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Pension Protection Act – Impact on Governmental Plans

The Pension Protection Act of 2006 (PPA) includes many provisions that will impact governmental plans. New flexibility in the minimum distribution rules gives governmental employers the opportunity to offer new payment options and protect existing ones. Special rules apply to benefits for school teachers, public safety officers and public safety employees. Many general provisions of the new law will also be of interest, including provisions regarding in-service distributions from pension plans, permissive service credit purchases, distribution timing and rollovers.

Background

President Bush signed the Pension Protection Act of 2006 (PPA) into law on August 17th. Although the primary focus of the PPA is the funding of private sector defined benefit plans, it has many provisions that affect governmental retirement plans. The PPA creates opportunities that many governmental employers, especially employers of school teachers and public safety employees, will want to take advantage of.

Many of the provisions affecting governmental employers are effective upon enactment and some have retroactive effect. Governmental employers have until the last day of the plan year beginning on or after January 1, 2011 to retroactively amend their plans to comply with the applicable PPA provisions (as long as they are operated in accordance with the provisions from their effective dates).

An overview of the PPA provisions that affect governmental employers is provided below.

PPA Provisions Directed at Governmental Employers

Minimum Distribution Rules

Code Section 401(a)(9) imposes minimum distribution standards on qualified retirement plans, including governmental plans. Current IRS regulations permit annuity distribution options in governmental plans in place before April 17, 2002 to satisfy Section 401(a)(9) by meeting a reasonable good faith compliance standard.

The PPA directs the IRS to issue regulations for governmental plans clarifying that a plan's distribution options will be deemed to be in compliance with Section 401(a)(9) for all years that the section applies to them as long as they represent a reasonable good faith interpretation of the rules.

> ***BUCK COMMENT.*** *Governmental plans should already be operating in good faith compliance with the minimum distribution rules and existing distribution options will continue to be protected. The PPA may encourage employers to offer new annuity distribution options under this reasonable good faith standard.*

Public Safety Officers and Employees

Retiree Medical Premiums for Public Safety Officers. An important PPA provision allows public safety officers who separate from service at the plan's normal retirement age or on account of disability to elect to have up to $3,000 per year of their otherwise taxable retirement distributions from a qualified retirement plan, a Section 403(b) plan or a Section 457(b) plan transferred directly to pay for retiree medical or long-term care insurance premiums on a pre-tax basis. A "public safety officer" is defined as a law enforcement officer, firefighter, chaplain, or member of a rescue or ambulance crew. This provision is effective for distributions in taxable years beginning in 2007.

> ***BUCK COMMENT.*** *Thus, it appears that a public safety officer who is eligible for an early retirement benefit or an unreduced retirement benefit before normal retirement age will not qualify for this exclusion from income. Plan sponsors must amend their plans if they wish to take advantage of this provision.*

Distributions to Public Safety Employees Over Age 50. Distributions from a governmental defined benefit plan made after August 17, 2006 to qualified public safety employees who separate from service after attaining age 50 will not be subject to the 10% early distribution penalty tax. A "qualified public safety employee" is any employee of a state or political subdivision of a state who provides police protection, fire-fighting services, or emergency medical services for any area within the jurisdiction of such state or political subdivision.

> ***BUCK COMMENT.*** *This provision was driven by the tax treatment of deferred retirement option plans (DROPs). An employee who retired prior to attaining age 55, who elected a lump sum DROP benefit, and who elected not to roll over the distribution was subject to income taxes and the 10% early distribution penalty tax. Public safety employees who retire before attaining age 50 and elect a lump sum DROP benefit are still subject to the penalty tax unless they roll over the distribution. A plan amendment is not needed to take advantage of this provision.*

School Teachers

Early Retirement Incentive Plans. Prior to the PPA, if a school district or tax-exempt educational association provided early retirement subsidies or temporary supplements outside of a defined benefit plan, the benefits were considered deferred compensation subject to Section 457. These benefits could also violate age discrimination standards under the Age Discrimination in Employment Act (ADEA) because they are typically more valuable to younger early retirees than older retirees.

The PPA amends Section 457 to provide that early retirement incentive plans that are coordinated with governmental defined benefit plans will be treated as bona fide severance plans and therefore not subject to the Section 457 limits. The law amends ERISA to provide that they are treated as welfare plans for ERISA purposes. Finally, the law amends ADEA to provide that they will be treated as defined benefit plans and not as providing severance pay for purposes of ADEA. These provisions are generally effective August 17, 2006. The amendments to Section 457 apply to taxable years ending after August 17, 2006. The ERISA amendment is effective for plan years ending after August 17, 2006.

Employment Retention Plans. The PPA provides that school districts and tax-exempt educational associations may provide a retention benefit of up to two times the applicable Section 457(b) limits on deferrals (e.g., two times $15,000 in 2006) without the benefit being treated as deferred compensation subject to Section 457(f) – i.e., the amounts are not includable in income until paid. In addition, the PPA provides that these plans are treated as welfare plans under ERISA. This provision is effective August 17, 2006 and applies to taxable years ending after August 17, 2006.

Permissive Service Credit Purchases

Governmental defined benefit plans often allow participants to be credited with permissive service credit if they make voluntary contributions in an amount necessary to fund the benefit attributable to the service credited. Code Section 415(n) permits a governmental plan to ignore Section 415(c) (which limits employee after-tax contributions to a retirement plan) when an employee purchases service credits with after-tax contributions, and instead to include the benefit attributable to those contributions in the employer provided benefit in testing for compliance with Section 415(b). The IRS had ruled earlier that Section 415(n) was only available if the employee had actually performed service not considered by the governmental plan and had also ruled that Section 415(n) was not available when an employee made an after-tax contribution to become eligible for an early retirement subsidy (e.g., a buy down of the actuarial reduction for early commencement).

Effective retroactively to plan years after the enactment of the Tax Reform Act of 1997, the PPA amends Section 415(n) to clarify that no actual performance of service is required and that Section 415(n) is available for actuarial reduction buy downs.

Effective retroactively to plan years after the enactment of EGTRRA, the law provides that permissive service credits purchased through trustee-to-trustee transfers from Section 457(b) and Section 403(b) plans are not subject to the limitations on nonqualified service and that the amounts transferred are subject to the defined benefit plan's distribution rules.

Exemption from Nondiscrimination and Minimum Participation Rules

Retirement plans sponsored by state and local governmental or other political subdivisions are exempt from the Code's rules regarding discrimination in favor of highly-compensated employees and minimum participation. Certain other governmental plans (e.g., international organizations) have been subject to these rules, although a moratorium on the application of these rules has been in effect indefinitely pending the issuance of final IRS guidance. (See our February 14, 2003 *For Your Information*.)

The PPA now explicitly exempts all governmental plans from the nondiscrimination and minimum participation rules, effective August 17, 2006.

Indian Tribal Plans

The new law amends the Code and ERISA to include plans maintained by Indian tribal governments in the definition of governmental plans – but only for employees performing governmental functions and not commercial functions. This provision is effective for any year beginning on or after August 17, 2006.

> ***BUCK COMMENT.*** *We understand that there will be an attempt to have the governmental function requirement modified in a technical corrections bill.*

Participation Rules for Section 457(b) Plans

The PPA provides that an individual that received a distribution of $3,500 or less under Section 457(e)(9) before the enactment of the Small Business Job Protection Act of 1996 is not precluded from participating in a Section 457(b) plan.

General PPA Provisions that Affect Governmental Employers

Extension of EGTRRA Provisions

Certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) affecting retirement plans (e.g., the increases in benefit, contribution and compensation limits, the availability of Roth 401(k) and Roth 403(b) contributions, pre-tax catch-up contributions to defined contribution plans) have been made permanent. Many of these provisions directly affect Section 403(b) plans and Section 457 deferred compensation plans.

Phased Retirement

IRS regulations define a defined benefit pension plan as one that provides for payments after retirement or separation from service. Although IRS rulings have permitted in-service distributions from pension plans after an employee attains normal retirement age, they have not allowed employers to offer in-service distributions prior to a plan's normal retirement age (i.e., phased retirement).

Effective for distributions in plan years beginning after January 1, 2007, the PPA provides that a pension plan may make in-service distributions to employees who have attained age 62 and are still actively employed.

> ***BUCK COMMENT.*** *This provision is more restrictive than IRS' proposed approach under which in-service distributions would be allowed starting at age 59½.*
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> *Employers who want to offer phased retirement will need to carefully consider all of the issues before implementing it – e.g., whether additional accruals should be offset for the value of the distributions, whether in-service distributions at age 62 will be available to all employees or only employees that agree to work part-time, and how to distribute any new accruals.*

Changes to Rollover Rules

402(f) Notices. Employees receiving eligible rollover distributions must receive a notice not more than 90 or less than 30 days prior to the distribution advising them of their rollover rights and the rules on tax withholding (the 402(f) notice). Effective for years beginning after 2006, the 402(f) notice may be provided up to 180 days prior to the distribution.

Non-Spouse Beneficiary Rollovers to an IRA. Surviving spouses may roll over eligible rollover distributions (e.g., lump sums and installment payments for less than 10 years) from a qualified plan, a Section 403(b) plan or a Section 457(b) plan to an IRA. Currently, a non-spouse beneficiary may not roll over such a distribution to an IRA.

Effective for distributions after 2006, the PPA allows a non-spouse beneficiary (e.g., child, domestic partner) to make a direct transfer of the distribution from a qualified plan, a Section 403(b) plan or a Section 457(b) plan to an IRA (but not to another qualified plan). This transfer is treated like a non-spouse inherited IRA. In general, distributions from the rollover IRA must either be paid in full within five years of the employee's death or must commence within 12 months of the employee's death over the life expectancy of the non-spouse beneficiary.

> ***BUCK COMMENT.*** *This provision will permit the non-spouse beneficiary to spread the taxation of the distribution over a 5-year period or over his or her lifetime.*
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> *Although eligible rollover distributions not rolled over are subject to mandatory 20% federal income tax withholding, the non-spouse distribution not rolled over will be subject to the 10% voluntary withholding and*

not the mandatory 20% withholding. The IRS is expected to issue a new model 402(f) notice that would address this change.

After-Tax Rollovers. EGTRRA permitted an employee to roll over after-tax amounts to an IRA or a qualified defined contribution plan that separately accounts for the after-tax amount and the earnings on the after-tax rollover.

Effective for taxable years beginning after 2006, rollovers of after-tax amounts to defined benefit plans and Section 403(b) plans that agree to accept them will also be permitted – provided the recipient plan separately accounts for the rollover and the earnings on the rollover.

Roth IRA Rollovers. Currently, an employee may not roll over an eligible rollover distribution from a qualified plan, a Section 403(b) plan or a Section 457 plan directly to a Roth IRA. The employee must roll over the distribution into a regular IRA, and then convert that IRA into a Roth IRA.

Effective for distributions from these plans beginning in 2008, an employee may elect a direct rollover to a Roth IRA, provided the current rules for converting a regular IRA to a Roth IRA are satisfied (e.g., amounts generally are subject to income taxation for the year of the transfer).

Hardship Withdrawals

Active employees may not receive in-service distributions from Section 401(k) and Section 403(b) plans prior to attaining age 59½, or from Section 457(b) plans prior to attaining age 70½, unless the participant (or spouse or tax dependent) has a hardship or unforeseen emergency.

The PPA directs Treasury to issue guidance by February 17, 2007 allowing plans to permit a hardship distribution to an employee based on the financial hardship or unforeseen emergency of the employee's plan beneficiary (who may be other than a spouse or tax dependent – e.g., a domestic partner). For example, a Section 457(b) plan can be amended to provide that if the employee's adult child or domestic partner is the beneficiary of the employee's Section 457(b) plan and that beneficiary has a financial hardship (such as unreimbursed medical expenses or expenses for the repair of a principal residence), the employee may receive a hardship withdrawal. The withdrawal will be taxable to the employee.

Distributions to Active Duty Military Reservists

A distribution between September 11, 2001 and December 31, 2007 from an IRA or from a Section 401(k) or Section 403(b) plan that is attributable to employer contributions to an employee who is called to active military service for a period of at least 180 days will not be subject to the 10% early distribution penalty tax. The reservist may repay the withdrawal to the IRA within two years following the end of active duty, or August 17, 2008 if longer, without violating the limits on contributions to IRAs. The contribution will not be deductible by the individual.

Automatic Enrollment

The PPA contains many provisions that encourage defined contribution plan sponsors to set up automatic enrollment features to boost participation. Many private sector plan sponsors are expected to add automatic enrollment provisions to their plans – governmental plan sponsors may also wish to consider adding these provisions.

Cash Balance Plans

The PPA now prescribes rules under which hybrid pension plans, including cash balance plans, may be designed or conversions may be made to these plans without running afoul of IRS and ADEA rules. ADEA is amended to state that any defined benefit plan will not discriminate on the basis of age if under the terms of the plan, the accrued benefit of any employee is not less than the accrued benefit of any similarly situated younger employee. In light of this more certain environment, governmental entities may wish to review whether a cash balance or other hybrid plan is a feasible alternative for providing pension benefits to their employees.

Conclusion

Governmental employers should be pleased with the new law, as it clarifies and liberalizes many provisions that they were concerned with. International organizations will be relieved that nondiscrimination testing has once and for all been eliminated. In any event, governmental employers have greater flexibility and many opportunities to improve their benefit offerings in light of changes made by the PPA.

Buck's consultants would be pleased to discuss the provisions of the new law affecting governmental employers and help in implementing any changes to your plans.
