The Pension Protection Act of 2006

The Pension Protection Act (PPA) has something for everyone. While media focus has been on the new law’s overhaul of the rules governing defined benefit pension plans, the legislation also makes a variety of changes affecting 401(k) and other defined contribution plans, plan sponsors, and participating employees.

**EGTRRA Provisions**

PPA makes permanent all retirement plan and IRA related changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), including:

- The increases in maximum annual salary deferrals to 401(k), 403(b), and 457 plans and in IRA contribution limits;
- Catch-up contributions for individuals age 50 or older;
- The option to treat elective deferrals as after-tax Roth contributions (if the plan permits); and,
- The Saver’s Credit for lower-income individuals who save for retirement. Under PPA, the income limits for the credit will now be adjusted for inflation.

**Incentives To Save**

PPA contains numerous provisions designed to help plan sponsors encourage employees to better plan for retirement.

- Elimination of conflicts with state laws on wage withholding without employee consent.

**Investment advice.** The new law allows retirement plan service providers who offer investments to the plan (“fiduciary advisers”) to provide advice and, if warranted, recommend their own funds without violating fiduciary rules. To qualify, an investment advice arrangement has to be fee-neutral with respect to the investments chosen or use an unbiased computer model certified by an independent expert to create a recommended portfolio for a participant’s consideration. The new rules generally apply beginning in 2007.

**New participant disclosure rules.** Generally, for plan years beginning after 2006, 401(k) and other defined contribution plans must provide participants who can direct their own investments with benefit statements at least quarterly. Participants who cannot direct investments must receive at least one statement a year. For defined benefit plans, employees having nonforfeitable accrued benefits generally must receive a benefit statement at least once every three years (or on written request). The U.S. Department of Labor will issue model benefit statements that will satisfy these requirements.

*(continued on page 2)*
DB(k) plans. Beginning in 2010, employers will be able to offer “eligible combined plans” that combine elements of a defined benefit plan with those of a 401(k) plan. The employer cannot have more than 500 employees. The 401(k) component of the plan must include a 4% of pay automatic enrollment feature and a fully vested 50% match on the first 4% of pay deferred. Other requirements apply.

Direct rollovers to Roth IRAs. Starting in 2008, participants will be able to make direct rollovers from employer-sponsored plans to Roth IRAs. Such rollovers will be taxable events.

In-service distributions. For distributions in plan years beginning after 2006, defined benefit plans can make in-service distributions to participants age 62 or older seeking to phase into retirement.

Beneficiary Provisions

PPA makes it easier for beneficiaries to move their benefits to other retirement plans and to receive plan distributions.

Hardship distributions. Hardship distributions are allowed for hardships of 401(k) plan beneficiaries who are not a participant’s spouse or dependent. Similar rules apply for unforeseeable financial emergencies for beneficiaries in 457(b) and 409A nonqualified arrangements.

Inherited benefits. Beginning in 2007, non-spouse plan beneficiaries can roll over inherited 401(k) and other retirement account balances to their own IRAs. Previously, only surviving spouses could do this. Non-spouse beneficiaries generally will have to begin their distributions immediately; surviving spouses can continue to wait until they turn age 70½.

New Defined Benefit Plan Rules

For defined benefit plans, the new law:

- Reforms plan funding requirements;
- Increases the tax deduction limits for defined benefit plan sponsors, under certain conditions;
- Changes the rules for calculating lump-sum distributions from defined benefit plans;
- Provides special funding relief for specific industries, including airlines and defense contractors;
- Restricts benefit payouts with respect to underfunded plans and imposes significant tax penalties on executives whose employers set aside or reserve assets in nonqualified deferred compensation plans when the employer’s defined benefit plan is “at risk” or the plan sponsor is in bankruptcy.

The defined benefit provisions are generally effective for the 2008 plan year (with some exceptions).

Improperly Excluded Employees

SITUATION: We recently discovered that one of our employees became eligible to participate in our 401(k) plan in February. However, she was not notified of her eligibility, nor invited to attend our monthly enrollment meeting. We notified her as soon as we found the error, and she joined the plan on September 1st.

QUESTION: Can we correct the mistake without being penalized for our error?

ANSWER: Yes. You can use the U.S. Department of Labor’s recently updated Employee Plans Compliance Resolution System (EPCRS) to bring your plan back into compliance with the tax law. The Self-Correction Program (SCP) component of EPCRS lets a plan sponsor identify and correct operational failures without notifying the IRS or paying any fee.

DISCUSSION: Under the old EPCRS, employers could correct full-year exclusions by making a qualified nonelective employer contribution (QNEC) to the excluded employee’s account to make up for the employee’s “lost opportunity” to make elective deferrals (other than designated Roth contributions). The QNEC was calculated by multiplying the employee’s compensation during the period of exclusion by the actual deferral percentage (ADP) of the employee’s group — nonhighly compensated employee or highly compensated employee.

The new EPCRS allows employers to correct partial-year exclusions. And it adds a new correction method that is generally less costly to employers: The employer must make a QNEC equal to 50% of the amount calculated under the old method.*

For example, let’s say your employee is a nonhighly compensated employee whose compensation during the exclusion period was $17,500. (You can use a prorated share of the annual compensation.) Your ADP for nonhighly compensated employees is 3%. To correct your error, you would need to make a QNEC of $262.50 to the employee’s plan account ($17,500 compensation × 3% ADP = $525 × 50% = $262.50).**

If you make employer matching contributions, you would also have to make a contribution equal to the match on $525. For instance, if your employer match is 50% of employee contributions up to 5% of compensation, your matching contribution would be $262.50.**

The “missed deferral opportunity” correction method cannot be used until after any necessary ADP and ACP test failures have been corrected.

* Special rules apply to safe harbor 401(k) plans.
** Required contributions must be adjusted for earnings until the contributions are made.
Highlights of the EPCRS Changes

Retirement plan administration is complex. As a result, unintentional errors may occur. To address this situation, the Internal Revenue Service established a program in the early 1990s to allow plan sponsors to correct mistakes while preserving the available tax benefits for both employers and employees.

The program is the Employee Plans Compliance Resolution System (EPCRS), and it is occasionally updated to address developing issues. The latest EPCRS enhancement was issued in May as IRS Revenue Procedure 2006-27. The changes generally become effective September 1, 2006.

The EPCRS consists of three programs: the Self-Correction Program (SCP), the Voluntary Compliance Program (VCP), and the Closing Agreement Program (Audit CAP).

SCP. Under SCP, a plan sponsor may correct insignificant "operational failures" without paying a sanction, provided there are established plan procedures and the retirement plan document has been approved by the IRS.

VCP. The VCP allows a plan sponsor to submit more complex corrections for formal IRS approval. Under the program, the employer corrects the failure and pays a fee based on the number of plan participants. A VCP application may be filed up until a plan becomes the subject of an IRS audit. (VCP has an anonymous submission option that permits an employer to see what the IRS will require to bring its plan back into compliance before agreeing to the solution.)

Audit CAP. If a failure (other than one corrected through SCP or VCP) is identified during an IRS audit, the plan sponsor is required to correct the failure and pay a sanction. The sanctions are greater than the fees imposed under VCP for two reasons: to encourage voluntary submissions, and to impose fees that bear a "reasonable relationship" to the nature, extent, and severity of the failure. When setting the sanction amount, the IRS does take into consideration the extent to which an employer attempted to make a correction before the audit began.

New corrections for plan loan errors. EPCRS provides standardized correction methods for errors that frequently arise in day-to-day administration. Let’s take a look at an area recently enhanced by new EPCRS correction methods: participant loans.

Exceeding the five-year term. If a loan was initiated with a repayment period of longer than five years (and the loan was not used to purchase a primary residence), the employer may correct the nonconforming loan by making a submission through VCP. The applicable correction is to shorten the remaining term of the loan as of the date the error is discovered so the loan will mature within five years of its origination date. In addition, the loan repayment schedule must be re-amortized. Note that the correction is not available if the discovery is made beyond five years from the loan origination date.

Paying Overdue Amounts During the Grace Period. When a participant is behind in loan repayments, but the loan is not deemed in default, he or she may either repay the overdue amount as a lump sum or re-amortize the amount over the remaining loan period. Grace periods are optional. If a plan includes a grace period for loans, the period may not extend beyond the end of the calendar quarter following the date of the first nonpayment.
Making Things Right

“A recent update to the VFCP expands the program and makes it easier to use.”

As plan fiduciaries, employers have numerous responsibilities. It can be easy to inadvertently fail to carry out each and every one of them. To help, the Voluntary Fiduciary Correction Program (VFCP) offered by the U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) allows plan officials to identify and voluntarily correct certain fiduciary violations. A recent update to the VFCP expands the program and makes it easier to use.

The VFCP is open to anyone who may be liable for a fiduciary violation under ERISA. However, EBSA will not consider a VFCP application if either the plan or the applicant is “under investigation” or the application contains evidence of potential criminal violations. The updated VFCP more narrowly defines “under investigation.”

New Covered Transactions

The updated VFCP also adds four new transactions eligible for correction, bringing the total number of covered transactions that can be corrected under the program to 19. (A full list is available online, www.dol.gov/ebsa/newsroom/fs2006vfcp.html.) The transactions that can be corrected include:

- Improper participant loan transactions, including plan loans that exceed the tax law’s dollar and duration limits or level amortization requirement, as incorporated in the plan’s terms.
- Defaulted loans caused by the failure to withhold loan repayments from an employee’s wages.
- Certain violations involving the use of plan assets to pay expenses that the sponsor should have paid.
- Situations in which a plan owns an illiquid asset — such as restricted stock, limited partnership interests, real estate, or collectibles — and the fiduciary has determined that continuing to hold the asset is not in the best interest of plan participants.

Other Changes

The new VFCP also:

- Provides additional ways to correct other transactions;
- Reduces the number of supporting documents an employer has to provide;
- Includes a model application and application submission checklist; and
- Provides an online calculator for determining the amount to be restored to a plan.

The model application, checklist, and calculator can all be found on www.dol.gov/ebsa.

Can We Help?

Our firm offers a broad range of employee benefit plan services. If we can be of service to you, please call.

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