Focus on 457℠

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PENSION PROTECTION ACT OF 2006

Summary of Significant Provisions Impacting Governmental 457(b) and Grandfathered Governmental 401(k) Plans

After months of negotiations in conference committee, the Senate passed HR 4, called the Pension Protection Act of 2006 (Act) on August 3, 2006 matching the bill passed by the House on July 28, 2006. President Bush signed the bill on August 17, 2006. Most importantly for governmental 457(b) and grandfathered governmental 401(k) plans, the Act includes the permanent extension of the EGTRRA retirement savings provisions. Other important provisions dealing with automatic enrollment and participant investment advice do not impact governmental plans except to the extent that the plan sponsor chooses to use ERISA provisions as a guide in the design and governance of their plans.

This edition of *Focus on 457* summarizes some of the major provisions important to governmental providers of 457(b) and grandfathered governmental 401(k) plans. It does not address the provisions in the Act that apply to defined benefit plans, 403(b) arrangements and church plans.

Expanded Benefits for "Non-Spouse" Beneficiaries

The Act includes provisions allowing non-spouse beneficiaries to roll over retirement benefits to their own account, and to be eligible for hardship distributions:

- The first provision allows the transfer of a participant's retirement account to a non-spouse beneficiary (domestic partner, sibling, parent, child, etc.) when the participant dies. The surviving partner or other non-spouse beneficiary will now be able to transfer the participant's account into an Individual Retirement Account (IRA) and leave the money in the IRA until he or she attains age 70 ½. Under current law, non-spouse beneficiaries who did not want to take the participant's entire account within five years of the participant's death had to begin taking required minimum distributions by December 31 of the year following the participant's death. Such benefits had to be taken in substantially equal payments at least annually over a period not exceeding the beneficiary's life expectancy.

- The second provision, which addresses retirement plan hardship distributions, allows domestic partners and other non-spouse beneficiaries (such as a sibling, child, parent, etc) similar access to laws that permit participants to draw upon funds in the case of qualifying medical or financial emergency. In the past, federal law applied only to spouses and dependents of participants when accessing retirement funds for qualifying financial emergencies.

There are two important items to note in regard to these new provisions:

- The participant must designate their domestic partner or other non-spouse individual(s) such as a child, parent, etc as a beneficiary for the above to apply. Coverage is not automatic for non-spouse beneficiaries, and;

- State laws may have some impact, particularly in states where rights of any beneficiary do not apply until the death of the participant, and/or where state law provides for Domestic Partner benefits.

Since this is a major change from current law, we will be addressing this subject (Domestic Partner and Non-Spouse beneficiaries) in a separate issue of *Focus on 457* as more becomes known about the new law.

EGTRRA Permanency

The Act makes permanent each of the following plan enhancements enacted in the Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA). Without this action, each of the provisions was set to expire on December 31, 2010:

- Increased contribution limits to qualified plans, 403(b)s, 457(b) plans and IRAs.

- Cost of living increases for participant contributions.
- Age-50 catch-up contributions and cost of living increases.
- Roth 401(k)s effective January 1, 2006.
- Deemed IRAs under employer-sponsored plans.
- Enhanced portability, including rollovers allowed for governmental 457(b) plans.
- Flexible distributions from governmental 457(b) plans (no more irrevocable elections of a fixed future date to begin distributions).
- Qualified Domestic Relations Orders for governmental 457(b) plans.

Saver's Tax Credit Permanency and Enhancements

The Saver's Tax Credit, which was scheduled to expire at the end of 2006, is also made permanent. Additional changes to the Saver's Tax Credit indexing the income limits for cost of living increases, allowing more employees to take advantage of the credit. The Act also allows taxpayers entitled to a refund to deposit their Saver's Tax Credit refund directly into an IRA.

Provisions Specifically Applicable to Governmental Plans

Tax-Free Pension Distributions to Pay Premiums for Health and LTC Insurance for Public Safety Officers: Beginning in 2007, retired or disabled public safety officers (i.e., law enforcement officers, firefighters, or rescue squad or ambulance crew) may exclude up to $3,000 of distributions from a governmental qualified retirement plan, 403(b) annuity, or 457(b) plan for the direct payment of premiums for coverage for the public safety officer, his or her spouse, and his or her dependents under an accident or health insurance plan or qualified long-term care insurance contract.

Purchase of Permissive Service Credit: The Act amends the purchase of service credit and transfer rules enacted in 1997 and 2001. This is very welcome news for employers in states such as California. California AB 55 and California AB 719 amended the Government Code to allow eligible members to purchase additional retirement service credit in a governmental defined benefit plan prior to severance from employment. The passage of these two bills allowed members, subject to certain eligibility requirements, to purchase "additional" service credit (sometimes referred to as "airtime"). Other states have enacted similar provisions. Prior to the Act, however, it was unclear whether the Internal Revenue Code allowed employees to transfer funds from their 457(b) plan to purchase the service credit.

The Act amends the purchase of service credit rules to clarify that state and local governmental employees may purchase enhanced benefits and benefits for which there is no performance of actual service ("airtime"). Additionally, the transfer rules are amended to clarify that the purchase of the service credit may be made by transferring amounts from governmental 457(b) plans. With respect to distributions of amounts attributable to transfers of 457(b) plan assets, the distribution rules applicable to defined benefit plans apply.

Waiver of the 10 Percent Penalty on Certain Distributions to Certain Public Safety Employees: Under current law, a 10% premature withdrawal penalty tax applies to any distribution from a governmental qualified plan prior to age 59 ½ unless a exception applies. Under current law, the penalty tax does not apply to employees who sever employment after attainment of age 55. Many public safety employees, (i.e., a police officer, fire fighter, or emergency medical services employee) participate in Deferred Retirement Option Plans (DROP) which allow them to take their pension benefits in a lump sum, and many of them sever employment prior to age 55. Effective upon the date of enactment, the 10-percent early withdrawal penalty tax will not apply to distributions from a governmental pension plan made to a public safety employee who severs employment after the attainment of age 50.

Clarification of the Minimum Distribution Rules: The Act directs Treasury to issue regulations under which a governmental plan is treated as complying with the minimum distribution rules (retroactive to effective date of the requirements) if it complies with a reasonable, good faith interpretation of those requirements. This relaxation of the required minimum distribution rules is apt to cause some confusion, but is designed to ease the burden on governmental employers.

Nondiscrimination Rules: Effective after the date of enactment, all governmental plans (not just state and local plans) would be exempt from the nondiscrimination and minimum participation rules. This primarily impacts plans offered by the federal government.

Indian Tribal Government Plans: The Act clarifies that a plan is treated as a governmental plan if it is maintained by an Indian tribal government, a subdivision, agency or instrumentality of such government. In order to qualify as a governmental plan, all of the participants must be employees whose services are substantially in the performance of essential governmental functions, not in the performance of commercial activities (whether or not it is an essential government function). This would exclude employees of Indian Gaming establishments and other business enterprises whose primary purpose is commercial rather than governmental. This provision is effective for plan years beginning on or after the enactment date.

Automatic Enrollment in Governmental 457(b) and 401(k) Plans

Governmental employers have been allowed to automatically enroll employees into their 457(b) plans and grandfathered 401(k) plans for several years. In fact, the federal government has issued several revenue rulings, each designed to encourage employers to include an automatic enrollment feature in their salary reduction savings plans. As early as 1998, Revenue Ruling 98-30 permitted automatic enrollment in 401(k) plans for new hires. In 2000, Revenue Ruling 2000-8 specifically permitted automatic enrollment for current employees in 401(k) plans; Revenue Ruling 2000-35 addressed automatic enrollment in 403(b) plans for employees of public schools, other educational and charitable organizations; and Revenue Ruling 2000-33 permitted automatic enrollment in 457(b) plans for state and local government employees.

Employers subject to ERISA however, were still reluctant to implement automatic enrollment without fiduciary relief from the Department of Labor. The Act creates an automatic enrollment safe-harbor plan design called a "Qualified Automatic Contribution Arrangement." ERISA employers now have three options with respect to the 401(k) nondiscrimination rules: (1) perform regular testing, taking corrective action if the plan fails the test; (2) comply with the old safe harbor, or (3) adopt automatic enrollment and comply with the new safe harbor.

Governmental plans are exempt from ERISA and thus do not have to comply with the Qualified Automatic Contribution Arrangement requirements. Some employers may, however, want to use these requirements as a guide in designing their program.

Qualified Automatic Contribution Arrangements must include the following features:

- Initial automatic enrollment percentage between 3% and 10%.

- Automatic enrollment percentage must increase to no less than:
  - 4% in the second year,
  - 5% in the third year, and
  - 6% in all subsequent years.

- The automatic election must be capped at 10% and must cease to apply if the employee makes an affirmative election to opt out of the plan or adjust their contribution percentage.

- Participants in the plan prior to the date the plan is amended to include automatic enrollment may be excluded.

- Minimum employer contribution must be either:
  - 3% nonelective contribution; or

    - 100% of the first 1% deferred and 50% of the next 5% deferred.

- Contributions must vest 100% within two years.

- Employees must receive advance notice of their right (1) to opt out of plan participation or (2) to elect a different contribution percentage.

- The advance notice must identify the default investment option for the automatic deferrals for employees who have not made an investment election.

- Beginning in 2008, employees must have 90 days from the first payroll date in which the automatic deferral was made to elect to have the automatic contributions returned as an "erroneous contribution."

    - Erroneous contributions are not included in non-discrimination testing and are not subject to the 10% early distribution tax penalty.
    - Distributions of erroneous contributions must be made by April 15 of the following year.

Governmental employers may be concerned about the "minimum employer contribution" requirements in the new Qualified Automatic Contribution Arrangement described above (since most governmental 457(b) and 401(k) plans do not have an employer contribution, or if they do, it may be below the amounts required). Governmental plans are, however, exempt from ERISA and do not have to comply with the Qualified Automatic Contribution Arrangement requirements. Governmental employers may rely upon the prior Revenue Rulings noted above.

Preemption of State Law

Under the Act, ERISA supersedes state laws (e.g., laws that require an employee signature prior to any deduction being taken from the paycheck) that would directly or indirectly prohibit or restrict the employer's adoption of an automatic contribution arrangement meeting certain notice and withdrawal requirements.

Governmental plans, however, will have to determine whether they can implement an automatic enrollment feature without changes to state payroll laws.

Default Investment Safe Harbor

For ERISA plans, the Department of Labor (DOL) is directed to issue a fiduciary safe harbor under ERISA section 404(c) within the next 60 days for the investment of assets in an individual account plan where participants are deemed to be exercising investment control.

The default would apply only to situations where the participant fails to make an investment election. The default investments must include a mix of asset classes consistent with preservation of capital or long term capital appreciation.

An annual notice is required within a reasonable period of time before each plan year explaining the employee's right to designate investment options and what the default fund is if they fail to make an allocation. The employee must also be given a reasonable time period after receipt of the notice to make an election prior to the beginning of the plan year. The relief will be effective for plan years after December 31, 2006.

Relief is also provided in situations where one or more funds are eliminated or replaced and participant assets are automatically reallocated to remaining or new funds. If the participant does not affirmatively select a reallocation, 404(c) protection applies if certain requirements are met.

These requirements will be provided to the reader upon request and can be used by governmental plans as a guide to designating a default investment option under an automatic enrollment program.

Expansion of Rollover Rules

Converting Plan Distributions Into Roth IRAs. Section 401(k), 403(b) and governmental 457(b) assets may be converted directly into a Roth IRA subject to the Roth IRA conversion rules (income limits and taxation), eliminating the intermediate step of rolling to a traditional IRA. The taxable portion of the rollover amount is taxed at the time of rollover.

Rollovers by Non-Spouse Beneficiaries. As mentioned previously, non-spouse beneficiaries will now be able to roll over distributions from a qualified plan, 403(b) or governmental 457(b) into an IRA. The beneficiary's IRA will be treated as an "inherited" IRA, allowing the beneficiary to delay receipt of required minimum distributions until he or she attains age 70 ½. If the beneficiary leaves the money in the participant's plan, required minimum distributions must begin by December 31 of the year following the year of the participant's death.

Investment Advice to Plan Participants

By way of background, persons affiliated with funds offered under a 401(k) plan are considered related parties and generally cannot advise participants about what funds to invest in. In the past, the DOL has issued prohibited transaction relief for "education" provided by a related party, and for "model-driven" advice supervised by a third party. The Act codifies the model-driven prohibited transaction relief and allows related parties, called fiduciary advisers, to provide advice under a flat fee arrangement.

Model-driven arrangements must have an unaffiliated "eligible investment expert" certify that certain requirements discussed below are met. The advisor must retain records demonstrating compliance for at least six years. The model must:

- Apply generally accepted investment theories that take into account the historic returns of different asset classes over defined period of time.
- Utilize relevant information about the participant (e.g., age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments).
- Utilize prescribed objective criteria to make fund-specific asset allocation recommendations.
- Operate in a manner that is not biased in favor of investments offered by the adviser or an affiliate.
- Take all investment options available under the plan into account and not be biased towards affiliated funds.

The flat fee advice arrangement must provide that "any fees … received by the fiduciary adviser for investment advice.…do not vary depending upon the basis of any investment option selected." Under this exemption, fiduciary advisers may provide participant level investment advice with respect to funds on which the adviser receives compensation.

The plan fiduciary must expressly authorize the advice arrangement and an independent auditor must conduct an annual audit of the arrangement and issue a written report to the authorizing fiduciary. The plan sponsor/fiduciary is generally relieved of fiduciary responsibility for the investment advice provided by an adviser and has no duty to monitor the specific investment advice given to participants. The plan sponsor/fiduciary is not, however, relieved of its responsibility for the prudent selection and monitoring of the financial adviser.

The adviser must be a registered investment adviser, a bank or similar financial institution so long as the advice is provided through a trust department, an insurance company, or a registered broker or dealer. The fees charged must be reasonable and at least as favorable as in an arms-length transaction.

The adviser must provide advance notice to participants and must update the notice annually or upon request. The notice must contain the following information:

- The role of any affiliated party in the development of the advice program and the selection of investment options.
- The past performance and historical rates of return of the investment options.

- All fees related to the advice that the adviser or any affiliate is to receive (the DOL is to create a model disclosure form).
- Any affiliation of the adviser to any of the investment options.
- How information provided by the participant will be used or disclosed.
- The types of services to be provided by the adviser.
- The fact that the adviser is a fiduciary.
- The option of the participant to separately arrange for advice from an unaffiliated adviser.

The primary impact on governmental plan sponsors is that the Act now permits one of your investment managers to provide investment advice to plan participants. As noted above, however, plan sponsors who choose to allow an investment provider or recordkeeper to offer advice have more onerous requirements than those who choose to use an independent third party.

ERISA Section 404(c) Protection Available During Black-Outs

For those governmental plans using ERISA section 404(c) as a guide, the DOL is to issue guidance on the responsibilities of plan fiduciaries during a blackout. Plan fiduciaries will receive protection under ERISA section 404(c) during a blackout period if:

- The plan was in compliance with section 404(c) prior to the blackout.
- Participants are given notice within 30-60 days prior to the blackout informing them about the new investment options and explaining what will happen in the absence of an election.
- The account is transferred either in accordance with the participants' elections, or mapped into funds with similar risk and return characteristics.

Other Changes

Tax-free IRA Distributions for Charitable Giving. IRA owners who are at least age 70 ½ may make tax free distributions of up to $100,000 from an IRA during 2006 and 2007 if the distribution is made payable to a charitable organization. This rule does not apply to distributions from SEP-IRAs or SIMPLE-IRAs.

Tax Refunds. Individuals who will be receiving federal income refunds will be able to request that the IRS send the refund directly into an IRA, subject to the contribution limits.

Hardship Withdrawals and Unforeseeable Emergencies can be made to the participant's beneficiary under the plan even if that beneficiary is not the participant's spouse or dependent. We will review this for any new regulations that may be issued since under most state laws, the beneficiary is not truly the beneficiary until the participant's death. At that time, the beneficiary would be allowed to take a distribution on account of death and would not need to request a hardship or unforeseeable emergency withdrawal.

Qualified Reservists called up to active duty between September 11, 2001 and December 31, 2007 for more than 179 days could take distributions from the plan without a 10% premature distribution penalty. A two-year rollover rule would apply following the end of the active duty period.

We will be monitoring any additional guidance, rulings or regulations applicable to these provisions. Please address any questions you may have to your relationship manager or contact Marilyn R. Collister at 303-737-3819 or marilyn.collister@gwrs.com with questions you would like us to address.

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