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Technical Bulletins: Essentials of the Pension Protection Act

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THE UNIVERSITY of TENNESSEE

MUNICIPAL TECHNICAL ADVISORY SERVICE

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TECHNICAL bulletin

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ESSENTIALS OF THE PENSION PROTECTION ACT

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Referred to as the most significant and sweeping pension reform in more than 30 years, the Pension Protection Act (PPA) was signed into law on August 17, 2006 (H.R. 4, Public Law 109-280). Regulatory agencies such as the Department of Labor and Internal Revenue Service have spent much of the last 20 months clarifying the new rules and offering advice on the near 1,000-page law, which impacts retirement plans of all types, including profit-sharing and 401(k) plans. Although it is still unclear what the long-term impact is on the landscape of retirement plans, most agree that it is largely positive as it allows American workers to expand their retirement opportunities while improving the pension system at large.

The PPA addresses underfunding issues related primarily to private sector pension plans. In the last decade there has been much attention drawn to a number of large, underfunded pension plans that have unexpectedly terminated or drastically reduced benefits due to severe funding issues, leaving large numbers of employees largely unprepared for retirement. The legislation aims at protecting mature workers who participate in traditional pension (DB) plans that may be at risk of wearaway — the freezing or reduction of pension benefits after conversion of a cash balance pension plan.

DEFINED BENEFIT PLANS (DB)

A defined benefit plan is an employer-sponsored benefit plan that promises the participant a specific monthly benefit at retirement and may state this as an exact dollar amount. Monthly benefits could also be calculated through a formula that considers a participant's salary and service. Unlike defined contribution plans, the participant is not required to make investment decisions. A defined benefit plan is sometimes referred to as a fully-funded pension plan or traditional type of pension plan.

DEFINED CONTRIBUTION PLANS (DC)

A defined contribution plan provides an individual account for each participant. The benefits are based on the amount contributed into the plan and are also affected by income, expenses, gains and losses. There are no promises of a set monthly benefit at retirement. Some examples of defined contribution plans include 401(k), 457, 403(b) plans, employee stock ownership plans and profit sharing plans.

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Through the Pension Protection Act, Congress attempts to provide workers with enhanced security by strengthening funding requirements and administration of defined benefit pension plans. The PPA also contains provisions for defined contribution plans such as 401(k) plans, IRAs, 457 plans, and 403(b) plans.

Although much of the PPA may not currently affect the administration of your city's plan, it is important to be familiar with the key features of the new act because it is expected that this reform will drastically impact state and local policies for years to come.

The PPA includes provisions that:

- Require adequate pension plan funding by holding employers accountable for all obligations equaling the full value of accrued benefits;
- Prevent employers from underfunding plans and making failed promises by shortening the period in which a plan can amortize liabilities;
- Require that poorly funded plans have shorter amortization periods and increased contribution requirements;
- Increase limits on employees' and employers' tax-deductible contributions for traditional pension plans as well as 401(k), 403(b), and 457(b) plans;
- Encourage automatic enrollment in retirement plans that will also increase the probability of passing discrimination testing;
- Clarify discrimination rules on cash balance plans;
- Allow eligible public safety employees to retire at a younger age without tax penalty;
- Clarify eligible public service employees' ability to purchase "service credits" in state or local pension plans for certain time periods;
- Require that participant communication be expanded, clarified and provided more frequently;
- Make it easier for employers to provide investment advice to employees;
- Offer plan sponsors the opportunity to transfer excess pension assets from DB plans to fund projected retiree healthcare costs for up to 10 years;
- Make permanent the additional $5,000 catch-up provision for workers age 50 and older;
- Allow additional tax credit available to taxpayers with gross incomes of less than $25,000 single and $50,000 married;
- Make Roth 401(k) plans more attractive by making the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provisions permanent;
- Require increased transparency on fees, funding status, material changes, conflicts of interest, compensation, fiduciary changes etc.;
- Allow taxpayers to deposit a portion of their federal income tax directly into an IRA;
- Provide ease of portability between plans; and
- Make permanent the "saver's credit," which provides up to a 50 percent tax credit for low- and moderate-income families who contribute up to $2,000 a year to a retirement plan.

The PPA makes long-anticipated funding reforms and contains a number of tax advantages for workers saving for retirement. Among other laws, the PPA amends the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). The PPA also makes permanent many of the retirement provisions temporarily imposed through EGTRRA, which would have expired at the close of 2010. Most notably, it allows faster vesting and higher deferral and contribution limits.

The PPA does not address funding issues for most city pension plans because public sector pension plans are governed by state laws rather than the federal government or ERISA, which governs workplace retirement plans in the private sector.

The act penalizes employers who fail to set aside enough reserves to adequately fund current and future pension obligations by requiring that those companies pay additional premiums. The new funding provisions are designed to have plan assets equal to 100 percent of liabilities within seven years. The law provides for exceptions for certain industries such as airline, steel and automobile.

The act encourages employers to enroll employees in retirement plans such as 401(k), 403(b), and 457(b) plans through automatic enrollment by preempting state laws that may have designated these practices as illegal “withholding of wages” in the past. It is projected that automatic enrollment provisions will increase participation by up to 35 percent. Employers who adopt automatic enrollment may be required to defer certain percentages of pay as determined by plan type. The plans must also adhere to matching and vesting schedules.

The PPA strengthens employers’ ability to provide retirement-related advice to employees by allowing a plan’s investment platform provider to advise plan sponsors and participants on their retirement plans as long as the communication meets the disclosure requirements of the act.

While the new law focuses largely on private sector pension plans, it does have some provisions that affect pensions for public-sector workers and employees who participate in 457 and 403(b) plans as well as employees enrolled in state pension plans, specifically public safety employees.

PUBLIC EMPLOYEES

The act provides enhanced benefits for public safety workers. In addition to firefighters, police officers, and emergency medical service workers, the act’s definition of public safety officers includes chaplains and individuals involved in crime and juvenile delinquency control such as corrections, probation, parole and judicial officers.

One of the more significant changes that affect public employees is the enhanced retirement benefit for public safety officers that will now allow those employees to retire earlier than other groups of employees due to the strenuous nature of their work. Previously, these employees were penalized with a 10 percent early withdrawal penalty on DB pension payments if they retired before age 55. The act lowers that age to 50 for public safety employees.

The new legislation also allows retired or disabled public safety officers to pay up to $3,000 toward healthcare premiums and long-term care premiums for themselves, spouse or dependents with pre-tax dollars from their pension checks.

In addition, the PPA allows public sector employees to buy service credits in their state or local pension plan for the years they were not employed or may have worked with another employer. This means the employee can use his or her own money, which includes funds from a 403(b) or 457 plan, to pay for service credits.

If money is transferred, it will be subject to the rules of the pension plan. These purchases are subject to plan rules and eligibility requirements.

NON-SPOUSE BENEFICIARY CHANGES — OPTIONAL

The PPA includes optional provisions that allow an eligible non-spouse beneficiary of a 457 plan to rollover the funds to an inherited individual retirement account (IRA). Participants may also have the option of making a hardship withdrawal if an eligible crisis befalls the participant, their opposite-sex partner, spouses, dependents, domestic partners or nondependents.

NON-RETIREMENT RELATED TAX BENEFITS

The law significantly changes certain rules that apply to donating to charities. No deduction is allowed for cash, check, or other monetary donations unless the taxpayer has a bank record or written receipt from the charity. It also prohibits deductions for clothing and household donations that are not in “good condition.”

In addition, the law extends the tax benefits of the Section 529 — college savings plans of those planning for their children’s and grandchildren’s educations.

Beginning in 2010, the PPA affords individuals who have built up cash value in an annuity or life insurance policy the ability to purchase long-term care insurance coverage without declaring the premium payments as income for tax purposes, therefore allowing them to receive benefits tax free.

For more information and guidance on the Pension Protection Act, visit www.irs.gov/irb/2007-05_IRB/ar11.html.

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