

## **PENSION PROTECTION ACT OF 2006 SUMMARY**

Signed into law on August 17, 2006

### **I. Effects on Individuals.**

#### **A. IRA, 401k, and other Retirement Plan Provisions**

While the bulk of the Pension Protection Act is designed to force employers to shore up their pension plans, there are sections that are aimed at individuals. There's an important new provision for non-spouse beneficiaries of a retirement plan. The new law allows non-spouse beneficiaries to roll over assets inherited from a qualified retirement plan into an IRA. The beneficiary will avoid tax on the rollover, and will be taxed only when the assets are withdrawn. Previously, this tax treatment was available only for people who inherited retirement assets from a deceased spouse. The new law will mean more flexible retirement and estate planning for non-spouse beneficiaries, such as domestic partners.

The Pension Protection Act allows a direct rollover from a 401k to a Roth IRA, with the rollover treated as a Roth conversion.

The new law extends a number of retirement benefits. IRA contributions will be \$4,000 in 2006 and 2007, \$5,000 in 2008, and adjusted for inflation after 2008. Catch-up contributions for individuals age 50 or older will be \$1,000 for IRAs, \$2,500 for SIMPLE-IRAs, and \$5,000 for 401k plans. IRA catch-up contribution limits, however, will not be adjusted for inflation. SIMPLE and 401k catch-up contributions will be adjusted in \$500 increments based on inflation.

The new law permanently allows for Roth 401k and Roth 403b plans. Under previous tax law, Roth-type 401k and 403b plans were not allowed after 2010. The new law removes this sunset provision. Like a Roth IRA, an individual makes post-tax contributions to a Roth 401k or Roth 403b plan, up to the plan limits. The assets grow tax-deferred and may be withdrawn tax-free in retirement.

The new law also permanently allows the Retirement Savings Tax Credit, which would have expired at the end of 2006.

#### **B. More Flexible Rules on Hardship Distributions**

Section 826 of the Pension Protection Act of 2006 , P.L. 109-280, directs Treasury, by February 13, 2007, to modify the rules for determining whether a participant has had a hardship under §401(k)(2)(B)(i)(IV) to provide that if an event (including the occurrence of a medical expense) would constitute a

hardship under the plan if it occurred with respect to the participant's spouse or dependent (as defined in §152), that event will, to the extent permitted under a plan, constitute a hardship if it occurs with respect to a person who is a participant's beneficiary under the plan.

### **C. New Rules on Charitable Donations**

The Pension Protection Act toughens the tax laws for charitable donations. Under the new law, taxpayers must keep records of all cash donations. Individuals must show a receipt from the charity, a canceled check, or credit card statement to prove their donation. No tax deduction will be allowed if the taxpayer cannot provide any supporting documentation. Taxpayers will not need to mail in the receipts with their tax return. Instead, taxpayers will need to keep receipts and other documentation with their copy of the return in the event of an IRS audit.

The new law also toughens the rules for non-cash donations. Donated items, such as cars, clothing, and household goods, must be in good condition. The new law does not define 'good condition. No tax deduction is allowed for items in less than good condition.

The Pension Protection Act allows taxpayers to donate money to charity directly from their IRA account. The distributions will be tax-free and avoid the penalty on early withdrawals. Taxpayers are allowed to donate up to \$100,000 per year from their IRA. Since the distribution will not be included in taxable income, individuals will not be able to claim a tax deduction for the charitable contribution.

### **D. Tax Free Distributions from IRA**

The new law provides an exclusion from gross income for certain distributions up to \$100,000 from a traditional IRA to charity. Effective for a two-year period (January 1, 2006-December 31, 2007), distributions made from an IRA to a qualifying charity are excluded from the income of the IRA owner. The owner must be at least age 70 to take advantage of this provision, and the amount excluded is limited to \$100,000 per year.

This provision removes a number of impediments that stood in the way of IRA owners who wanted to give all or a portion of their IRA to charity. Under the usual rules, a gift from an IRA to charity is treated as a taxable distribution to the owner, who then has to claim an itemized deduction for the gift. Treating the gift as a distribution has adverse tax consequences to the owner, including the possibility of the alternative minimum tax and the loss of itemized deductions and personal exemptions. Because the deduction is limited to 50% of the IRA owner's adjusted gross income, often the owner does not get a full deduction in the year of the gift.

These impediments are removed for qualifying owners by treating the distribution as an exclusion from income, rather than as a deduction. Because there is only a two-year window, quick action should be taken to make such a gift, by those at least age 70, if they so choose.

The new law also raises the charitable deduction limit from 30 percent to 50 percent of adjusted gross income for qualified conservation contributions, provided that such contribution does not prevent the use of the donated land for farming or ranching purposes.

## **II. Effects on Single Employer Plans**

Plan sponsors of single-employer pension plans must amend their plans to comply with the changes to the funding rules by the Pension Protection Act of 2006, which replaced the pension funding rules of the tax Code and the Employee Retirement Income Security Act with a different set of rules for determining minimum required contributions. These provisions are effective beginning with the 2008 plan year.

Single-employer defined benefit plans are subject to minimum funding requirements. The amount of contributions required to be made by the plan sponsor for a plan year generally is the amount needed to fund benefits earned during that year and that year's portion of other liabilities that are amortized over a period of years.

### **A. Calculating Minimum Required Contributions—Before 2006 PPA**

Under pre-2006 PPA law, employers had considerable flexibility to choose the assumptions and methods used to calculate minimum funding requirements. However, employers with plans that are less than 90% funded generally must have made contributions to those plans on a more accelerated basis under the deficit reduction contribution rules, using specified interest and mortality assumptions.

### **B. Calculating Minimum Required Contributions—After 2006 PPA**

Under PPA, a plan's minimum required contribution for a plan year depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. Credit balances may be used in certain circumstances to reduce the minimum required contribution. PPA permits plan sponsors to make additional contributions of up to 150% of current liability in order to encourage them to increase their funding during good economic times. However, a plan sponsor may not use a credit balance if its pension plan is less than 80% funded.

PPA requires employers to make contributions to ensure that plans meet a 100% funding target. If a plan has a funding shortfall, the Act requires the plan sponsor to make additional contributions to eliminate the shortfall over a 7-year period.

The minimum required contribution under 2006 PPA is calculated first by subtracting credit balances, if permitted. Next, the value of plan assets is compared to the funding target. If plan assets are less than the funding target, a "waiver amortization charge" may be added to the minimum required contribution.

PPA provides that the Secretary of the Treasury may waive all or a portion of the contributions required for a year. This amount is called the "waived funding deficiency." If a plan has a waived funding deficiency for any of the five preceding plan years, the minimum required contribution for the plan year is increased by the waiver amortization charge for the plan year.

### **C. At-risk Status**

If a plan is less than 60% funded, the plan is considered under PPA to be in "at-risk" status, and contributions to the plan must be accelerated. The change of the plan's funding assumptions to at-risk liability phase in over a 5-year period.

## **III. Other Effects of the Pension Protection Act of 2006 on Fiduciaries (Employers)**

### **A. Terms and Standards**

Under ERISA, a person or entity is considered a fiduciary to the extent that the person: exercises any discretionary authority or discretionary control over management of the plan; renders investment advice for compensation with respect to any property of the plan, or has the authority to do so; has any discretionary authority or discretionary responsibility in the plan's administration; or exercises any authority or control over management or disposition of plan assets. Under the 2006 PPA, the term "plan assets" is defined for transactions occurring after August 17, 2006, by reference to the Labor Department regulations. Thus, the 2006 PPA essentially authorized the regulations that previously were interpretive only. It also directed in part how the regulations must calculate the 25% threshold for significant participation by benefit plan investors in the determination of when an entity's assets are treated as plan assets.

In addition, under the 2006 PPA, the Labor Secretary must issue regulations to clarify that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary is not subject to the "safest available annuity" standard under Labor Department Interpretive Bulletin 95-1, but remains subject to otherwise applicable fiduciary standards.

## **B. Notice Requirements**

The new law submits plan administrators to additional notice requirements also. The administrator is required to provide the PBGC and each plan participant and beneficiary annual plan funding notice no later than 120 days after the end of the plan year. Within 30 days after an individual becomes eligible to exercise the right to direct the proceeds from the divestment of employer securities with respect to any type of contribution the administrator shall provide to such individual a notice setting forth such a right and describing the importance of diversification.

An administrator must provide a pension benefit statement to:

- Participants in Individual Account Plan that can direct the investment of assets in his or her account quarterly
- Participants in Individual Account Plan that can't direct the investment of assets in his or her account annually.
- Participants in defined benefit plans at least once every 3 years and upon request.

## **C. Employer Tax benefits**

Many pensions are underfunded, which means that promised pension benefits could potentially exceed the funds available, leaving pensions strapped for cash. The Pension Protection Act of 2006 "requires most pension plans to become fully funded over a seven-year period" starting in 2008, according to a CCH Tax Briefing. To achieve full pension funding, the new law allows employers to deduct the cost of making additional contributions to fund the pension, provides strict funding guidelines, and imposes a 10% excise tax on companies that fail to correct their funding deficiencies.

The Pension Protection Act provides or extends over 20 tax benefits for other retirement savings. Employers are now allowed to automatically enroll their employees into a 401k retirement plan with default contribution levels. Employees will need to opt-out of the 401k if they don't want to utilize the 401k plan. Military personnel who are called to active duty can now take a penalty-free withdrawal from their 401k or IRA if they are called to active duty between September 11, 2001, and December 31, 2007. The IRS will allow these individuals to re-deposit the withdrawal up to two years after the end of their active duty and thereby avoid paying income tax on the withdrawal. The new law also makes it much easier to make hardship withdrawals from 401k plans. The new law also allows hardship withdrawals "with respect to any person listed as a beneficiary under the 401(k) plan," according to CCH.

#### **D. Participant-Directed Accounts**

Under the 2006 PPA, a plan fiduciary may have fiduciary liability in plan years beginning after 2007 for a blackout period during which the fiduciary suspends the ability of a participant (or beneficiary) to direct the investment of the assets in his or her account. However, in cases in which a fiduciary meets ERISA's requirements for authorizing and implementing a blackout period, no person who otherwise is a fiduciary is liable under ERISA for any loss occurring during the blackout period. The Labor Secretary must issue guidance by August 17, 2007, on how an employer or other affected fiduciary can satisfy its fiduciary responsibilities during a blackout period.

If, for plan years beginning after 2006, a plan invests amounts in a default arrangement in accordance with Labor Department regulations while waiting for the participant to make an affirmative election regarding investments, the participant is treated as exercising control with respect to those assets. Under the 2006 PPA, the Labor regulations must be issued by February 17, 2007, and must provide guidance on the types of investments that may be designated as default investments under the arrangement. The plan fiduciary avoids responsibility for the investment decision by following the regulations and by providing written notice to the participant of his or her rights and obligations under the arrangement.

If investment options offered under a plan change, and the participant does not provide timely affirmative investment instructions, in plan years beginning after 2007, the plan fiduciary may avoid responsibility for the reinvestment decision. Under the 2006 PPA, the participant may be considered to exercise control over the assets in his or her account if: (1) the participant made the pre-changeover investment; (2) the plan administrator provides written notice of the change in investment options 30 to 60 days before the effective date of the change, compares the existing and new investment options, and explains the changeover that will occur if the participant does not provide affirmative investment instructions; and (3) the participant's account is reinvested among new or remaining investment options that have characteristics that are reasonably similar to the characteristics of the pre-changeover investment options.

#### **E. Divestment of Employer Securities**

For plan years beginning after 2006, fiduciaries must act in accordance with the diversification requirements provided for by the 2006 PPA for qualifying employer securities held in certain individual account plans that hold publicly-traded employer securities, unless the plan is exempt from the diversification requirement. A plan that is subject to the diversification requirement must permit a participant, or any beneficiary entitled to exercise a participant's rights, to divest

that portion of the account attributable to employee contributions and elective deferrals invested in employer securities and to reinvest an equivalent amount in other investment options. The plan also must allow each participant who has completed at least three years of service, his or her beneficiary, or the beneficiary of a deceased participant to divest the portion of the account that is attributable to employer contributions (other than elective deferrals) invested in employer securities. A three-year phase in of diversification applies for each class of securities if the employer contribution portion of the account consists of employer securities acquired in a plan year beginning before 2007. However, the phase in does not apply to a participant who has attained age 55 and completed at least three years of service before the first plan year beginning after 2005. Rules apply regarding the investment options, the time for divestment and reinvestment, notice of the right to divest, and any restrictions or conditions on the investment of employer securities.

An employer generally may not require its employees to invest more than 10% of their §401(k) plan contributions in qualifying employer securities or qualifying employer real property under the terms of the plan or at the direction of anyone other than the participant or beneficiary. The 2006 PPA made permanent an exception to this so-called “§401(k) diversification rule” that provides that the 10% limit on plan investments does not apply to elective deferrals that are invested in these assets if the assets were acquired before 1999.

## **F. Investment Advice**

The Labor Department permits a party-in-interest to provide investment advice using an objective computer model of investment alternatives, subject to certain limitations. The Pension Protection Act of 2006 (2006 PPA) amends the Code and ERISA to provide a safe harbor, beginning in 2007, for employers to provide investment advice to help employees manage their §401(k) accounts. The prohibited transaction exemption applies for investment advice tailored to a recipient and provided by a qualified fiduciary adviser through an eligible investment advice arrangement. It applies to the rendering of the advice, the transaction entered into pursuant to the advice, and any receipt of fees or other compensation in connection with the advice or investment transaction.

A qualified fiduciary adviser is a plan fiduciary who is registered as an investment adviser under federal securities law or state law, registered as a broker or dealer under federal securities law, a financial institution regulated by applicable banking laws, an insurance company, and securities laws. The term also encompasses affiliates or agents of these persons.

There are two types of eligible investment advice arrangements: flat fee and computer model. A flat-fee based eligible investment advice arrangement exists if a qualified fiduciary adviser provides advice related to employer-

sponsored plans and IRAs (and Archer MSAs, health savings accounts, and Coverdell education savings accounts) and charges a flat rate fee that does not take into account the investments selected.

An eligible computer model arrangement uses a computer model that is pre-certified by an independent eligible investment expert. The only investment advice provided under the program is the advice generated by the computer model and the transaction occurs solely at the direction of the participant or beneficiary.

As safeguards for participants and beneficiaries, both types of arrangements require that:

- a plan fiduciary other than the person offering the advice program or investment options must expressly authorize the arrangement;
- the investment transaction must occur solely at the direction of the recipient of the advice;
- an independent auditor must audit the arrangement annually and make a written report stating that the arrangement complies with the exemption provisions;
- the fiduciary adviser must provide disclosures required under securities laws;
- the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be;
- compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable;
- the fiduciary adviser must keep evidence that he or she complied with the exemption for six years after providing the advice; and
- the fiduciary adviser must disclose specific information to the participant or beneficiary, as discussed below.

The disclosure that the fiduciary adviser must make in writing (or electronically) and in a clear and conspicuous manner to the participant or beneficiary must include the following information: any fees and other compensation; any potential conflicts; past performance of the plan's investment options; available services; a statement that the adviser is acting as a fiduciary of the plan; a statement that the recipient of the advice may arrange for advice from an unaffiliated advisor; and how participant information will be used. The disclosure must be made before advice is first given, at least annually after the initial disclosure, whenever the employee requests the information, and whenever there is a material change to the fiduciary adviser's fees or affiliations.

The 2006 PPA prohibited transaction exemption for investment advice generated by computer model does not apply to IRAs, Archer MSAs, health savings accounts, and Coverdell education savings accounts. However, Congress directed the Labor Department and the Treasury, by the end of 2007,

to determine whether a computer model is available that takes into account the personal and subjective criteria about the account beneficiary, that is appropriate for the broader range of investment options common to these types of savings options, and that allows the account beneficiary enough flexibility in obtaining advice to evaluate and select investment options.

If the Labor Department determines that such a computer model is available, once certified, the computer model would be an option for providing investment advice related to IRAs. If the Labor Department concludes that an appropriate model is not available, the Labor Department will issue a class exemption that protects IRA account holders from biased advice without requiring fee-leveling or a computer model. Thereafter, anyone could ask the Labor Department to make a determination on a computer model investment advice program. The class exemption will sunset on the later of two years after the Labor Department makes this subsequent determination that an appropriate IRA computer model is available or three years after the class exemption is issued.

## **G. Prohibited Transactions**

The 2006 PPA added statutory exemptions that provide specific relief for fiduciaries engaging in or permitting the plan to engage in transactions otherwise prohibited by ERISA or the tax Code. The addition of these exemptions does not alter existing individual or class exemptions. Each of the following transactions is exempt from the prohibited transaction rules if it occurs after August 17, 2006, and if it meets the criteria for the exemption:

- *Transactions with Service Providers for Adequate Consideration.* A plan may engage in sales of property, leases, loans, and transfers or use of plan assets with a party in interest (also called a disqualified person) as long as the plan receives no less, nor pays no more, than adequate consideration in connection with the transaction. However, the exemption does not apply to a fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or provides investment advice with respect to the assets.
- *Block Trades.* The purchase or sale of securities in blocks of at least 10,000 shares with a market value of at least \$200,000 that will be allocated among two or more client accounts of a fiduciary between a plan and a party in interest may be exempt from the prohibited transaction rules. However, the exemption does not appear to cover transactions with a party in interest that is a fiduciary.
- *Transactions Made Through an Electronic Communications Network.* A plan and a party in interest may enter into a transaction involving the purchase or sale of securities (or other property determined under Labor Department regulations) that is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue that is subject to federal or foreign regulation and oversight.
- *Foreign Exchange Transactions.* A plan may engage in a foreign exchange transaction with a bank or broker-dealer (or an affiliate of either) that is a fiduciary

in connection with the sale, purchase, or holding of securities or other investment assets. However, the exemption is not available to managers of bank collective funds with discretion over assets.

- *Cross Trading.* A plan that has over \$100 million in assets may engage in a transaction involving the purchase and sale of a security between the plan and any other account managed by the same investment manager.
- *Correction of Transactions Involving Securities.* A fiduciary is relieved from liability for engaging in prohibited transaction involving the acquisition, holding or sale of securities or commodities if the transaction is corrected within 14 days after the fiduciary discovers or reasonably should have discovered that the transaction was prohibited. Relief is not available for transactions involving the sale or acquisition of an employer security or the acquisition, sale, or lease of employer real property. It also is not available if any fiduciary knew or should have known that the transaction was prohibited.

In addition, the 2006 PPA made permanent the provision that allows for plan loans to S corporation shareholders by excluding S corporation shareholders from the definition of owner-employees for purposes of the rule treating plan loans to owner-employees as prohibited transactions.

#### **H. Bond Requirements**

Each fiduciary of an employee benefit plan must be bonded and the maximum bond amount that may be set at the start of each fiscal year is \$500,000, unless the Labor Secretary sets a higher bond amount after notice and the opportunity for a hearing. Under the 2006 PPA, the maximum bond that may be required for a fiduciary of a plan that holds employer securities is increased to \$1,000,000 for plan years beginning after 2007, unless the Labor Secretary sets a higher bond amount after notice and the opportunity for a hearing.

Also, under the 2006 PPA, for plan years beginning after August 17, 2006, broker-dealers who are subject to the Securities Exchange Commission's fidelity bonding requirements of a self-regulatory organization do not need to be bonded.

#### **I. Penalties**

The PPA added several types of notices that must be provided to beneficiaries and participants by fiduciaries, including pension benefit statements and notice of the right to divest employer securities. The 2006 PPA also imposed civil penalties on plan administrators and other fiduciaries that fail to comply with these provisions. In addition, under the 2006 PPA, a fiduciary that commits the crime of coercive interference with the exercise of the ERISA rights of a beneficiary or participant after August 16, 2006, is subject to a fine of \$100,000 (increased from \$10,000) or 10 years in prison (increased from one year), or both.