

# **PENSION PROTECTION ACT OF 2006**

## **Summary of Certain Provisions Affecting Governmental Plans**

**Prepared for the  
National Association of State Retirement Administrators**

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**PENSION PROTECTION ACT OF 2006**  
**SUMMARY OF PROVISIONS AFFECTING GOVERNMENT PLANS**

**INTRODUCTION**

On July 28, 2006, the House of Representatives passed the massive Pension Protection Act of 2006 ("PPA"), and on August 3, 2006, the Senate adopted the PPA in the same form. The Act was signed by President Bush on August 17, 2006.

The 907 page PPA makes significant changes to the federal law affecting defined benefit plans, "hybrid" plans (such as cash balance plans), and defined contribution plans, as well as a variety of other plans, resulting in extensive and far-reaching effects on a broad spectrum of employee benefit plans. We have generally arranged our discussion in Internal Revenue Code section order, followed by ERISA and ADEA provisions and then followed by non-code amendments. We have included PPA provisions that amend ERISA where we believe that governmental plans would benefit from that discussion.

With respect to each PPA Section that we have addressed, we have provided the title of the section from the PPA, a summary of the law, and the effective date of the provision.

We welcome comments and questions about this summary.

**DEFINED TERMS**

In this document we have used the following defined terms:

ADEA	The Age Discrimination in Employment Act
EGTRRA	The Economic Growth and Tax Relief Reconciliation Act of 2001
ERISA	The Employee Retirement Income Security Act of 1974
IRC or Code	The Internal Revenue Code of 1986, as amended
IRS	The Internal Revenue Service
JCT Explanation	The Joint Committee on Taxation Technical Explanation
PPA	The Pension Protection Act of 2006

**RELEVANT PPA PROVISIONS AFFECTING  
THE INTERNAL REVENUE CODE**

**IRC § 25B—SAVER'S CREDIT AND INFLATION INDEXING OF GROSS  
INCOME LIMITATIONS ON CERTAIN RETIREMENT SAVINGS  
INCENTIVES (PPA §§ 812 AND 833)**

**Summary of Law**

Section 833 of the PPA amends IRC § 25B to index the gross income limits for claiming the Retirement Savings Contributions Credit, known as the Saver's Credit. EGTRRA established a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions of up to \$2,000, subject to a phase-out based on the taxpayer's adjusted gross income. The maximum tax credit is the lesser of \$1,000 or the individual's tax liability without the credit. The current tax credit rates and income limits are as follows:

**Rates for Saver's Credit  
(based on adjusted gross income)**

<b>Joint Filers</b>	<b>Heads of Households</b>	<b>All Other Filers</b>	<b>Credit Rate</b>
\$0 – \$30,000	\$0 – \$22,500	\$0 – \$15,000	50 percent
\$30,001 – \$32,500	\$22,501 – \$24,375	\$15,001 – \$16,250	20 percent
\$32,501 – \$50,000	\$24,376 – \$37,500	\$16,251 – \$25,000	10 percent
Over \$50,000	Over \$37,500	Over \$25,000	0 percent

The Saver's Credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity plan (a "section 403(b) plan"), an eligible deferred compensation arrangement of a state or local government (a "section 457(b) plan"), a simple retirement account ("SIMPLE"), or a simplified employee pension ("SEP"); (2) contributions to a traditional IRA or Roth IRA; and (3) voluntary after-tax employee contributions to a section 403(b) plan or qualified 401(a) retirement plan.

The PPA makes two changes to the Saver's Credit:

- it provides for inflation adjustments to the adjusted gross income limitations, and
- it makes permanent the Saver's Credit, which was set to expire on December 31, 2006.<sup>1</sup>

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<sup>1</sup> We note that the JCT Explanation (but not the PPA itself) states that an individual may direct that the amount of any refund attributable to the Saver's Credit be directly deposited by the Federal government into an applicable retirement plan, meaning an IRA, qualified retirement 401(a) plan, section 403(b) plan, or section 457(b) plan designated by the individual (if the plan or other arrangement agrees to accept such direct deposits). Because these statements appear in the JCT Explanation we have noted them, but we believe they may be remnants of language that did not make it into the final bill. At this time, it appears unlikely this provision is actually applicable, as the Saver's Credit is designed as a non-refundable tax credit. See, however, Section 830 of the PPA, which allows individual tax refunds generally to be directed to individual retirement plans.

The PPA also amends IRC § 219(g) and IRC § 408A(c)(3) to provide for inflation adjustments (in \$1,000 increments) to the income limits applicable to determining eligibility for Roth IRA contributions and deductible IRA contributions. Other existing limits and rules remain applicable.

### **Effective Dates**

The extension of the Saver's Credit is effective on enactment. Indexing begins for taxable years beginning after December 31, 2006.

### **IRC § 72(t)—PENALTY FREE WITHDRAWALS FROM RETIREMENT PLANS FOR INDIVIDUALS CALLED TO ACTIVE DUTY FOR AT LEAST 179 DAYS (PPA § 827)**

[MANDATORY]

### **Summary of Law**

Section 827 of the PPA amends IRC § 72(t) to eliminate the 10% early distribution penalty with regard to "qualified reservist distributions," which are distributions to reservists who are ordered or called to active military duty for more than 179 days or an indefinite period. The distribution must be made from a traditional or Roth IRA, or from elective deferrals under a 401(k) plan or a 403(b) program, during the active duty period (treated as beginning on the date of the order or call to duty), but a severance of employment is not required. A 401(k) plan or 403(b) program does not violate the in-service distribution restrictions by making a qualified reservist distribution.

The qualified reservist distribution may be contributed to an IRA (not the distributing 403(b) or 401(k) plan) (in one or more payments) outside the maximum contribution limits within two years after the active duty ends. The amendment pertains to individuals called to active duty after September 11, 2001, and affected taxpayers may claim a refund or credit for penalty taxes already paid if claimed before the close of the two-year period.

IRS News Release 2006-152 established the instructions for claiming a refund for this penalty, via an amended individual income tax return (Form 1040X). The distributing plan will not need to file an amended Form 1099R.

### **Effective Date**

A qualified reservist distribution applies to an individual ordered or called to active duty after September 11, 2001, and before December 31, 2007. The waiver of penalty and distribution limitations is effective for distributions after September 11, 2001. The two-year period runs to the later of the actual two year period or August 17, 2008.

**IRC § 72(t)—WAIVER OF 10 PERCENT EARLY WITHDRAWAL PENALTY  
BY CERTAIN DISTRIBUTIONS OF PENSION PLANS FOR  
PUBLIC SAFETY EMPLOYEES (PPA § 828)**

**[MANDATORY]**

**Summary of Law**

Section 828 of the PPA amends IRC § 72(t) to provide important relief for public safety employees in governmental defined benefit plans with some type of a partial lump sum option, a deferred retirement option feature, a lump sum refund, or other non-substantially equal periodic payments. It creates an exception to the 10% premature distribution penalty for payments made to a qualified member who separates from service (e.g., retires) after age 50 (rather than age 55). The IRS issued the 2006 Instructions for Form 1099R last week and determined that Code 2 will be used for these distributions – "Early distribution, exception applies."

A qualified member includes any employee who provides police protection, firefighting services or EMT services for any area within the jurisdiction of the state or political subdivisions.

**Effective Date**

Effective for distributions paid after August 17, 2006. This is not limited to distributions commencing after August 17, 2006.

**IRC § 401(a)(5) & IRC § 401(a)(26)—EXTENSION TO ALL GOVERNMENTAL  
PLANS OF CURRENT MORATORIUM ON APPLICATION OF CERTAIN  
NONDISCRIMINATION RULES APPLICABLE TO STATE AND  
LOCAL PLANS (PPA § 861)**

**Summary of Law**

Section 861 of the PPA amends IRC §§ 401(a)(5) and (a)(26) and 401(k)(3) to broaden the exemption from nondiscrimination rules to all governmental plans. State and local governmental plans had already been exempt. This is not an exemption, it is a grant of flexibility.

**Effective Date**

Effective for any year beginning after August 17, 2006. Treasury officials have publicly said that governmental plans may immediately use this standard.

**IRC § 401(a)(9)—CLARIFICATION OF MINIMUM DISTRIBUTION RULES  
FOR GOVERNMENTAL PLANS (PPA § 823)**

[PERMISSIVE]

**Summary of Law**

Section 823 of the PPA requires the Secretary of the Treasury to issue regulations to provide relief for governmental plans with respect to the minimum distribution rules of IRC § 401(a)(9). The regulations must allow governmental plans to comply with "a reasonable good faith interpretation of the statutory requirements."

**Effective Date**

The provision is effective August 17, 2006. However, the JCT Explanation states the Congressional intent that the regulations apply for periods before August 17, 2006.

**IRC § 401(a)(36)—DISTRIBUTIONS DURING WORKING RETIREMENT  
(PPA § 905)**

[PERMISSIVE]

**Summary of Law**

Section 905 of the PPA amends IRC § 401(a) and § 3(2)(A) of the ERISA to permit distributions from qualified pension plans to individuals who have not separated from employment. This Section allows (but does not mandate) a qualified pension plan to provide that a distribution may be made to an employee who reaches age 62 even though the employee has not separated from service. Previously, the IRS has indicated that the prohibition on in-service distributions did not prevent benefit commencement to an employee who had reached normal retirement age (or eligibility for an unreduced benefit under the terms of the plan).

**Effective Date**

Effective for distributions made in plan years beginning after December 31, 2006.

**IRC § 401(k) & IRC § 414(w)—INCREASING PARTICIPATION THROUGH  
AUTOMATIC CONTRIBUTION ARRANGEMENTS (PPA § 902)**

[PERMISSIVE]

**Summary of Law**

The PPA adds IRC § 414(w), establishing rules for "eligible automatic contribution arrangements." These are generally defined as arrangements where a participant is treated as having elected to have an employer make a plan contribution on behalf of the participant as a uniform percentage of the participant's compensation until the participant specifically elects not to have such contribution made (or elects a different contribution percentage rate). An eligible

automatic arrangement is also required to provide that, in the absence of investment direction by the participant, automatic contributions must be invested in accordance with ERISA § 404(c)(5). Under IRC § 414(w), an employer may allow in-service "permissive withdrawals" from such an arrangement, in which case employees can avoid the early distribution penalty if the withdrawal is made within 90 days of the first automatic contribution and the plan meets new notice requirements. Generally, the notice must be provided annually to employees in the automatic contribution arrangement, explaining the terms of the arrangement and the employee's rights under the arrangement. Qualified section 401(a) plans, section 403(b) plans, and section 457(b) plans are covered by this new provision.

While not directly applicable to governmental plans, we note that Section 902 of the PPA amends IRC § 401(k) to address automatic contribution arrangements, creating standards for a new automatic safe harbor deferral structure – a "qualified automatic contribution arrangement." This option may be attractive to private employers because a "qualified automatic contribution option" is considered to meet nondiscrimination tests for elective deferrals (ADP test) and matching contributions (ACP test). Neither the ADP nor ACP tests are applicable to grandfathered governmental section 401(k) plans. The Section limits the percentage of compensation that may be subject to automatic contributions in a qualified automatic contribution arrangement, and it requires that employees have the right to opt out. It further imposes vesting and withdrawal requirements and it adds participant notice requirements. These new provisions would also be applicable to private sector section 403(b) plans.

State laws that might prohibit or restrict an automatic contribution arrangement are preempted for ERISA covered plans, but not for governmental plans. The JCT Explanation provides that the:

Labor Secretary may establish minimum standards for such arrangements in order for preemption to apply. An automatic contribution arrangement is an arrangement: (1) under which a participant may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash, (2) under which a participant is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or elects to have contributions made at a different percentage), and (3) under which contributions are invested in accordance with regulations issued by the Secretary of Labor relating to default investments as provided under the bill. The State preemption rules under the bill are not limited to arrangements that meet the requirements of a qualified enrollment feature.

### **Effective Date**

Effective for plan years beginning after December 31, 2007. The preemption of conflicting state laws and regulations is effective August 17, 2006 for ERISA covered plans. Governmental plans may need to have state or local law changes if they wish to use this.

**IRC § 402—ROLLOVERS OF AFTER-TAX AMOUNTS**  
**(PPA § 822)**

[PERMISSIVE]

**Summary of Law**

Section 822 of the PPA amends IRC § 402(c)(2)(A) to permit qualified plans (whether defined benefit or defined contribution) and section 403(b) plans to accept after-tax direct rollover amounts from a qualified retirement plan, so long as the plan separately accounts for such after-tax amounts. (Previously only qualified defined contribution plans could accept such after-tax rollover amounts.) This may entail significant accounting and programming changes.

**Effective Date**

Effective for taxable years beginning after December 31, 2006. Plan may need legislative changes to implement this.

**IRC § 402(c)—ROLLOVERS BY NONSPOUSE BENEFICIARIES OF CERTAIN**  
**RETIREMENT PLAN DISTRIBUTIONS (PPA § 829)**

[MANDATORY]

**Summary of Law**

Section 829 of the PPA amends IRC §§ 402(c), 403(b), and 457(b) to provide an additional option for nonspouse beneficiaries who are eligible to receive distributions from qualified retirement plans, section 403(b) plans and section 457(b) governmental plans. Nonspouse beneficiaries previously were not permitted to rollover distributions from such plans. Now, if a distribution would otherwise be an eligible rollover distribution, a nonspouse beneficiary, who is a designated beneficiary as defined by IRC § 401(a)(9)(E), may rollover the distribution to an individual retirement account or individual retirement annuity established for the purpose of receiving the distribution. The account or annuity will be treated as an "inherited" individual retirement account or annuity. This means, for example, that distributions from the inherited IRA would be subject to the minimum distribution rules applicable to IRA beneficiaries, rather than the five-year rule for distributions from a qualified plan.

This may affect distribution forms and elections, staff education, member and beneficiary education, and programming. One outstanding question is whether the mandatory 20% withholding will apply if the nonspouse beneficiary does not elect a direct rollover. The safest approach for a system would probably be to assume that a system will have to apply the 20% withholding on nonspouse beneficiaries who elect not to do a direct rollover.

**Effective Date**

Effective for distributions after December 31, 2006.

**IRC § 402—DISTRIBUTIONS FROM GOVERNMENTAL RETIREMENT PLANS  
FOR HEALTH AND LONG-TERM CARE INSURANCE  
FOR PUBLIC SAFETY OFFICERS (PPA § 845)**

**[GENERALLY PERMISSIVE]**

**Summary of Law**

Section 845 of the PPA amends IRC § 402 and makes one of the most dramatic changes in the PPA. This section allows "eligible retired public safety officers" to make an election to exclude from federal gross income up to \$3,000 of their retirement plan benefits used for health insurance or long term care insurance premiums. All eligible retirement plans must be treated as a single plan, *i.e.*, a retiree gets only one \$3,000 exclusion per year.

This election is available only if the plan agrees to deduct and then directly remit premiums.

An eligible public safety officer must be separated from service as a public safety officer with an employer maintaining or participating in the retirement plan from which the distributions are made. Unlike other tax laws that use different definitions of public safety officers, this Section uses the definition in Section 1204(8)(A) of the Omnibus Crime Control and Safe Streets Act of 1986 (42 U.S.C. 3796b(9)(A)). That definition includes the following individuals serving a public agency in an official capacity:

- an individual involved in crime and juvenile delinquency control or reduction, or enforcement of the criminal laws (including juvenile delinquency), including, but not limited to police, corrections, probation, parole, and judicial officers;
- professional firefighters;
- officially recognized or designated public employee members of a rescue squad or ambulance crew;
- officially recognized or designated members of a legally organized volunteer fire department; and
- officially recognized or designated chaplains of volunteer fire departments, fire departments, and police departments.

In addition, the member must be separated from service by reason of disability or attainment of normal retirement age to be eligible for this exclusion.

This exclusion pertains to distributions from governmental defined benefit plans, governmental defined contribution plans, section 403(b) plans, and section 457(b) plans.

We believe the IRS will likely conclude "health insurance" includes vision, dental, and health plans described under Code Sections 104 and 105. It also seems likely the IRS will conclude that an actual member election must be made.

## **Effective Date**

Effective for distributions in taxable years beginning after December 31, 2006.

### **IRC § 408A—DIRECT ROLLOVERS FROM RETIREMENT PLANS TO ROTH IRAS (PPA § 824)**

[MANDATORY]

## **Summary of Law**

Section 824 of the PPA amends IRC § 408A(d) and adds IRC § 408A(e) to allow members in eligible retirement plans (including qualified defined benefit and defined contribution plans, section 403(b) plans, and section 457(b) governmental plans) to make direct rollovers of eligible rollover distributions from such plans to Roth IRAs, subject to the rules that apply to rollovers from a traditional IRA to a Roth IRA. These rules provide that a rollover from a qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions). Additionally, the 10% premature distribution tax does not apply.

Such rollovers are subject to the limitations on rollovers to Roth IRAs based on modified adjusted gross income under IRC § 408A(c)(3)(B). This means that an individual with adjusted gross income of \$100,000 or more could not elect this direct rollover option. See IRC § 408A(c)(3)(B) (tax years beginning on or before December 31, 2009). See, also, changes to IRC § 408A contained in Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) for rollovers in 2010.

This change may affect distribution forms and elections. State or local legislative changes may also be necessary. You should watch for further IRS instructions on this.

## **Effective Date**

Effective for distributions made after December 31, 2007.

### **IRC § 414(d)—TREATMENT OF CERTAIN PENSION PLANS OF INDIAN TRIBAL GOVERNMENTS (PPA § 906)**

## **Summary of Law**

Section 906 of the PPA amends IRC § 414(d) and ERISA § 3(32), along with conforming amendments to other IRC and ERISA sections, to include plans maintained by Indian tribal governments as governmental plans. Indian tribal governments are defined by reference to IRC §§ 7701(a)(40) and 7871(d). Additionally, under Section 906, the special benefit limitations applicable to employees of police and fire departments of a state or political subdivision (IRC § 415(b)(2)(H)) apply to such employees of an Indian tribe or any subdivision, agency, or instrumentality thereof. In addition, the rules relating to pick up contributions under governmental plans (IRC § 414(h)) and special benefit limitations for governmental plans (IRC

§ 415(b)(10)) apply to tribal plans treated as governmental plans under the provision. Tribal government plans would also be exempt from the PBGC plan termination program.

However, such a plan may only cover employees substantially all of whose services are provided in the performance of essential governmental functions, but that are not commercial activities. The JCT Explanation provides examples of this distinction—a governmental plan could include the teachers in tribal schools, but could not include tribal employees who are employed by a hotel, casino, service station, convenience store, or marina operated by a tribal government.

IRS Notice 2006-89 creates relief for certain plans, time to "sort out" employee categories, and a strategy for creating a separate plan for commercial employees. In addition, on August 9, 2006, Treasury issued proposed regulations on the definition of essential governmental functions for tax-exempt bonds that they have now indicated would be helpful in analyzing this PPA provision.

### **Effective Date**

Effective for plan years beginning on or after August 17, 2006.

### **IRC § 414(p)—REGULATIONS ON TIME AND ORDER OF ISSUANCE OF DOMESTIC RELATIONS ORDERS (PPA § 1001)**

[PERMISSIVE]

### **Summary of Law**

While Section 1001 of the PPA does not amend either the IRC or ERISA, it requires the Secretary of Labor to issue regulations under IRC § 414(p) and ERISA § 206(d)(3) to clarify that a domestic relations order will not fail to be treated as a qualified domestic relations order ("QDRO") (so long as it otherwise meets the requirements of a QDRO) solely because the order is issued after or revises another such order or because of the time that it is issued.

### **Effective Date**

Effective August 17, 2006. The regulations must be issued by the Secretary of Labor within one year.

### **IRC § 414(x)—TREATMENT OF ELIGIBLE COMBINED DEFINED BENEFIT PLANS AND QUALIFIED CASH OR DEFERRED ARRANGEMENTS (PPA § 903)**

### **Summary of Law**

Section 903 of the PPA provides special rules for eligible combined plans, which include a defined benefit and a deferred contribution plan with a qualified cash or deferred arrangement ("CODA"). This has been referred to as the "DB/k plan." While as a general matter this Section

will not apply to most government plans, we have included a summary of this provision because it may be relevant to some governmental plans. These special rules apply to plans that:

- are maintained by a small employer under a broader definition that includes employers who employed an average of at least 2 but not more than 500 (versus 50) employees;
- consists of a defined benefit plan and applicable defined contribution plan;
- the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan; and
- with respect to which certain benefit, contribution, vesting, and nondiscrimination requirements are met.

An applicable defined contribution plan is a 401(k) plan. The requirements for a DB/k plan represent a modification of nondiscrimination rules that are applicable to private sector plans. These are:

- the accrued benefit of each participant derived from employer contributions, when expressed as an annual retirement benefit, is not less than the applicable percentage of the participant's final average pay;
- the contribution requirements with respect to the CODA are met if it constitutes an automatic contribution arrangement and the employer is required to make matching contributions equal to 50 percent of the elective contributions of the employee, with an elective contribution ceiling of 4 percent of compensation; and
- the vesting requirement for an employee who has completed at least 3 years of service is a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

All contributions, benefits, rights, and features under each plan must be provided uniformly to all participants. The requirements of IRC § 401(a)(4) and IRC § 410(b) must be met without taking into account social security and without being combined with any other plan. There must be an annual notice of rights and obligations.

Consistent provisions were added to ERISA at § 210(e).

### **Effective Date**

Effective for plan years beginning after December 31, 2009.

**IRC § 415(b)(2)(E)—INTEREST RATE ASSUMPTION FOR APPLYING BENEFIT  
LIMITATIONS TO LUMP SUM DISTRIBUTIONS (PPA § 303)**

**Summary of Law**

In order to calculate lump sums (and other benefit forms) to which IRC § 417(e) (qualified joint and survivor annuities) applies, interest rate assumptions for IRC § 415(b) limitation purposes were changed by the PPA from using just the interest rate on 30-year Treasury securities to the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the interest rate on 30-year Treasury securities were the interest rate assumption. The result is that the greatest of this rate, 5.5%, or the interest rate specified in the plan must be used. In the case of a plan under which lump-sum benefits are determined solely as required under the minimum value rules (rather than using an interest rate that results in larger lump-sum benefits), the interest rate specified in the plan is the interest rate applicable under the minimum value rules.

This provision is only applicable to benefits covered by IRC § 417(e) (and this section is not applicable to government plans). Other benefit adjustments are subject to the rule in IRC § 415(b)(2)(E)(i), which is that the interest rate assumption shall not be less than the greater of 5% or the rate specified in the plan.

**Effective Date**

Effective for distributions made in years beginning after December 31, 2005.

**IRC § 415(n)—CLARIFICATIONS REGARDING PURCHASE OF  
PERMISSIVE SERVICE CREDIT (PPA § 821)**

[PERMISSIVE]

**Summary of Law**

Section 821 of the PPA amends IRC § 415(n) (containing more favorable limits for permissible service credit purchases), providing significant relief concerning the definition of "permissive service credit," as interpreted by the IRS in several recent private letter rulings. First, it clarifies that participants (as opposed to just current employees) are eligible for this provision. Second, this Section provides that permissive service may include periods for which there is no performance of service ("airtime") (subject to the limits on nonqualified service), and also may include service already credited in the plan, where an increased (or enhanced) benefit is being purchased. Third, it clarifies the definition of educational organization service to include non-U.S. schools. Fourth, the Section clarifies that the limits on nonqualified service credit purchases do not apply to trustee-to-trustee transfers from a section 457(b) plan or a section 403(b) plan. Fifth, the Section provides that, once a trustee-to-trustee transfer is made from such a plan to a governmental defined benefit plan, the defined benefit distribution rules are applicable to the transferred amounts and to the benefits attributable to these amounts.

In new instructions to Form 1099R just issued by the Internal Revenue Service, the IRS has indicated the transferred amounts used to purchase permissive service should not be reported on Form 1099R.

### **Effective Date**

The provision is generally effective as if included in the amendments made by Section 1526 of the Taxpayer Relief Act of 1997 (contributions after December 31, 1997), except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by Section 647 of EGTRRA (transfers after December 31, 2001).

### **IRC § 420—USE OF EXCESS PENSION ASSETS FOR FUTURE RETIREE HEALTH BENEFITS AND COLLECTIVELY BARGAINED RETIREE HEALTH BENEFITS (PPA § 841)**

[MANDATORY]

### **Summary of Law**

Section 841 of the PPA amends IRC § 420 to lower the 125% funding threshold to 120% in the case of "qualified future" and collectively bargained transfers for determining the amount that may be transferred from pension assets to retiree medical accounts. The lower threshold applies if the transfer is to fund current and future retiree medical benefits and must be made for at least a two-year period (the "transfer period"). During the transfer period, the defined benefit plan's funding must be kept at the minimum level. Special rules are provided for collectively bargained plans. (Note: There is a technical problem with the statutory language, but we anticipate a correction on that language.)

### **Effective Date**

Effective for transfers after August 17, 2006.

### **IRC § 457, IRC § 403(b), & IRC § 401(k)—MODIFICATIONS OF RULES GOVERNING HARDSHIPS AND UNFORESEEN FINANCIAL EMERGENCIES (PPA § 826)**

[PERMISSIVE]

### **Summary of Law**

Without making a change in the Code, Section 826 of the PPA directs the Secretary of the Treasury to issue regulations within six months (*i.e.*, by February 17, 2007) to provide greater flexibility for purposes of hardship or unforeseeable financial emergency distributions from section 401(k), section 403(b), and section 457(b) plans, as well as nonqualified deferred compensation plans under IRC § 409A. Under current regulations, a hardship or unforeseeable financial emergency includes a hardship or unforeseeable financial emergency of a participant's spouse or dependent. The Treasury is directed to modify the hardship regulations to permit a hardship or unforeseeable financial emergency distribution with respect to any beneficiary of a

participant designated under the plan who experiences a hardship or unforeseen financial emergency.

### **Effective Date**

Effective August 17, 2006.

## **IRC § 457(e)—ELIGIBILITY FOR PARTICIPATION IN RETIREMENT PLANS (PPA § 825)**

### **Summary of Law**

Section 825 of the PPA provides relief for individuals who received distributions from a section 457(b) plan under IRC § 457(e)(9) prior to the amendments of the Small Business Job Protection Act of 1996.

### **Effective Date**

Effective August 17, 2006.

## **IRC § 457(e) AND IRC § 457(f)—VOLUNTARY EARLY RETIREMENT INCENTIVE AND EMPLOYMENT RETENTION PLANS MAINTAINED BY LOCAL EDUCATIONAL AGENCIES AND OTHER ENTITIES (PPA § 1104)**

### **Summary of Law**

Section 1104 of the PPA amends IRC § 457(e)(11) and ADEA § 4(l)(1) (along with coordinating amendments to ERISA) to exempt certain voluntary early retirement incentive plans ("VERIPs") maintained by local educational agencies and certain tax-exempt education associations from IRC § 457 because they are deemed to be bona fide severance pay plans. Non-governmental VERIPs under this provision will also be treated as welfare benefit plans under ERISA. An "applicable voluntary early retirement incentive plan" is treated as a bona fide severance pay plan with respect to any payments or supplements made as an early retirement benefit, a retirement-type subsidy, or a Social Security supplement, to the extent the payments or supplements could otherwise have been provided under a defined benefit plan that is maintained by a State or local government (or an instrumentality of a State or local government) or by a tax-exempt education association and are in coordination with such a defined benefit plan. For purposes of IRC § 457(e)(11) but not for ADEA § 4(l)(1), the determination of whether these payments could have been provided under the defined benefit plan is to be determined as if IRC § 411 applied to the defined benefit plan. For purposes of ADEA, however, the VERIP is treated as part of the defined benefit pension plan and is not considered severance pay.

Section 1104 of the PPA also amends IRC § 457(f) to exempt certain employment retention plans ("ERPs") maintained by local educational agencies and certain tax-exempt education associations from IRC § 457(f). Non-governmental ERPs will be treated as welfare benefit plans under ERISA. An ERP will be excluded from IRC § 457(f) coverage, so long as the benefits payable to the participant are not in excess of twice the applicable dollar limit determined under IRC § 457(e)(15) (for 2006, the dollar limit under IRC § 457(e)(15) is

\$15,000). The ERP must be designed to pay, upon termination of employment, compensation to an employee of a local educational agency or a tax-exempt education association for the purposes of retaining the services of the employee or rewarding the employee for service with one or more agencies or associations.

For purposes of both the VERIPs and the ERPs, a local educational agency is defined by Section 9101 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 7801) and an education association is defined to mean an association that principally represents employees in one or more local educational agencies and which is described in IRC § 501(c)(5) or (6) and exempt from taxation under IRC § 501(a).

### **Effective Date**

Effective August 17, 2006, and applicable to taxable years and plan years ending after August 17, 2006. PPA Section 1104(d)(4) provides that nothing in the amendments made by PPA § 1104 shall alter or amend the construction of the IRC, ERISA, or ADEA as applied to any plan, arrangement, or conduct to which the amendments do not apply. IRS and EEOC interpretations will be critical when interpreting these changes.

## **IRC § 3304(a)—NO REDUCTION IN UNEMPLOYMENT COMPENSATION AS A RESULT OF PENSION ROLLOVERS (PPA § 1105)**

[MANDATORY]

### **Summary of Law**

Section 1105 of the PPA amends IRC § 3304(a) to provide that unemployment compensation cannot be reduced as a result of any pension, retirement or retired pay, annuity, or similar payment which is a rollover distribution and, therefore, not includible in the gross income of the individual for the taxable year in which it is paid.

### **Effective Date**

Effective for unemployment compensation paid for weeks beginning on or after August 17, 2006.

**RELEVANT PPA PROVISIONS AFFECTING ERISA AND ADEA**

**ERISA § 3(42)—PROHIBITED TRANSACTION RULES RELATING  
TO FINANCIAL INSTITUTIONS – DEFINITION OF  
PLAN ASSET VEHICLE (PPA § 611(f))**

**Summary of Law**

PPA § 611 makes a number of amendments regarding investments and financial institutions for ERISA-covered plans. In addition, PPA § 611(f) adds a definition of plan assets as ERISA § 3(42), which may have significance for governmental plans that invest in private equity. The JCT Explanation explains the present law and the PPA changes as follows:

Under ERISA regulations . . . , when a plan holds a non-publicly-traded equity interest in an entity, the assets of the entity may be considered plan assets in certain circumstances unless equity participation in the entity by benefit plan investors is not significant. *[footnote omitted]* In general, such equity participation is significant if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value of any class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors, defined as (1) employer-sponsored plans (including those exempt from ERISA, such as governmental plans), (2) other arrangements, such as IRAs, that are subject only to the prohibited transaction rules of the Code, and (3) any entity whose assets are plan assets by reason of a plan's investment in the entity. *[footnote omitted]* In that case, unless an exception applies, plan assets include the plan's equity interest in the entity and an undivided interest in each of the underlying assets of the entity.

\* \* \*

Under the provision, the term 'plan assets' means plan assets as defined under regulations prescribed by the Secretary of Labor. Under the regulations, the assets of any entity are not to be treated as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total value of each class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors. For this purpose, an entity is considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors, which means an employee benefit plan subject to the fiduciary rules of ERISA, any plan to which the prohibited transaction rules of the Code applies, and any entity whose underlying assets include plan assets by reason of a plan's investment in such entity.

**Effective Date**

Effective with respect to transactions occurring after August 17, 2006.

**ERISA § 204(b), IRC § 411, & ADEA § 4(i)—BENEFIT  
ACCRUAL STANDARDS (PPA § 701)**

[RESERVED]

**ERISA § 404(c)—TREATMENT OF INVESTMENT OF ASSETS BY PLAN  
WHERE PARTICIPANT FAILS TO EXERCISE  
INVESTMENT ELECTION (PPA § 624)**

**Summary of Law**

Section 624 of the PPA amends ERISA § 404(c) (as amended by Section 622 of the PPA) to address ERISA's fiduciary liability provisions where a participant in an individual account plan fails to make an investment election, resulting in the account being invested in the plan's default investment options. If certain requirements are met, ERISA § 404(c) provides protection from fiduciary liability under an individual account plan where the participant directs the investment of his or her account, under the general premise that in this situation it is the participant (not the plan fiduciary) that is controlling the investment of the account. PPA amends this ERISA provision to provide that if:

- the plan fiduciaries establish default investment options in accordance with regulations to be issued by the Department of Labor; and
- an annual notice is provided to participants regarding their right to direct the investment of their accounts and explaining how accounts will be invested in the absence of a participant's investment election;

the participant will be treated as exercising control over the assets in the account for purposes of the fiduciary liability exception under ERISA § 404(c).

**Effective Date**

Effective for plan years beginning after December 31, 2006. The final regulations must be issued by the Department of Labor no later than February 17, 2007. (Note: the Department of Labor issued proposed regulations on September 27, 2006 on this provision. While not directly applicable to governmental plans, the regulations will be an important consideration for governmental plans contemplating a change in default elections.)

**ERISA § 408(b)—PROHIBITED TRANSACTION EXEMPTION FOR  
PROVISION OF INVESTMENT ADVICE (PPA § 601)**

**Summary of Law**

Section 601(a)(1) of the PPA amends ERISA § 408(b)(14) and IRC § 4975(d)(17) to create a new exemption from the prohibited transaction rules with respect to investment advice. It applies to advice provided after December 31, 2006. It provides that employers are exempt from fiduciary liability with respect to prohibited transactions under ERISA and the IRC when they provide participants in 401(k) plans and IRAs investment advice, despite conflicts of

interest, if the investment advice is provided using an "eligible investment advice arrangement." Such an arrangement must meet various requirements but generally must be fee neutral for the adviser with respect to investment options chosen or be a computer model meeting various standards. There are also audit and certification requirements.

Investment advice provided by a fiduciary adviser under the fee neutral approach must include certain disclosures and the adviser must be either a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker or dealer under the Securities and Exchange Act of 1934, including affiliates and employees, agents, and representatives of these advisers. A six-year record keeping requirement is also included.

Investment advice provided using a computer model must use a model that applies generally accepted investment theories. It must take into account the historic returns of different asset classes over defined periods of time, utilize relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments. The model must utilize prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan. It must operate in a manner that is not biased in favor of investments offered by the fiduciary adviser providing the model or a person with a material affiliation or contractual relationship with the fiduciary adviser. It must take into account all investment options under the plan in specifying how a participant's account balance should be invested. The model may not be inappropriately weighted with respect to any investment option.

The Secretary of Labor, in consultation with the Secretary of the Treasury, is to solicit and review information on the feasibility of using computer model investment advice programs for individual retirement accounts, individual retirement annuities, Archer MSAs, health savings accounts, and Coverdell education savings accounts.

### **Effective Date**

The amendments to ERISA § 408(b) and § 408(g) apply with respect to advice referred to in ERISA § 3(21)(A)(ii) that is provided after December 31, 2006.

The amendments to IRC § 4975(d)(3) are effective August 17, 2006. The other provisions apply with respect to advice referred to in IRC § 4975(c)(3)(B) after December 31, 2006.

## RELEVANT NON-CODE PPA PROVISIONS

### SECTION 811 OF THE PPA—PENSIONS AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS OF ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 MADE PERMANENT

#### Summary of Law

Section 811 of the PPA makes the expiration of EGTRRA inapplicable to the changes made to pension and individual retirement arrangements by EGTRRA. Under EGTRRA, the provisions relating to pensions and IRAs did not apply for taxable, plan or limitation years beginning after December 31, 2010.

The JCT Explanation gives the following list of affected provisions (we have included only those of interest to governmental plans):

#### Individual retirement arrangements ("IRAs")

- Increases in the IRA contribution limits, including the ability to make catch-up contributions (secs. 219, 408, and 408A of the Code and sec. 601 of EGTRRA); and
- Rules relating to deemed IRAs under employer plans (sec. 408(q) of the Code and sec. 602 of EGTRRA).

#### Expanding coverage

- Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plan (secs. 401(a)(17), 402(g), 408(p), 414(v), 415, and 457 of the Code and sec. 611 of EGTRRA);
- Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations (sec. 457 of the Code and sec. 615 of EGTRRA); and
- Option to treat elective deferrals as after-tax Roth contributions (sec. 402A of the Code and sec. 617 of EGTRRA).

#### Enhancing fairness

- Catch-up contributions for individuals age 50 and older (sec. 414 of the Code and sec. 631 of EGTRRA);
- Equitable treatment for contributions of employees to defined contribution plans (secs. 403(b), 415, and 457 of the Code and sec. 632 of EGTRRA);

- Modifications to minimum distribution rules (sec. 401(a)(9) of the Code and sec. 634 of EGTRRA);
- Clarification of tax treatment of division of section 457 plan benefits upon divorce (secs. 414(p) and 457 of the Code and sec. 635 of EGTRRA); and
- Provisions relating to hardship withdrawals (secs. 401(k) and 402 of the Code and sec. 636 of EGTRRA).

#### Increasing portability

- Rollovers of retirement plan and IRA distributions (secs. 401, 402, 403(b), 408, 457, and 3405 of the Code and secs. 641-644 of EGTRRA);
- Rationalization of restrictions on distributions (secs. 401(k), 403(b), and 457 of the Code and sec. 646 of EGTRRA);
- Purchase of service credit under governmental pension plans (secs. 403(b) and 457 of the Code and sec. 647 of EGTRRA);
- Minimum distribution and inclusion requirements of section 457 plans (sec. 457 of the Code and sec. 649 of EGTRRA); and
- Automatic rollovers of certain mandatory distributions (secs. 401(a)(31) and 402(f)(1) of the Code and sec. 657 of EGTRRA).

#### **Effective Date**

Effective August 17, 2006.

### **SECTION 830 OF THE PPA—DIRECT PAYMENT OF TAX REFUNDS TO INDIVIDUAL RETIREMENT PLANS**

#### **Summary of Law**

Section 830 of the PPA requires the Secretary of the Treasury to make a form available so that individuals may direct a tax refund to an individual retirement plan. The direct deposit for tax refunds would be available for only traditional individual retirement accounts (IRC § 408(a)) and individual retirement annuities (IRC § 408(b)).

#### **Effective Date**

Effective for taxable years beginning after December 31, 2006.

**SECTION 1101 OF THE PPA—EMPLOYEE PLANS  
COMPLIANCE RESOLUTION SYSTEM**

**Summary of Law**

Section 1101 of the PPA encourages the IRS to expand and extend the Employee Plans Compliance Resolution System ("EPCRS") and in particular the use of the Self-Correction Program. The Section, according to the JCT Explanation:

. . . clarifies that the Secretary of the Treasury has the full authority to establish and implement EPCRS (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise or other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure.

The Secretary of the Treasury is directed to continue to update and improve EPCRS (or any successor program), giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures, (3) extending the duration of the self-correction period under SCP for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under SCP during audit, and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

**Effective Date**

Effective August 17, 2006. Note: The IRS has recently issued a new revenue procedure on EPCRS, Rev. Proc. 2006-27.

**SECTION 1107 OF THE PPA—PROVISIONS  
RELATING TO PLAN AMENDMENTS**

**Summary of Law**

Section 1107 of the PPA provides guidance on plan amendments with respect to the PPA.

**Effective Date**

Amendments must be made by the last day of the first plan year beginning on or after January 1, 2009 (2011 for government plans).

## **SECTION 1304 OF THE PPA—QUALIFIED TUITION PROGRAMS**

### **Summary of Law**

Section 1304 of the PPA makes qualified tuition programs (known as "529 programs") permanent. These programs allow an individual to establish a tax-deferred account to either prepay qualified higher education expenses on a beneficiary's behalf (a "prepaid tuition program") or make contributions to the account to pay for future qualified higher education expenses (a "savings account program").

### **Effective Date**

Effective August 17, 2006.

## **CIRCULAR 230 DISCLOSURE**

To ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

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