



JoAnne Flynn  
691 N. Squirrel Road  
Suite 222  
Auburn Hills, MI 48326  
248-373-2500  
JoAnne.Flynn@RaymondJames.com

# The Pension Protection Act of 2006

# The Pension Protection Act of 2006

- Introduction
- Plan Amendments
- Portability and vesting rules
- Distribution rules
- Additional IRA Provisions
- Life, health, and medical benefits
- Retirement plan diversification
- Automatic enrollment arrangements
- Cash balance and other hybrid plans
- Eligible combined defined benefit plans and qualified cash or deferred arrangements ("DB/K Plan")
- Investment advice, prohibited transactions, and fiduciary rules
- Defined benefit plan funding and related rules
- Provisions relating to exempt organizations
- EGTRRA retirement and Section 529 provisions made permanent
- Saver's credit made permanent, income limits indexed

## Introduction

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 into law. The law attempts to shore up the nation's pension system, and the Pension Benefit Guaranty Corporation (PBGC), by making sweeping changes to the funding rules that apply to defined benefit pension plans. The law also encourages retirement saving, and ends uncertainty by making permanent the IRA, pension, and Section 529 provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which had been scheduled to expire at the end of 2010.

## Plan Amendments

The Pension Protection Act contains provisions that are effective on a variety of dates. While plans must comply with each provision as of the applicable date, plan amendments are not required until the end of the first plan year beginning on or after January 1, 2009 (that is, by December 31, 2009 for calendar year plans). Governmental plans need not be amended until the end of the first plan year beginning on or after January 1, 2011.

## Portability and vesting rules

### ***Rollover of after-tax dollars***

Prior to the Act, a distribution of employee after-tax contributions from a qualified retirement plan could be rolled over only to a qualified defined contribution plan or to a traditional IRA. For taxable years beginning after December 31, 2006, the Act also allows employee after-tax contributions to be rolled over to a defined benefit plan or to a tax-sheltered annuity. As under present law, the rollover must be a direct rollover, and the plan to which the rollover is made must separately

account for after-tax contributions (and earnings on those contributions).

### ***Direct rollovers from retirement plans to Roth IRAs***

For distributions after December 31, 2007, the Act allows direct rollovers from tax-qualified retirement plans, tax-sheltered annuities, and governmental 457 plans to Roth IRAs, subject to the present law rules that generally apply to rollovers from traditional IRAs to Roth IRAs. For example, a rollover from a tax-qualified retirement plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax doesn't apply. Similarly, an individual with AGI of \$100,000 or more can't make a direct rollover to a Roth IRA. (Note: the \$100,000 income limit is repealed by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) after 2009.)

### ***Faster vesting of employer nonelective contributions***

Prior to the Act, a faster vesting schedule was required for employer matching contributions to defined contribution plans than was required for other ("nonelective") employer contributions. Effective for contributions in plan years beginning after December 31, 2006, the Act applies this faster vesting schedule to all employer contributions made to qualified defined contribution plans, and to other defined contribution plans covered under ERISA (for example, certain 403(b) plans).

Under the Act, all employer contributions must vest:

- 100 percent upon the completion of three years of service, or
- 20 percent for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service

This provision doesn't apply to any employee until he or she has an hour of service after the effective date. Further, when applying the new vesting schedule, service before the effective date is taken into account.

**Caution:** Generally, a later effective date applies to collectively bargained plans.

## Distribution rules

### ***Rollovers by nonspouse beneficiaries***

Effective for distributions after December 31, 2006, the Act provides that a participant's designated beneficiary may transfer distributions from a qualified retirement plan, governmental section 457 plan, and tax-sheltered annuity directly to an IRA. Currently, only surviving spouses have this option. The IRA is treated as an inherited IRA. Thus, for example, distributions from the inherited IRA are subject to the required minimum distribution rules applicable to beneficiaries, not IRA owners. To the extent provided by the Secretary of the Treasury, the provision may also apply to benefits payable to a trust maintained for a designated beneficiary.

### ***Hardship distributions and unforeseen financial emergencies***

Effective upon enactment, 401(k), 403(b), 457(b), and nonqualified deferred compensation plans can let participants request a distribution of pre-tax contributions if the participant's plan beneficiary incurs a hardship (unforeseen financial emergency in the case of 457(b) and NQDC plans). In general, prior to the Act, only a hardship or unforeseen financial emergency incurred by the participant, the participant's spouse, or the participant's dependent could trigger a distribution. The Act requires the Secretary of the Treasury to issue rules within 180 days after the date of enactment.

### ***Distributions during working retirement***

Effective for distributions in plan years beginning after December 31, 2006, a pension plan can pay benefits to a participant who has attained age 62 even if the participant is still actively employed. Prior to the Act, in-service distributions could be made to active employees only after they attained the normal retirement age specified by the pension plan (usually age 65). This provision is intended to facilitate "phased retirement" programs.

### ***Qualified reservist distributions***

The Act creates a new exception to the 10-percent early withdrawal tax for "qualified reservist distributions." The Act also amends the distribution rules applicable to 401(k) and 403(b) plans to allow these plans to make qualified reservist distributions. A qualified reservist distribution is a distribution:

1. To an individual ordered or called to active duty after September 11, 2001, and before December 31, 2007
2. From an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar arrangement
3. Made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and
4. That's made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after active duty ends (or, if later, the two year period beginning August 17, 2006) make one or more contributions to an IRA in an aggregate amount not to exceed the amount of the qualified reservist distribution. The dollar limitations otherwise applicable to contributions to IRAs don't apply to, and no deduction is allowed for, these contributions.

### ***Spousal pension protection—requirement for additional survivor annuity option***

Defined benefit pension plans and money purchase pension plans must provide benefits in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and the participant's spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse that's not less than 50 percent, and not more than 100 percent, of the amount payable during the joint lives of the participant and spouse.

For plan years beginning after December 31, 2007, defined benefit plans must offer a "qualified optional survivor annuity." The Act provides that if the survivor annuity provided by the plan's QJSA

is less than 75 percent, a participant must be allowed to instead elect a 75 percent survivor annuity. If the survivor annuity provided by the plan's QJSA is greater than or equal to 75 percent, the participant must be allowed to instead elect a 50 percent survivor annuity. This qualified optional survivor annuity is actuarially equivalent to a single annuity for the life of the participant.

**Caution:** Generally, a later effective date applies to collectively bargained plans.

### ***Exception to 10% additional tax for distributions from pension plans of public safety employees***

Effective upon enactment, the Act provides that the 10-percent early withdrawal penalty tax doesn't apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50.

A qualified public safety employee is an employee of a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the State or political subdivision.

### ***Tax-free distributions from governmental retirement plans for premiums for health and long-term care insurance for public safety officers***

For distributions after December 31, 2006, the Act provides that eligible retired public safety officers who elect to have qualified health insurance premiums deducted from their governmental qualified plan, 403(b) annuity, or 457 plan benefits, and paid directly to the insurer, can exclude those premiums from income (up to a maximum exclusion of \$3,000 annually).

Qualified health insurance premiums include premiums for accident or health insurance or qualified long-term care insurance contracts covering the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The qualified health insurance premiums do not have to be for a plan sponsored by the employer; however, the exclusion does not apply to premiums paid by the employee and reimbursed with pension distributions.

Amounts excluded from income under the provision aren't taken into account in determining the itemized deduction for medical expenses under Internal Revenue Code Section 213 or the deduction for health insurance of self-employed individuals under Section 162.

## **Additional IRA Provisions**

### ***Direct deposit of tax refunds in an IRA***

Beginning with the 2007 tax year, the Act allows a taxpayer to deposit all or part of his or her tax refund directly to an IRA (subject to the normal rules governing the amount, timing, and deductibility of IRA contributions).

### ***Additional IRA contributions for certain employees (the "Enron" provision)***

The Act provides that an "applicable individual" may elect to make additional IRA contributions of up to \$3,000 for tax years 2007 through 2009. An applicable individual who elects to make these additional IRA contributions can't make IRA catch-up contributions that are otherwise available to individuals aged 50 and older. While stated more broadly in the Act, an "applicable individual" is generally an employee of Enron Corporation who participated in the Enron 401(k) plan at least 6 months prior to the date that company filed for bankruptcy.

### ***Inflation indexing of IRA gross income limits***

The Act indexes the IRA contribution income limits for inflation, beginning in 2007. Indexing applies to the income limits for deductible contributions for active participants in an employer-sponsored plan, the income limits for deductible contributions if the individual is not an active participant but the individual's spouse is, and the income limits for Roth IRA contributions. Indexed amounts are rounded to the nearest multiple of \$1,000. The provision does not affect the phase-out ranges under present law. In addition, the provision does not index the income limits for taxpayers who are married filing separately, or the income limits that apply to eligibility for Roth IRA conversions.

## Life, health, and medical benefits

### ***Tax treatment of company-owned life insurance ("COLI")***

The Act provides generally that, in the case of an employer-owned life insurance contract ("COLI"), the amount an employer can exclude from income as a death benefit can't exceed the premiums and other amounts paid by the employer for the contract. The excess death benefit is included in income.

An employer-owned life insurance contract is defined as a life insurance contract which (1) is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary, and (2) covers the life of an individual who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

The Act provides several exceptions to the general rule:

- If notice and consent requirements are met, the income inclusion rule doesn't apply to an amount received by reason of the death of an insured individual who was an employee at any time during the 12-month period before the insured's death, or who, at the time the contract was issued, was a director or "highly compensated employee" or "highly compensated individual."

**Tip:** A "highly compensated employee" is defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees. A "highly compensated individual" is defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35 percent of employees for the highest-paid 25 percent of employees.

- If notice and consent requirements are met, the income inclusion rule doesn't apply to an amount received by reason of the death of an insured, to the extent the amount is (1) paid to

a member of the family of the insured, to an individual who is the designated beneficiary of the insured under the contract (other than an applicable policyholder), to a trust established for the benefit of any such member of the family or designated beneficiary, or to the estate of the insured; or (2) used to purchase an equity (or partnership capital or profits) interest in the applicable policyholder from such a family member, beneficiary, trust or estate.

Notice and consent requirements of the provision are met if, before the issuance of the contract, (1) the employee is notified in writing that the employer intends to insure the employee's life, and is notified of the maximum face amount at issue of the life insurance contract that the employer might take out on the life of the employee, (2) the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (3) the employee is informed in writing that the employer will be a beneficiary of any proceeds payable on the death of the employee.

### ***Tax treatment of combined annuity or life insurance contracts with a long-term care insurance feature***

Effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009, the Act provides tax rules for long-term care insurance that's provided by a rider on, or as part of, an annuity contract, and also modifies the current tax rules for long-term care insurance coverage provided in conjunction with a life insurance contract.

- Any charge against the cash value of an annuity contract, or the cash surrender value of a life insurance contract, used as payment for coverage under a qualified long term care insurance contract that's part of, or a rider on, the annuity or life insurance contract is not includable in income. The investment in the contract is reduced (but not below zero) by the charge.
- For exchanges occurring after December 31, 2009, the rules for tax-free exchanges of certain insurance contracts are expanded. No gain or loss is recognized on the exchange of a life insurance contract, an endowment contract, an annuity contract, or a qualified long-term care insurance contract for a qualified long-term care insurance contract. The provision provides that a contract does not fail to be treated as an annuity contract, or as a life insurance contract, solely because a qualified long-term care insurance contract is a part of or a rider on such contract, for purposes of the rules for tax-free exchanges of certain insurance contracts.
- Except as otherwise provided in regulations, for Federal tax purposes, in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract. The term "portion" means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits provided under a separate contract, whether or not the payment of such amounts causes a reduction in the life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value.
- No deduction as a medical expense is allowed for any payment made for coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract.

## Retirement plan diversification

Effective for plan years beginning after December 31, 2006, in order to satisfy the plan qualification requirements of the Internal Revenue Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities. These plans must allow "applicable individuals" to direct that the portion of the individual's account held in employer securities be invested in "alternative investments."

An applicable individual includes: (1) any plan participant; and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

The diversification requirements generally apply to an "applicable defined contribution plan," which means a defined contribution plan that holds publicly-traded employer securities (i.e., securities issued by the employer or a member of the employer's controlled group of corporations that are readily tradable on an established securities market).

While the diversification requirements don't apply generally to ESOPs they do apply to ESOPs that hold contributions subject to Section 401(k) or 401(m) nondiscrimination testing (e.g., KSOPS). The new diversification requirements also don't apply to one-participant retirement plans.

These diversification provisions apply to all amounts attributable to employee elective deferrals and after-tax contributions that are invested in employer securities. In the case of amounts attributable to employer contributions that are invested in employer securities, the new rules apply to an applicable individual who is a participant with three years of service, a beneficiary of such a participant, or a beneficiary of a deceased participant. A transition rule applies to amounts attributable to employer contributions that are invested in employer securities acquired before the effective date of the Act.

A plan subject to the diversification requirements is required to give applicable individuals a choice (at least quarterly) of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. It's intended that other investment options generally offered by the plan also must be available to applicable individuals. It's further intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes, except in unusual circumstances.

**Caution:** Generally, a later effective date applies to collectively bargained plans.

**Tip:** A special effective date applies with respect to employer matching and nonelective contributions (and earnings) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum.

## Automatic enrollment arrangements

### *In general*

Effective for years beginning after December 31, 2007, a 401(k) plan that contains an automatic enrollment feature that satisfies certain deferral, contribution, and notice requirements (a "qualified automatic enrollment feature") is treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions. In addition, a plan consisting solely of contributions made pursuant to a qualified automatic enrollment feature isn't subject to the top-heavy rules. These new provisions also apply with respect to matching contributions under a section 403(b) annuity. The Act also clarifies that State law can not directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in a 401(k) or 403(b) plan.

### ***Automatic deferral requirements***

A qualified automatic enrollment feature must provide that, unless an employee elects otherwise, the employee is treated as making an election to defer a stated percentage of compensation not in excess of 10 percent and at least equal to: three percent of compensation for the first year the deemed election applies to the participant; four percent during the second year; five percent during the third year; and six percent during the fourth year and thereafter. The stated percentage must be applied uniformly to all eligible employees who haven't made an affirmative election to participate, or not participate, in the plan.

### ***Matching or nonelective contribution requirement***

An automatic enrollment feature satisfies the contribution requirement if the employer either

- Satisfies a matching contribution requirement or
- Makes a nonelective contribution to a defined contribution plan of at least three percent of compensation for each nonhighly compensated employee who is eligible to participate in the automatic enrollment feature

A plan generally satisfies the matching contribution requirement if, under the arrangement:

- The employer matches 100 percent of the first one percent of each nonhighly compensated employee's elective deferrals, and 50 percent of the employee's elective deferrals between one and six percent, and
- The rate of matching contributions applicable to deferrals by highly compensated employees is not greater than the rate of matching contributions applicable to deferrals by nonhighly compensated employees

A plan including an automatic enrollment feature that provides for matching contributions is also deemed to satisfy the ACP test if the following additional requirements are met:

- Matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation,
- The rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and
- The rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee

Any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic enrollment feature are satisfied are subject to the withdrawal

rules applicable to elective contributions, and must vest at least as rapidly as under two-year cliff vesting. That is, employees with at least two years of service must be 100 percent vested with respect to such contributions.

### ***Notice requirement***

Each employee eligible to participate in the arrangement must receive notice of the arrangement which is sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and is written in a manner calculated to be understood by the average employee to whom the arrangement applies. The notice must explain:

- The employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to elect to have contributions made in a different amount; and
- How contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is to be made to make an election with respect to contributions and investments

## Cash balance and other hybrid plans

### ***Age discrimination rules in general***

The Act provides that a pension plan (including a hybrid plan) doesn't discriminate on the basis of age if an older participant's accrued benefit, (determined as of the date specified in the plan) would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant. When testing for discrimination, the accrued benefit may be calculated as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation.

### ***Cash balance plans***

Cash balance plans typically provide for employer contributions to a hypothetical account maintained for an employee, and an interest credit that applies to those contributions. Cash balance plans have been attacked as discriminatory because an amount credited to a younger employer's hypothetical account would be worth more at retirement than a similar amount credited to the account of an older employee. (For example, \$1,000 credited to a 20 year old employee's account will grow to a much larger amount at age 65 than \$1,000 credited to the account of a 55 year old employee.) By allowing cash balance plans to test for age discrimination using hypothetical account balances, the Act makes clear that these plans are not discriminatory solely because of the time value of money, an issue that had been hotly litigated.

To satisfy age discrimination rules, a cash balance plan must also meet the following requirements:

- Interest — To avoid an unreasonable disparity between younger and older workers, the Act requires that the interest rate for a plan year can't exceed a market rate of return. A plan can provide for a reasonable minimum guaranteed rate of return or for a rate or return that is equal to the greater of a fixed or variable rate of return.

- Conversions — Prior to the Act, defined benefit plans that were converted to cash balance plans often provided that an employee wouldn't accrue any additional pension benefit until the employee's benefit under the new formula (counting all the employee's years of service) exceeded the employee's pre-conversion benefit. The Act prohibits this type of "wearaway" formula. For conversions after June 29, 2005, a plan must provide that the accrued benefit of any individual who was a participant immediately before the conversion isn't less than the sum of:
  - ◆ The participant's accrued benefit for years of service before the effective date of the conversion, determined under the terms of the plan as in effect before the conversion; plus
  - ◆ The participant's accrued benefit for years of service after the effective date of the conversion, determined under the terms of the plan as in effect after the terms of the conversion
- Vesting — A cash balance plan must provide that each employee who has completed at least three years of service is fully vested in employer contributions

The Act also clarifies that a cash balance plan can pay a lump sum benefit equal to the participant's hypothetical account balance, a provision very favorable to cash balance plan sponsors. Prior to the Act it wasn't clear if the lump sum had to instead equal the present value of a projected future retirement benefit, which in some cases resulted in a lump sum payment greater than the employee's hypothetical account balance—the so-called "whipsaw" problem.

### **Effective date**

In general, these changes are effective for periods beginning on or after June 29, 2005. In the case of a cash balance plan in existence on June 29, 2005, however, the interest credit and vesting requirements generally apply to years beginning after December 31, 2007 (later for collectively bargained plans). The provision relating to conversions of plans generally applies to plan amendments adopted after and taking effect after June 29, 2005. The Act is prospective only—it doesn't provide any protection against age discrimination claims arising prior to the effective date of the Act.

## **Eligible combined defined benefit plans and qualified cash or deferred arrangements ("DB/K Plan")**

Effective for plan years beginning after December 31, 2009, the Act provides rules for an "eligible combined plan." An eligible combined plan is a plan:

- That is maintained by an employer that is a small employer at the time the plan is established (a small employer is an employer that employed an average of at least two, but not more than 500, employees on business days during the preceding calendar year and at least two employees on the first day of the plan year);
- That consists of a defined benefit plan and a 401(k) 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 to the extent necessary for the separate application of the Internal Revenue Code and ERISA; and
- That meets certain benefit, contribution, vesting and nondiscrimination requirements

Plans that meet these requirements are exempt from ADP/ACP and top-heavy testing. Employers maintaining these plans will have the convenience of maintaining the two plans within a single plan document, with a single Form 5500 filing.

## Investment advice, prohibited transactions, and fiduciary rules

### *Investment Advice*

The Act adds a new exemption to the prohibited transaction rules that apply to employer-sponsored retirement plans and IRAs. An exception is created for the provision of investment advice on or after January 1, 2007, through an "eligible investment advice arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan, and to beneficiaries of IRAs.

If the requirements under the Act are met, the following are exempt from prohibited transaction treatment:

1. The provision of investment advice;
2. An investment transaction (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and
3. The direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice

The prohibited transaction exemptions provided under the Act do not in any manner alter existing individual or class exemptions provided by statute or administrative action.

Eligible investment advice arrangements — The exemptions provided under the Act apply in connection with the provision of investment advice by a fiduciary advisor under an "eligible investment advice arrangement." An eligible investment advice arrangement is an arrangement that:

- Provides that any fees (including any commission or compensation) received by the fiduciary advisor for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected, or
- Uses a qualified computer model under an investment advice program in connection with the provision of investment advice to a participant or beneficiary

**Caution:** The exemptions provided under the Act with respect to an eligible investment advice arrangement involving a computer model don't apply to IRAs. If the Secretary of Labor determines that there is a computer model investment advice program that can be used by IRAs, the exemptions provided under the Act with respect to an eligible investment advice arrangement involving a computer model can apply to IRAs.

With respect to defined contribution plans, an eligible investment advice arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan, or (3) any affiliate of (1) or (2).

Specific audit, notice, disclosure, and other requirements apply:

A. Audit requirement – An annual audit by an independent auditor is required

B. Notice requirement – Before the initial provision of investment advice, the fiduciary advisor must provide written notice (which may be in electronic form) to the recipient of the advice, including information relating to:

1. The role of any related party in the development of the investment advice program or the selection of investment options under the plan;
2. Past performance and rates of return for each investment option offered under the plan;
3. Any fees or other compensation to be received by the fiduciary advisor or affiliate;
4. Any material affiliation or contractual relationship of the fiduciary advisor or affiliates in the security or other property involved in the investment transaction;
5. The manner and under what circumstances any participant or beneficiary information will be used or disclosed;
6. The types of services provided by the fiduciary advisor in connection with the provision of investment advice;
7. The advisor's status as a fiduciary of the plan in connection with the provision of the advice; and
8. The ability of the recipient of the advice separately to arrange for the provision of advice by another advisor that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property

C. Other requirements:

- The fiduciary advisor must provide disclosures applicable under securities laws;
- An investment transaction must occur solely at the direction of the recipient of the advice;
- Compensation received by the fiduciary advisor or affiliates in connection with an investment transaction must be reasonable; and
- The terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be

The Act does not exempt the employer or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary advisor who provides investment advice to a plan. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary advisor. The Act also provides that nothing in the fiduciary responsibility provisions of ERISA is to be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

### ***Fiduciary protection for default investments***

Individual account plans (like 401(k) plans) often allow participants to make investment decisions with respect to their accounts. In general, plan fiduciaries don't have liability for investment decisions made by plan participants if participants exercise control over the investment of their individual accounts, as determined under ERISA regulations. A plan fiduciary may be responsible for the investment alternatives made available to participants, but not for the specific investment decisions made by participants.

Effective for plan years beginning after December 31, 2006, the Act provides that a participant is treated as exercising control with respect to assets in an individual account plan if such amounts are invested in a default arrangement in accordance with Department of Labor regulations until the participant makes an affirmative election regarding investments. This provision provides protection

for plan fiduciaries when, for example, a participant is automatically enrolled in a 401(k) plan, and the participant's contributions are placed in a default investment specified by the plan.

The Secretary of Labor is directed to issue regulations under the provision within six months of the date of enactment which would provide guidance on the appropriateness of certain investments for designation as default investments under a plan. On September 27, 2006, the Department of Labor issued proposed regulations under this provision.

In order for a fiduciary to be protected, the plan administrator must give each participant notice which is sufficiently accurate and comprehensive to apprise the participant of his or her rights and obligations, and is written in a manner to be understood by the average participant. The notice must include an explanation of the participant's right to specifically elect to exercise control over the assets in the participant's account. In addition, the participant must have a reasonable period of time after receipt of the notice and before the assets are first invested to make such an election. The notice must also explain how contributions will be invested in the absence of any investment election by the employee.

### ***ERISA bonding requirements***

For plan years beginning after December 31, 2007, the Act increases the maximum bond required under ERISA from \$500,000 to \$1 million for plans that hold employer securities.

### ***Other exemptions from the prohibited transaction rules***

The following are also exempted from the prohibited transaction rules under ERISA and the Internal Revenue Code:

- Purchases and sales of securities or other property if made through an electronic communication network, alternative trading system, or similar execution system.
- Certain block trades between a plan and a disqualified person (other than a fiduciary)
- Certain transactions (such as sales of property, loans, and transfers or use of plan assets) between a plan and a person that is a party in interest solely by reason of providing services (or solely by reason of having certain relationships with a service provider), but only if, in connection with the transaction, the plan receives no less, nor pays no more, than adequate consideration.
- Qualified foreign exchange transactions between a bank or broker-dealer (or an affiliate of either) and a plan in connection with the sale, purchase, or holding of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets).
- A transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager if certain requirements are met.
- A transaction in connection with the acquisition, holding, or disposition of any security or commodity if the transaction is corrected within a certain period, generally within 14 days of the date the disqualified person (or other person knowingly participating in the transaction) discovers, or reasonably should have discovered, the transaction was a prohibited transaction.

## Defined benefit plan funding and related rules

### *Funding rules for single–employer defined benefit plans*

The Act completely replaces the funding rules for single employer pension plans:

- The special interest rate used in determining current plan liability established by the Pension Funding Equity Act of 2004 is extended to plan years beginning after December 31, 2005 and before January 1, 2008. So, for plan years beginning in 2006 and 2007, the interest rate used in determining current liability for funding must be within 90 to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long–term investment–grade corporate bonds during the four–year period ending on the last day before the plan year begins.
- For plan years beginning after December 31, 2007, the Act repeals the present–law funding rules and provides a new set of rules for determining minimum required contributions. Under the Act, the minimum required contribution to a single–employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target (the present value of all benefits accrued or earned as of the beginning of the plan year) and target normal cost (the present value of benefits expected to accrue or be earned during the plan year).
- For plan years beginning after December 31, 2007, the Act specifies the interest rate that must be used in determining a plan's target normal cost and funding target. A special transition rule is provided for plan years beginning in 2008 and 2009.
- Special accelerated funding rules apply to "at risk" plans (generally, plans with less than 80% funding).

### *Benefit limitations for single–employer defined benefit plans*

For plan years beginning after December 31, 2007, the Act restricts plans that don't meet specified funding levels from taking actions that might place the plan at further risk—for example, increasing benefits or paying benefits in the form of a lump sum.

Specifically:

- If a plan's adjusted funding target attainment percentage (generally, the ratio of assets to target liability) is below 80%, the plan may not have benefit increases
- If a plan's adjusted funding target attainment percentage is between 60% and 80%, lump sum payments are limited
- If a plan's adjusted funding target attainment percentage is below 60%, the plan is prohibited from triggering shutdown benefits and from accelerating payments (including lump sums), and benefit accruals are frozen

**Caution:** Special rules apply to collectively bargained plans.

### *Funding rules for multiemployer defined benefit plans*

The Act tightens up the funding rules that apply to multiemployer defined benefit plans, and adds new rules for multiemployer plans that are "endangered" or "seriously endangered" (plans that are less than 80% funded) and "critical" (plans that are less than 65% funded).

While the new funding rules apply to plan years beginning in 2008, the rules that govern "seriously endangered" and "critical" plans expire after 2014.

### ***Funding of nonqualified deferred compensation plans***

If, during a "restricted period," an employer sets aside assets in a rabbi trust or other arrangement to fund nonqualified deferred compensation benefits for an "applicable covered employee," that employee will be subject to income tax, an interest charge, and a 20 percent penalty on the amount set aside.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of an employer is in at risk-status, (2) any period in which the employer is in bankruptcy, and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the employer is terminated in an involuntary or distress termination. The provision does not apply with respect to assets set aside before a restricted period.

In general, applicable covered employees include the chief executive officer of the company, the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

### ***Pension Benefit Guaranty Corporation (PBGC) provisions***

The Act makes the following changes to the Pension Benefit Guaranty Corporation (PBGC) premium rules:

- For 2006 and 2007, the Act extends the present rule under which, in determining the amount of unfunded vested benefits for variable rate premium purposes, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term investment-grade corporate bonds for the month preceding the month in which the plan year begins.
- Beginning in 2008, the determination of unfunded vested benefits for purposes of the variable rate premium is modified to reflect the changes to the funding rules of the Act.
- The bill makes permanent the termination premium enacted in the Deficit Reduction Act of 2005 (a premium of \$1,250 per participant is imposed generally for the year of the termination and each of the following two years.)

### ***Deduction limitations increased***

Generally, employers have been able to deduct contributions that fund defined benefit plans up to 100% of the plan's current liability. Contributions in excess of the limit have been subject to a 10% excise tax.

The Act increases the deductible limit for single-employer plans to the year's normal cost (generally the cost of benefits accrued in the year) plus the amount necessary to fully fund the funding target. In addition, employers can contribute and deduct a cushion. The cushion is 50% of

the funding target plus additional amounts reflecting projections of the participants' compensation and the statutory compensation limits. (The Act allows plans to contribute and deduct the maximum at risk liability for both target and normal if this is more.) The provision is effective for contributions after 2007. For 2006 and 2007, the deduction limit is increased from 100% to 150% of the plan's current liability.

The Act increases the deduction limit for multiemployer plans to 140% of the plan's current liability. This provision is effective for contributions for years beginning in 2008.

Employers that sponsor both defined benefit plans and defined contribution plans face a combined limit on deductible contributions. The limit is the greater of the amount of the required minimum contribution to the defined benefit plan or 25% of compensation paid or accrued to plan participants during the year. The Act provides that employer contributions to a PBGC-covered defined benefit plan are deductible without affecting the combined limit. For defined contribution plans, only employer contributions in excess of 6% of compensation count towards the combined limit. The provision is effective for contributions for taxable years beginning after 2005 (after 2007 for single-employer plans).

## Provisions relating to exempt organizations

### ***Tax-free qualified charitable distributions from IRAs***

Effective for distributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008, the Act provides an exclusion from gross income for qualified charitable distributions from a traditional or Roth IRA:

- The exclusion may not exceed \$100,000 per taxpayer per taxable year.
- Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½.
- Special rules apply in determining the amount of an IRA distribution that is otherwise taxable.
- The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions.
- Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision.
- An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the provision are not taken into account in determining the deduction for charitable contributions under IRC Section 170.

### ***Basis adjustment to stock of S corporation contributing property***

Effective for contributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008, the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.

For example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500. The shareholder will be treated as having made a \$500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by \$200.

### ***Contributions of real property made for conservation purposes***

Effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

***Example(s): Assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carryover the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.***

**Tip:** In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

### ***Recapture of tax benefit on property not used for an exempt use***

Effective for contributions made and returns filed after September 1, 2006, a recovery of tax benefits is required for charitable contributions of tangible personal property when a fair market value deduction is claimed, but the property is not used for exempt purposes. This applies to appreciated tangible personal property that is identified by the donee organization, for example on the Form 8283, as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than \$5,000 is claimed ("applicable property").

If a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value. If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of:

- The amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over
- The donor's basis in such property at the time of the contribution.

There is no adjustment of the tax benefit if the donee organization makes a certification, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282, a copy of which is supplied to the donor).

### ***Charitable deduction for contributions of clothing and household items***

For contributions made after the date of enactment, no deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in good used condition or better.

Regulations may be issued that deny a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments.

A deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is more than \$500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.

Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

## ***Recordkeeping and substantiation requirements for certain charitable contributions***

For contributions made in taxable years beginning after the date of enactment, the substantiation rules for money contributions are more closely aligned to the substantiation rules for property. In the case of a charitable contribution of money, regardless of the amount, recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

The recordkeeping requirements may not be satisfied by maintaining other written records.

## ***Donor Advised Funds***

A "donor advised fund" is defined as a fund or account that is:

1. Separately identified by reference to contributions of a donor or donors
2. Owned and controlled by a sponsoring organization and
3. With respect to which a donor (or any person appointed or designated by such donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor.

All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund.

The provision defines a "sponsoring organization" as an organization that: (1) is described in section 170(c) (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States); (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.

A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. For example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively for the benefit of such sponsoring organization is not a donor advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund to such sponsoring organization. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund.

A fund or account may also be exempted from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose.

In addition:

- Contributions made to certain sponsoring organizations for maintenance in a donor advised fund are not eligible for a charitable deduction.
- The excess business holdings rules of IRC Section 4943 are applied to donor advised funds.
- Certain grants, loans, compensation, and other similar payments from a donor advised fund to a person that is a donor, donor advisor, or a person related to a donor or donor advisor is

automatically treated as an excess benefit transaction under section IRC Section 4958. Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

- In general, donors and donor advisors as well as persons related to a donor or donor advisor) are treated as disqualified persons under IRC Section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally).
- Certain distributions from a donor advised fund are subject to tax (taxable distributions include any distribution from a donor advised fund to a natural person or for any purpose other than a charitable purpose). In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization.
- New reporting requirements are established.

## EGTRRA retirement and Section 529 provisions made permanent

The Act repeals the sunset provision of EGTRRA as it applies to the following specific pension and IRA provisions:

- Increases in the IRA contribution limits, including the ability to make catch-up contributions
- Rules relating to deemed IRAs under employer plans
- Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans
- Application of prohibited transaction rules to plan loans of S corporation owners, partners, and sole proprietors
- Modification of the top-heavy rules
- Elective deferrals not taken into account for purposes of deduction limits
- Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations
- Modifications to deduction limits
- Option to treat elective deferrals as after-tax Roth contributions
- Credit for pension plan start-up costs
- Certain nonresident aliens excluded in applying minimum coverage requirements
- Catch-up contributions for individuals age 50 and older
- Equitable treatment for contributions of employees to defined contribution plans
- Faster vesting of employer matching contributions
- Modifications to minimum distribution rules
- Clarification of tax treatment of division of section 457 plan benefits upon divorce
- Provisions relating to hardship withdrawals
- Waiver of tax on nondeductible contributions for domestic and similar workers
- Rollovers of retirement plan and IRA distributions
- Treatment of forms of distribution
- Rationalization of restrictions on distributions
- Purchase of service credit under governmental pension plans
- Employers may disregard rollovers for purposes of cash-out rules
- Minimum distribution and inclusion requirements for section 457 plans
- Phase in repeal of 160 percent of current liability funding limit; maximum deduction rules
- Excise tax relief for sound pension funding
- Modifications to section 415 limits for multiemployer plans
- Investment of employee contributions in 401(k) plans
- Prohibited allocations of stock in an S corporation ESOP

- Automatic rollovers of certain mandatory distributions
- Clarification of treatment of contributions to a multiemployer plan
- Treatment of plan amendments reducing future benefit accruals
- Modification of timing of plan valuations
- ESOP dividends may be reinvested without loss of dividend deduction
- Repeal transition rule relating to certain highly compensated employees
- Treatment of employees of tax-exempt entities for purposes of nondiscrimination rules
- Treatment of employer-provided retirement advice
- Repeal of the multiple use test

The sunset provision of EGTRRA relating to qualified tuition programs is also repealed. As a result, the provisions of EGTRRA that relate to qualified tuition plans (e.g., the tax treatment of qualified 529 plan distributions) are made permanent. This means that qualified distributions from 529 plans will continue to be free from federal income tax after 2010.

### Saver's credit made permanent, income limits indexed

The Act makes the "saver's credit" permanent. The Act also provides 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 plan, section 403(b) annuity, or governmental section 457 plan designated by the individual (if the plan or other arrangement agrees to accept these direct deposits). In the case of a joint return, each spouse is entitled to designate an applicable retirement plan with respect to payments attributable to that spouse. The provision doesn't change the rules relating to the tax treatment of contributions to such plans or other arrangements.

While this provision is effective as of the date of enactment, the provision relating to direct deposit of refunds relating to the saver's credit is effective for taxable years beginning after December 31, 2006.

The Act also indexes the income limits applicable to the saver's credit for taxable years beginning after December 31, 2006. Indexed amounts are rounded to the nearest multiple of \$500. Under the indexed income limits, as under present law, the income limits for single taxpayers is one-half that for married taxpayers filing a joint return and the limits for heads of household are three-fourths that for married taxpayers filing a joint return.



JoAnne Flynn  
691 N. Squirrel Road  
Suite 222  
Auburn Hills, MI 48326  
248-373-2500  
JoAnne.Flynn@RaymondJames.com

This information was developed by Forefield, Inc. an independent third party. It is general in nature, is not a complete statement of all information necessary for making an investment decision, and is not a recommendation or a solicitation to buy or sell any security. Investments and strategies mentioned may not be suitable for all investors. Past performance may not be indicative of future results. Raymond James & Associates, Inc. does not provide advice on tax, legal or mortgage issues. These matters should be discussed with an appropriate professional.