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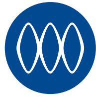

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Pension Protection Act of 2006: Provisions for Governmental Plans

By Adrien LaBombarde

The Pension Protection Act of 2006 (PPA), signed into law by the President on August 17, includes various provisions that have widespread application for all retirement plans. Included are rules regarding service purchases, portability, distribution requirements, nondiscrimination rules, and taxation issues. This *PERiScope* discusses the PPA provisions that are applicable to governmental plans.

Clarification of Certain Permissive Service Credit Purchases

The PPA clarifies that a governmental defined benefit plan may allow a member to obtain increased benefits by purchasing service credit for periods during which there was no performance of service (often called "airtime"), subject to the limits on nonqualified service (the five-year maximum being the most notable limit). The new law also exempts from testing against the §415 after-tax contribution limits any purchases made by means of a trustee-to-trustee transfer from a §403(b) annuity or §457 deferred compensation plan. Amounts so transferred become subject to the governmental plan's distribution rules. Such transfers are permissible even if made between plans maintained by different employers.

Portability/Rollovers

Governmental defined benefit plans may accept after-tax rollovers from 403(b) tax sheltered annuities, provided that the plans track the amounts separately from pre-tax amounts and the amounts are transferred in a direct rollover, effective for taxable years beginning in 2007. The PPA also includes a provision to allow direct rollovers of after-tax contributions to Roth individual retirement arrangements (IRAs), effective for rollover distributions made beginning in 2008.

Distribution Rules and Taxes

The PPA requires the IRS to publish regulations stating that a governmental defined benefit plan is to be treated as having complied with the §401(a)(9) minimum distribution rules if the plan had been following a reasonable good-faith interpretation of the statute. Although the PPA provision should generally provide relief for the past, governmental plans would remain subject to the specific rules under the IRS's minimum distribution regulations prospectively from the August 17, 2006 date of the PPA's enactment.

Early distributions in the form of a lump sum or a partial lump sum from a governmental defined benefit plan made at or after age 50 to a qualified public safety officer will be exempt from the otherwise applicable 10% excise tax (rather than at age 55 or later), effective upon the August 17, 2006 enactment date of the PPA. This change has a positive impact on public safety members who receive part of their benefit from a Deferred Retirement Option Plan (DROP) or a Partial Lump Sum Option (PLOP).

The PPA also waives the 10% early distribution tax penalty for amounts withdrawn from a defined contribution plan by employees who are military reservists or members of the National Guard who are called to active duty for at least 180 days. The amounts must be withdrawn while the employee is on active duty. Such employees are allowed to repay the withdrawn amounts into an IRA within two years of their return to employment; and any repaid amounts are not taken into account for the annual contribution limits imposed by the tax code. This provision is effective retroactively, applying to distributions after September 11, 2001.

Also, a tax-free distribution of up to $3,000 per year may be made from a governmental retirement plan, a 403(b) annuity or a governmental 457 plan to an eligible public safety officer for the purchase of health or long-term care insurance. The employee must have separated from service from the sponsoring employer due to disability or the attainment of normal retirement age. To be excluded from the employee's income, the premiums must be paid directly to the insurer from the eligible retirement plan; reimbursements of premiums paid by the employee are not eligible for the new tax break. This provision is effective for distributions made beginning in 2007.

Early Retirement and Employment Retention Incentives for Teachers

Under the PPA, plans maintained by a local educational agency or tax exempt educational association may provide voluntary early retirement benefits or retirement-type subsidies that will be treated as *bona fide* severance pay if made in coordination with a defined benefit plan maintained by an eligible governmental employer. In addition, for such agencies and associations, the law includes a provision relating to employment retention plans, under which compensation is paid to a terminated employee to retain the services of the employee or to reward the employee for past services. A special tax treatment is granted to amounts under an employment retention plan up to twice the applicable annual dollar limit on deferrals under section 457, i.e., $15,000 for 2006. The provisions are effective upon the PPA's date of enactment, but apply to taxable years ending after the date of enactment.

Permanent Extension of EGTRRA Provisions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included numerous changes to federal tax laws for retirement plans, including some that affect governmental plans. However, EGTRRA included a "sunset" provision, under which all changes enacted were to expire at the end of 2010, after which pre-EGTRRA rules would be restored. The PPA has eliminated the EGTRRA sunset, thereby permanently extending provisions of specific interest to governmental plans; these provisions include:

- Increases in dollar ceilings on annual compensation ($220,000 for 2006), annual contributions to DC plans ($44,000 for 2006), and annual benefits paid from DB plans ($175,000 for 2006 for retirements at ages 62-65).
- Age 50 "catch up contributions" to defined contribution plans.
- Trustee-to-trustee transfers from §403(b) and §457 plans to purchase permissive service credit.
- Modifications to minimum distribution rules to reflect current life expectancy.
- Repeal of coordination rules for §457 deferred compensation plans of state and local governments and tax-exempt organizations.
- Minimum distribution requirements for §457 plans.
- Clarification of tax treatment of §457 plan amounts upon divorce.
- Rollover of retirement plan and IRA distributions.

Extension of Exemption from Nondiscrimination Rules

Plans maintained by state and local governmental units have been exempt from the federal tax code's complicated rules prohibiting discrimination in favor of highly compensated employees. Other governmental retirement systems—e.g., those maintained by governmental agencies that operate independently from a state or local government—have technically remained subject to the nondiscrimination rules, although the IRS had indefinitely granted relief from application. The PPA now extends the exemption from the nondiscrimination rules to all governmental plans, effective for any year following the PPA's enactment.

Plan Amendments

Any corrective remedial amendments relating to the PPA provisions must be adopted by a governmental plan no later than the close of the plan year beginning in 2011. Prior to the adoption of a remedial amendment, the plan must be operated in accordance with the PPA.

Indian Tribal Plans

The PPA provides that the term "governmental plan" includes a defined benefit plan established or maintained by an Indian tribal government for its employees who perform governmental functions and not commercial activities. The effective date is date of enactment, August 17, 2006.

Cash Balance Plans

The PPA amends sections of ERISA and the Internal Revenue Code that pertain specifically to cash balance and other hybrid pension plans in the private sector. It also amends the Age Discrimination in Employment Act (ADEA), which applies to all plans and employers. These changes generally require that defined benefit plans provide equal treatment of "similarly situated" employees, regardless of age. This outcome is favorable for governmental plans as there is no cross reference to ERISA as had been in prior versions of the bill. In addition, a market rate of return is created as a maximum interest crediting rate, although the Treasury Department is to provide further guidance. These new provisions should be helpful for any system wishing to implement a cash balance plan.

Summary

The PPA has been widely reported in the media recently because of its sweeping changes in the private sector. While the changes for governmental plans were not so sweeping, there are nonetheless some important changes that may prove to be beneficial for many governmental systems and members.

Have You Properly "Picked Up"?

Employee contributions to a governmental retirement system are treated as employer contributions if the contributions are picked up by the employer under section 414(h)(2) of the tax code. In recently published Revenue Ruling 2006-43, the IRS points out that pick-up treatment requires formal action evidenced by a written document applicable to future amounts. Also, a pick-up arrangement may not permit a member to opt out of the pick-up or to receive the contributed amounts in lieu of the having the employer contribution paid to the plan. Public plans with pick-up arrangements that do not currently satisfy the formal action requirement may be eligible for relief if written documentation is adopted before January 1, 2009.

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