

Memorandum

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PENSION PROTECTION ACT **QUICK SUMMARY OF MAJOR PUBLIC SECTOR PROVISIONS**

The "Pension Protection Act of 2006" is on its way to the President for signature and he will sign it. This memo provides a quick summary of major public sector provisions.

If you want to read the 907 page bill, it is at

<http://waysandmeans.house.gov/media/pdf/taxdocs/pensiontextpt1.pdf>

A 43 page summary prepared by the Senate Finance Committee is at

<http://www.senate.gov/~finance/sitepages/leg/072806summarypensionconf.pdf>

A 4 page summary prepared by the Ways and Means Committee is at

<http://waysandmeans.house.gov/media/pdf/taxdocs/072806pensionsummary.pdf>

Summary of Major Public Sector Provisions

1. **Eases purchase of "airtime" and purchase of upgraded service credit** (Bill sec. 821) -- retroactively effective as if included in TRA '97 and EGTRRA

Current law prohibits the in-service transfer of 457 and 403(b) plan money to a defined benefit retirement system in order to pay for upgraded service, as from general to safety membership. Current law also is unclear on whether an in-service transfer of this money can be made to purchase service credit under a retirement system for "airtime" when no "service" has been performed. Also, current law prohibits the in-service transfer of this money when a member has fewer than 5 years of participation in the recipient defined benefit plan.

H.R. 4 makes the following changes:

- Allows the purchase of airtime with in-service transfers from 457 and 403(b) plans by eliminating the requirement that a transfer be for "performance of service".
- Allows the purchase of upgraded service credit (e.g., a move from general to safety credit) with in-service transfers from 457 plans by allowing purchase "to provide an increased benefit for [existing] service credit".
- Allows the purchase of airtime or of upgraded service credit with in-service transfers from 457 and 403(b) plans to purchase service if the member has fewer than 5 years of participation in the recipient plan.

- Clarifies that the distribution rules of the recipient defined benefit plan apply to benefits purchased with a transfer from a 457 or 403(b) plan.
2. **Clarifies minimum distribution rules from qualified retirement plans** (Bill sec. 823) -- effective on enactment

A number of public sector defined benefit retirement systems have had difficulty in meeting the “minimum distribution requirements” for qualified plans because they provide benefits that are unusual in the private sector or because they are subject to “vested rights” rules.

- H.R. 4 requires Treasury to issue regulations providing relief from these rules as long as the plan complies with a reasonable good faith interpretation of the statute (not of the existing regulations). The new regulations are to apply retroactively.
3. **Establishes New rules on what is a “hardship” for 457 and 403(b) plan distributions to beneficiaries** (Bill sec. 826) -- effective on issuance of new Treasury regulations
- Under current law, distributions can be made from 457 and 403(b) plans for “hardship” of a member, spouse or dependent. H. R. 4 directs Treasury to issue new regulations extending these rules to beneficiaries in addition to a spouse or dependent.
4. **Waives 10% “early withdrawal” penalty tax for safety employees who retire at or after age 50** (Bill sec. 828) -- effective for distributions after date of enactment

Under current law, a 10% penalty tax applies to distributions from a qualified plan to a person who retires before 55 unless, generally, the distribution is taken as an annuity. Therefore, lump sum distributions from a “401(a)” plan or a DROP account would be subject to this penalty. Of course, the tax can be avoided with a rollover to, e.g., an IRA.

- H.R. 4 lowers the age for avoiding the penalty to age 50 for employees who provide police protection, firefighters, or emergency medical services within the jurisdiction of their employer.
5. **Provides new tax free retiree health and long term care benefits for safety retirees** (Bill sec. 845) -- effective for years beginning after 12/31/06

Under current law, the IRS takes the position that retiree health premiums cannot be paid on a pre-tax basis by retirees from their pension. The IRS takes the position that only current employees can choose to pay for these premiums on a pre-tax basis from current salary. The IRS may not be right, but this is their published position.

H.R. 4 changes this rule for safety retirees as follows:

- Allows up to \$3,000 per year of pension distributions to be used, tax free and on an individual elective basis, to pay for health or long term care premiums for the retiree, spouse or dependent.
- Limits this provision to law enforcement officers, firefighters, chaplains, and members of a rescue squad or ambulance crew.
- Limits this provision also to qualified safety employees who retire on disability or after “normal retirement age” (a fuzzy concept in the public sector).
- Requires that the retirement plan pay the premiums directly to the vendor.
- Does not provide for a cost-of-living increase in the \$3,000 limit.

Because this provision will take effect on January 1, 2007, and requires that an election be made in advance of payment of premiums to be effective, public retirement systems may want to consider taking quick action including communications to members, providing election forms, and reviewing their systems to ensure that retirees can obtain full use of this benefit.

6. **Makes Permanent EGTRRA Benefit Provisions** (Bill Section 811) -- effective on enactment.

The bill makes permanent the favorable benefits provisions in EGTRRA including expanding: the “compensation” limits of section 401(a)(17), the annual benefit limits of section 415, the deduction limits for section 457(b), the elimination of coordination limits between section 457(b) and section 403(b) and 401(k) plans, the catch- contribution rules for members age 50 and over, and the rollover rules.

Other Major Provisions of Interest

H.R. 4 includes a number of other provisions that are not focused on the public sector but will affect public plans. Some of the most important are listed below.

1. **Vendors can give members investment advice** (Bill sec. 601) -- effective for transactions on or after 1/1/2007

Under ERISA, H.R. 4 allows vendors such as mutual funds that administer 401(k) plans to provide investment advice to individual participants using an objective computer model that is certified by an independent party. (There is no requirement for 401(k) plans, as there is for IRAs, that the adviser’s compensation not vary with the investments selected.) We expect to see this same model rolled out to participants of 457 plans and “401(a)” plans for public employees. However, because public employees and plan fiduciaries are governed by state law, not by ERISA, there may be additional legal issues to resolve before this model can be used.

2. **"Default" investments approved** (Bill sec. 624) -- effective for years beginning after 12/31/2006.

Under ERISA, H. R. 4 gives protection to fiduciaries where a member does not make an investment choice and the plan sponsor makes a default investment consistent with to-be-developed Labor Department regulations. This eases the administration for plans with automatic enrollment. This model may also help public sector plans.

3. **Changes the rule on paying retirement benefits to retirees who continue to work** (Bill sec. 905) -- effective for distributions in plan years beginning after 12/31/2006

Under current law, tax qualified pension plans cannot pay benefits to a retiree who continues to work until he/she has reached "normal retirement age". Normal retirement age is often a fuzzy concept in the public sector. The IRS had issued very complex proposed regulations to ease this rule, but they did not work. H.R. 4 cuts through the complexity and allows "in-service" pensions to be paid to an employee who is at least age 62.

4. **Expands IRS authority to work with qualified plans to correct errors** (Bill sec. 1101) -- effective on enactment.

The tax rules governing qualified retirement plans are very complex, and it can be very difficult for plans to comply with them. For a number of years, the IRS has operated a voluntary compliance program to encourage plans to correct problems and pay modest (usually) penalties. The program has been very successful but it has been hampered by limits on the IRS' ability to work with plans in some circumstances. H.R. 4 expands the IRS authority to work out corrections and allows the IRS to waive or reduce "any income, excise or other tax" to "ensure that any tax, penalty, or sanction is not excessive and bears a reasonable relationship" to the noncompliance. We expect that initially the IRS will exercise this new authority with caution, but that over time it may become of substantial importance to public retirement systems.

5. **Future Watch**

Much of the Bill deals with the minimum funding rules for private sector plans. These rules do not affect the public sector, but the Congress has shown some interest in the funding level of public plans, so this is an area to carefully watch. The Congress could regulate public sector plan funding through the tax qualification rules, which would most probably not involve any constitutional issues of federal regulation of state conduct.

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Please call any of our Benefits Group lawyers at 415 777 3200 if you have questions about this Bill. You may call: Bob Blum, Connie Hiatt, Marcus Wu, Ed Frueh, Carol Collins or Anne Hydorn.