA. The PPA permits non-spouse beneficiaries to roll inherited qualified plans or IRA proceeds into their own IRA. This permits the assets to remain tax-deferred and does not require the deceased's estate to pay tax on the transferred account balance.

The Act expands the ability to fund an IRA and allows for an IRA account balance to be directly transferred to a qualifying charity. Beginning in 2007, taxpayers can have their tax refunds contributed directly to an IRA. The PPA also provides for an exception for charitable contributions. Current law requires that charitable contributions from an IRA be taxed to the individual upon distribution as ordinary income, and upon the subsequent contribution a qualifying deduction is permitted. Effective now through December 31, 2007, distribu-

tions from an IRA to charity of up to \$100,000 may be made tax-free if the taxpayer is at least 70½ years old. This incentive for charitable giving is temporary and involves both traditional and Roth IRAs. The Act also extends the \$2,000 "saver's credit" and will index for inflation various IRA limitations.

Automatic Enrollment in 401(k) Plans

Current law provides that an employee must make an affirmative election to enroll in a 401(k) plan. Some plans allow for negative elections that reduce an employee's pay to fund 401(k) accounts; however, this has contradicted many state laws. Effective December 31, 2007, the PPA encourages automatic enrollment into 401(k) plans by superseding state laws. Now, employers can automatically deduct contributions to a 401(k) account from an employee's paycheck. This will encourage employees to begin contributing to a retirement plan early and will require an employee to elect that the contributions be discontinued. In order to remain compliant with Employee Retirement Income Security Act (ERISA), there are various caveats to the administration of the automatic enrollment provision. Also, companies are required to inform employees that they must opt out within 90 days of the automatic enrollment if they do not want

to participate. The employer's notice must also contain information as to contribution rate, investment choices, timing of current and future elections, and employer matching requirements.

Plan sponsors were concerned that automatic enrollment and subsequent withdrawals would cause various administrative and taxation issues. As such, the Act extends and clarifies various ERISA testing requirements. All refunds made to employees must now be taxed in the year they are distributed, whereas under the current regulations, any refunds made two and a half months into the next year were taxed in the prior year. In addition, there will be no automatic early withdrawal penalty for employees who opt out of the automatic enrollment election.

The Act also creates a nondiscrimination safe harbor that is optional for all automatic enrollment plans. In order to comply with this safe harbor option, a company must match 100 percent of deferrals elected by the employee up to 1 percent of compensation, plus 50 percent of deferrals elected by the employee that fall between 1 and 6 percent of the employee's compensation or a uniform amount of at least 3 percent of an employee's compensation. Companies who choose to comply with this safe harbor rule may not be subject to the obligation to perform nondiscrimination tests (there is an additional requirement for actual contribution percentage (ACP) testing). In order to comply with the nondiscrimination rules, companies can either choose to perform the nondiscrimination tests, set up automatic enrollment and obey the safe harbor rule, or continue to follow the old safe harbor rule.

Diversification of Investments

In response to recent corporate scandals, the PPA allows for diversification of both retirement investment options and the ability to diversify corporate matching contributions. Currently, many companies encourage employees to invest in company securities, and almost all matching contributions are made with company

stock. However, with the demise of various public companies, the risk involved in these plans was made evident. This provision of the Act allows employees or their beneficiaries who have invested in publicly traded employer securities to diversify their investment within a specified time period. Companies are now required to provide at least three different investment opportunities with materially different risk factors to employees who participate in their plan. Also, employees who have participated in the plan for at least three years must be allowed to diversify any investments that were made on behalf of the employee by the employer. They must also be able to elect to diversify after-tax and deferral contributions. This is effective December 31, 2006 for all employees under the age of 55 who have been employed by the company for at least three years. Additionally, these rules do not apply to Employee Stock Ownership Plans (ESOPs).

Investment Advice

Current law and ERISA fiduciary standards prohibit certain transactions between retirement plans sponsored by the employer and a party-in-interest, including furnishing investment advice. Effective December 31, 2006, the PPA will add an exemption to these rules, permitting investment advice between the fiduciary advisors and the pension and 401(k) participating employees. The advisor would be compensated for their financial advice and be subject to a number of rules intended to avoid abuses. Different retirement plans are subject to different rules. Many advisors would be required to use a computer investment model that has been approved by an independent party. The Department of Labor and the Secretary of Treasurer have yet to determine if there is such a computer model, which will be effective on the date of enactment.

Under the new exemption, investment advice, investment transactions following such advice, and any fees or compensation associated with the advice or investment transaction will be permitted. Before providing the party-in-interest with advice,

the fiduciary adviser must provide a notice detailing their relationship to the plan as well as a statement notifying the party-in-interest of their option to choose another fiduciary adviser independent from the retirement plan. Also, financial institutions will now be able to provide investment advice to employees who are enrolled in retirement plans or IRAs without the computer model under the condition that the financial advisor's compensation is not determined by the employee's decision about investments.

Plan Administration and Disclosure Requirements

In an attempt to provide more complete and timely information the Act adds a number of new disclosure requirements. In 2008 defined benefit plans must provide a funding notice to plan participants, beneficiaries, and the Pension Benefit Guarantee Corporation (PBGC). Plans that are not 80% funded are required to make additional filings. For other retirement plans a benefit summary is required. The statement must include the participant accrued benefits, a breakdown of account balances allocated to various investments, and a vesting schedule indicating when each benefit is available. Self-directed defined benefit plans have additional requirements. Lastly, the Act revised Form 5500 requirements and eliminates the need for annual filings of single employer plans if their plan has only one participant and less than \$250,000 of assets.

Current Law Made Permanent

The PPA makes permanent a host of rules scheduled to expire in 2010. Many of these rules, affecting pensions, IRAs, and retirement plans, were enacted as part of EGTRRA in 2001. The PPA will make permanent the ability to continue to contribute the increased amount (maximum of \$15,000) to 401(k) plans and IRAs, the "catch up" contributions (maximum of \$5,000) for individuals age 50 and older, as well as other increased contribution limits. The act will also permanently enact the laws that created Roth IRAs, Roth

401(k)s, increased IRA rollover opportunities, requires mandatory cash outs of de minimis account balances, allows both 401(k) and 403(b) plans to make hardship distribution to any participating beneficiary, not just the spouse or dependent, and makes permanent Section 529 plans for college savings.

Defined Benefit Funding Requirements

The PPA has changed the cosmetic landscape of defined benefit funding of pension plans. The most significant changes are that: (1) the new funding target of all defined benefit plans is now 100 percent, (2) plans are considered at-risk if they are less than 80 percent funded, and (3) at-risk plans are prohibited from providing employers with credit balances. Moreover, multiemployer plans are prohibited from increasing benefits if the plan is less than 80 percent funded unless the shortfall is cured immediately.

Special Airline Funding Rules

Airlines, the likely impetus for plan funding reforms, who have already frozen their plans, have an extra 10 years to repay their

underfunding, providing them with a total of 17 years to settle up underfunding. Airlines that have not yet frozen their plans have an extra three years, for a total of 10 years, to cure their deficits. Other airlines will have less to contribute to be deemed fully funded. However, the PPA's most significant impact on airline pensions is its *de facto* ban on lump-sum payments to retirees.

Conclusion

The above are only a few of the many significant provisions that were enacted or will be enacted as a result of the PPA. Due to the size of the PPA, we could only provide an overview of a limited number of the provisions. There are numerous other law changes in the PPA, including provisions that affect medical and health plans, influence long-term care insurance, restrict the use of company owned life insurance to fund non-qualified deferred compensation, and provide additional charitable giving opportunities including raising the charitable deduction limit from 30 percent to 50 percent of AGI for qualified conservation contributions. To view the PPA document in its entirety, see the release from Congress at www.govtrack.us/data/us/bills.text/109/h/h4.pdf.

Should you have any questions regarding the PPA, please do not hesitate to contact the contributors.

Contributing Authors:

Derrick Neuhauser
312-856-9100
dneuhauser@bdo.com

Rania V. Sedhom
212-885-8000
rsedhom@bdo.com

Jessica Schuster
312-856-9100
jschuster@bdo.com

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