THE PENSION PROTECTION ACT OF 2006 BOLSTERS DEFINED CONTRIBUTION PLANS

FOR ADMINISTRATOR USE ONLY. NOT FOR DISTRIBUTION TO EMPLOYEES.

The Pension Protection Act of 2006 (PPA) was intended in large part to reform how defined benefit pension plans are funded and administered. But in this publication we will examine the provisions of the PPA that have the greatest impact on sponsors and participants of defined contribution retirement plans, IRAs and Section 529 College Savings Plans. Many of these provisions are good news for plan sponsors and participants, although, of course, some of the changes require plan sponsors to amend their plans and change certain procedures. Probably the best news in the PPA for defined contribution plans is that it did away with the so-called sunset provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that would have caused contribution limits and a wide range of other pension provisions to revert in 2011 to the pre-EGTRRA rules. This updated publication also examines guidance issued by the Internal Revenue Service and the Department of Labor in recent months clarifying various PPA provisions.

EGTRRA pension limits will not sunset in 2011

EGTRRA PERMANENCE. The Economic Growth and Tax Relief Reconciliation Act of 2001 liberalized a wide range of pension provisions. For example, it:

- raised contribution limits for defined contribution plans and IRAs
- eliminated the Maximum Exclusion (MEA) that complicated calculations (and often reduced contribution limits) for participants in 403(b) plans
- allowed rollovers between 403(b), qualified and public 457(b) plans
- permitted 403(b) and 401(k) plans to start accepting Roth-style contributions
- permitted participants age 50 and older to make additional catch-up contributions to retirement plans and IRAs
- eliminated the coordination of contributions to 457(b) plans with those to 403(b) or 401(k) plans and
- created a Saver's Credit that allowed taxpayers with adjusted gross incomes below $25,000 ($50,000 for married joint filers) to claim a tax credit for contributions of up to $2,000 a year to a retirement plan or IRA.

But a sunset provision in EGTRRA provided that on January 1, 2011, these provisions would generally cease to apply and pre-EGTRRA rules would be reinstated. So for example, under EGTRRA in 2010 the 402(g) limit on elective deferrals to 403(b) or 401(k) plans would have been $15,000 (plus whatever incremental cost-of-living adjustments accrue after the $15,000 level was attained in 2006). But in 2011, the sunset provision would have resulted in the

FINANCIAL SERVICES FOR THE GREATER GOOD®

MMD 005189 (6/07)

402(g) limit dropping back to its 2001 level of $10,500 (plus whatever incremental cost-of-living adjustments would have accrued under that limit if the EGTRRA provision had never gone into effect). The Saver's Credit was actually scheduled for an early sunset in 2007.

Thanks to the PPA, the EGTRRA pension provisions will not sunset, and various contribution limits will be eligible for additional cost-of-living adjustments after 2010.

529 COLLEGE SAVINGS PLANS. EGTRRA contained a number of provisions that made Section 529 College Savings Plans more attractive, including one that allowed tax-free treatment of qualified distributions from these plans. It also authorized the creation of prepaid tuition programs. All of these provisions were scheduled to sunset at the end of 2010. Fortunately, the PPA eliminates the sunset and makes EGTRRA's 529 provisions permanent.

AUTOMATIC ENROLLMENT. Most 403(b), 401(k) and governmental 457(b) plans require eligible employees to voluntarily sign an elective deferral agreement in order to participate in the plan. But many employees never get around to signing up for the plan. In addition to potentially undermining these employees' financial well being in retirement, low participation may lead to nondiscrimination problems for the plan. To get around these problems, some plan sponsors have chosen to adopt automatic enrollment features for their plans. Under these arrangements, all eligible employees are automatically enrolled in the plan at a specified contribution rate with contributions going into a default investment option selected by the plan sponsor. An employee can subsequently make an election to not participate, to contribute a different percentage of compensation to the plan and/or to transfer funds or change future contribution allocations from the default option to other investment options offered under the plan.

The new law creates incentives for automatic enrollment

Overcoming obstacles. Many plan sponsors have hesitated to adopt the automatic enrollment feature because:

- some states have wage laws prohibiting any deduction from an employee's wages without his or her authorization and
- they feared assuming fiduciary responsibility for their choice of a default investment option for automatic enrollment.

The PPA addressed both of these problems by providing that ERISA pre-empts any state law that would prohibit or restrict automatic enrollment to ERISA-covered plans (which would not include governmental and Church plans not subject to ERISA) and by instructing the Department of Labor to issue regulations to provide guidelines for selecting default investment options.

Creating incentives. Beyond just removing obstacles to wider use of automatic enrollment, the new law also provides plan sponsors with new incentives for adopting automatic enrollment:

- 401(k) and 403(b) plans that satisfy a new automatic enrollment safe harbor will be deemed to automatically satisfy some nondiscrimination and top-heavy requirements without testing (see "Automatic Enrollment Safe Harbors" box on page 3).
- Plans will be permitted to make corrective distributions of contributions and earnings to any employee who opts out of plan participation at any time during the first three months after the start of his or her automatic enrollment. Unlike other corrective distributions, these distributions will be taxed in the year distributed rather than in the year the contributions were made and will not be subject to a 10% early withdrawal excise tax regardless of the age of the participant.

These automatic enrollment provisions are generally effective in plan years beginning after December 31, 2007, and the ERISA preemption provisions apply as of August 17, 2006, the date of enactment of the PPA.

DEFAULT INVESTMENTS. Section 404(c) of ERISA provides fiduciaries of defined contribution plans with some protection against liability

AUTOMATIC ENROLLMENT SAFE HARBORS

Automatic enrollment plans that satisfy new safe harbor requirements established by the PPA are exempt from certain nondiscrimination requirements:

- Contributory 403(b) plans with automatic enrollment that satisfy safe harbor requirements will be deemed to satisfy Matching Test requirements automatically without testing.
- 401(k) plans with automatic enrollment that satisfy the safe harbor requirements will be deemed to satisfy Average Deferral Percentage (ADP), Average Contribution Percentage (ACP), and Top-Heavy requirements without testing.

These new safe harbors are in addition to the Design-Based Safe Harbor alternatives to the ADP and ACP/Matching Tests that have been available to 401(k) and 403(b) matching plans since 1999.

SAFE HARBOR REQUIREMENTS. To qualify for the safe harbors, automatic enrollment plans must provide an annual notice to employees providing information about the automatic enrollment provisions and about participants' right to opt out of participation or to change their deferral percentage and/or investment allocations. The plans must also set default contribution rates that never exceed 10%, but are at least 3% in the first year of automatic participation, 4% in the second year, 5% in the third year and 6% in the fourth and subsequent years. Employers must also either:

- provide a nonelective employer contribution of at least 3% for all eligible non-highly compensated employees regardless of whether they are enrolled under the automatic enrollment feature, have changed their contribution percentage or even if they have elected not to make any employee contributions at all. If nonelective employer contributions are made for non-highly compensated employees, they can also be provided to highly compensated employees.
- provide an employer match for all non-highly compensated employees equal to at least 100% for employee contributions of up 1% of compensation and 50% for contributions between 1% and 6%. No match can be provided for employee contributions in excess of 6% of compensation and the employer matching percentage cannot be higher for any employee than for any non-highly compensated employee with the same or a lower contribution percentage. If matching contributions are provided for non-highly compensated employees, they can also be provided for highly compensated employees.

All employer contributions must also vest within two years.

New regulation spells out requirements for default investment options

for participants' investment losses if the plan provides participants with the opportunity to allocate their investments among a range of appropriate investments, and meets certain other requirements. But it has not been clear how 404(c) protection would apply to participant funds automatically invested in a default investment option selected by the plan fiduciaries. The PPA instructed the Department of Labor to issue new regulations spelling out requirements for default investment options to qualify for protection under section 404(c).

The DOL did issue a regulation spelling out requirements for default investment options in September, 2006, a month after enactment of the PPA. However, the regulation was issued as a proposed regulation to be effective 60 days following publication as a final regulation.

Under the proposed regulation, a qualified default investment alternative must be diversified so as to minimize risk of large losses and must qualify as one of the following:

- An investment fund or portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income investments that varies depending on the participant's age, target retirement date or life expectancy. It appears that TIAA-CREF Lifecycle Funds meet these requirements;
- An investment fund or portfolio that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income investments based on a single target level of risk for all plan participants. Each plan would be required to select a mix of equity and fixed income investments based on the demographics of its own participants, taken as a whole. The regulations state that a balanced fund would meet these requirements if the balance was appropriate given participant demographics; or
- A managed account whereby an investment management service provided each participant with a mix of equity and fixed income investments appropriate to his or her age, target retirement date or life expectancy. The mix for each participant would need to be adjusted over time to reduce risk. The regulation indicates that an individually managed account could meet these requirements.

Money market, fixed income, stable value, and guaranteed investment products are not eligible as qualified default investment alternatives under the proposed regulation. But commenters have asked the DOL to add fixed income alternatives as acceptable default investment options.

PPA's new advice provisions supplement prior DOL guidance.

INVESTMENT ADVICE. The 2006 law provides two additional exemptions whereby investment advisors can provide investment advice to participants in individually directed defined contribution plans or IRAs with respect to the advisor's own funds or contracts or those of an affiliate. Under the PPA, an investment advisor that provides investment advice to plan participants with regard to its own funds and/or receives compensation for the provision of investment advice will not be considered to have violated prohibited transaction rules if:

- the advice is provided by a fiduciary advisor (such as a broker/dealer, investment advisor, bank or insurance company) selected by the plan fiduciary;
- the advisor undergoes an annual independent outside audit to ensure that the advice meets the statutory requirements and provides participants with detailed disclosures regarding fees and other financial arrangements;
- the advice is provided in a form understandable by an average investor and is updated at least annually, or whenever there has been a material change, at no additional charge;
- the advice is provided to participants through an eligible advice arrangement. There are two forms of eligible advice arrangements: a compensation-based arrangement and computer-model based arrangement.

Computer-model based arrangement. The advice must be provided by a fiduciary advisor based solely on a computer model certified as appropriate by an outside financial expert. This exemption is not yet available for IRAs.

Compensation-based arrangement. The advice must be provided by a fiduciary advisor whose compensation is not based upon the investment options selected.

In February 2007, the DOL issued Field Assistance Bulletin 2007-01 which provides some clarification regarding the PPA's investment advice provisions. According to the FAB, the PPA provisions supplemented without replacing previous DOL guidance concerning investment advice. Specifically the DOL stated that the provision of investment-related information and materials did not constitute investment advice and therefore was not subject to the ERISA rules governing investment

advice. The DOL also reaffirmed the so-called Sun America advisory opinion which permits a financial services firm to provide advice and managed allocation services with regard to its own funds without violating ERISA's prohibited transaction rules as long as the financial services firm relies on an independent financial expert to actually provide the allocations under its advice program.

New law imposes new benefit statement requirements

BENEFIT STATEMENTS. The PPA requires administrators of defined contribution plans to provide benefit statements to participants and beneficiaries at least quarterly in plan years beginning after December 31, 2006. The statements must include:

- the participant's balance in each account or fund to which he or she has a current allocation,
- restrictions on investment allocations, if any, and
- a cautionary statement on the need to maintain a diversified and well balanced portfolio.

Plan sponsors are also required to provide participants with a report on their current vesting status at least annually.

The PPA included a provision instructing the Department of Labor to provide model benefit statements that plan administrators and providers could use in developing statements for their participants that would satisfy the PPA requirements. The DOL has not yet produced model statements, but it has issued preliminary guidance in Field Assistance Bulletin 2006-3 that can be used to develop interim statements that will qualify as "good faith compliance" with PPA requirements until further guidance is issued (see box on page 6).

NEW VESTING SCHEDULE. EGTRRA required employer matching contributions to be 100% vested after completion of three years of service or 20% vested each year starting with year two. But employers were allowed to retain a slower vesting schedule for their non-matching employer contributions. The PPA requires employers to apply the faster schedule to all contributions in plan years beginning after December 31, 2006.

In January 2007 in Notice 2007-7, the IRS advised that amendments to plan vesting provisions may not result in the percentage of vested benefits being reduced for any employee. If the employer chooses to move from a cliff vesting schedule to a graded vesting schedule, any employee with at least three years of vesting service must be given the option of electing to remain under a cliff vesting schedule.

Married participants must be provided with a new spousal annuity option

NEW SPOUSAL ANNUITY REQUIREMENTS. Retirement plans subject to ERISA are required to provide benefits to married participants in the form of a qualified joint and survivor annuity (QJSA), with a lifetime benefit to the surviving spouse equal to at least 50% of the amount payable while the participant was alive. The spouse may waive this right, however, allowing the participant to take benefits in the form of a lump sum or in the form of an annuity option offered under the plan in addition to the QJSA option. These rules apply to ERISA covered pension plans and to ERISA covered profit sharing [e.g., 401(k)] plans that offer annuity payout options.

The PPA states that any ERISA covered plan that offers an annuity as a payout option must offer married participants the option of taking payouts from the plan in the form of a "qualified optional survivor annuity" (QOSA). A QOSA must provide a spousal survivor benefit of at least 75% of the amount payable to the participant in plan years beginning after December 31, 2007, if the plan offers a QJSA with an at least 50% (but less than 75%) survivor benefit. If its QJSA provides a survivor benefit of at least 75%, then it must add a QOSA with a survivor benefit of 50%. The PPA also extends the current 90 day period during which a spouse can waive his or her right to a QJSA to 180 days.

(continued on Page 7)

FIELD ASSISTANCE BULLETIN 2006-3 GUIDELINES FOR QUARTERLY BENEFIT STATEMENTS.

In Field Assistance Bulletin 2006-3 the DOL provided guidance for creating benefit statements that will qualify as good faith compliance with the PPA requirements until further guidance is issued.

According to the Bulletin, plans will be in good faith compliance with the PPA's benefit statement requirements if they provide participants with statements that contain at least the following information each quarter:

1. the value of each account, fund or other investment to which the participant has allocated funds during the previous quarter;
2. the vested amount of the participant's account balance at the end of the quarter or, if no funds are vested at quarter end, the earliest date on which the benefit will become vested (alternatively, vesting information may be provided only annually);
3. an explanation of any plan limitations or restrictions on any right of the participant to allocate plan contributions, change the allocation of his or her current account balance, or change the allocation of future contributions among the investment options offered under the plan;
4. an explanation of the importance of a well-balanced and diversified investment portfolio; and
5. a notice directing the participant or beneficiary to the internet website of the DOL for sources of information on individual investing and diversification.

Designing the statements. Under the Bulletin, plan sponsors or providers can use either a single quarterly statement or multiple documents or sources (such as emails, websites or newsletters) to provide the required benefit statement information. But participants and beneficiaries must receive an explanation of how and when the required information will be furnished or made available to them.

Delivering the statements. The Bulletin confirms that electronic media such as secure websites can be used to provide the required information if participants and beneficiaries are notified of their right to obtain a free paper version of the statement and necessary measures are taken to help ensure actual receipt of the material.

Deadline for statements. The benefits information must be supplied to participants and beneficiaries within 45 days of the end of each quarter.

Limits on investment allocations and transfers. While benefits statements must include information on any plan limitations and restrictions on participants' or beneficiaries' rights to allocate or transfer funds, the Bulletin does not require the statements to provide information on non-plan limitations and restrictions imposed by investment funds, other investment vehicles, or by state or federal securities laws.

Investment principles. The Bulletin provides the following as good faith language satisfying the requirement listed in #4, above to provide an explanation of the importance of a well-balanced and diversified investment portfolio:

> To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or

other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security, to perform poorly. If you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.

In deciding how to invest your retirement savings, you should take into account all of your assets, including any retirement savings outside of the Plan. No single approach is right for everyone because, among other factors, individuals have different financial goals, different time horizons for meeting their goals, and different tolerances for risk.

It is also important to periodically review your investment portfolio, your investment objectives, and the investment options under the Plan to help ensure that your retirement savings will meet your retirement goals.

DOL website. Plan administrators may satisfy the requirement that benefit statements include a notice directing participants and beneficiaries to a DOL website for information on individual investing and diversification (#5, above), by providing the following url in the benefit statements: **www.dol.gov/ebsa/investing.html**.

NOTICE AND CONSENT PERIODS FOR DISTRIBUTIONS. A participant requesting a distribution from a retirement plan that is eligible for rollover to another plan or to an IRA must be provided with a notice of his or her right to defer the distribution or make a tax-free rollover (known as a 402(f) notice) before the distributions begin. The PPA changes the time limit for delivering the 402(f) notice from 30 to 90 days before distributions begin to from 30 to 180 days in plan years beginning after December 31, 2006. The PPA also instructed the IRS to provide a new model notice that adds a description of the consequences of a failure to defer or roll over a distribution to the notice of the participant's right to defer the distribution or make a rollover.

Although the legal responsibility for providing 402(f) notices rests with the plan sponsor, TIAA-CREF fulfills this responsibility for participants requesting distributions for plans funded with TIAA-CREF contracts.

In Notice 2007-7, the IRS stated until a new model notice is issued, a defined contribution plan will be considered to be demonstrating good faith compliance with the new requirements if the notice it provides is reasonably intelligible to the average participant and includes:

- a description of the investment options and fees that will be available to the participant if he or she elects to leave the accumulation in the plan instead of taking an immediate distribution and
- an excerpt from the plan's Summary Plan Description covering any plan rules that might be expected to affect the participant's decision to take an immediate distribution or to postpone it.

NEW ROLLOVER RULES. Under EGTRRA, pretax amounts may be rolled over between 403(b) plans, between qualified plans, between public 457(b) plans and between IRAs. Pretax amounts may also be rolled over from any of these plan types to any of the others, if the receiving plan agrees to accept the rollover. These rollovers may be in the form of direct or indirect (60-day) rollovers.

EGTRRA provided somewhat different rules for rolling over ordinary after-tax amounts.

Defined benefit and money purchase plans will be allowed to offer in-service cash withdrawals

After-tax amounts can generally only be rolled over between plans of the same type (i.e., from a 403(b) plan to another 403(b) or from a qualified plan to another qualified plan) and only by direct rollover. After-tax amounts can be rolled over from either 403(b) or qualified plans to an IRA by either direct or 60-day rollover.

Still different rules apply to Roth rollovers under EGTRRA. Roth 403(b) or 401(k) accumulations can be rolled over only to other Roth plans or to Roth IRAs. Pretax accumulations cannot be rolled over to Roth IRAs. And Roth IRAs can only be rolled over to other Roth IRAs. Taxpayers with adjusted gross incomes under $100,000 can convert their Traditional IRA accumulations (including amounts rolled over from retirement plans) into Roth IRAs by paying taxes on the pretax amount converted.

PPA rollover rules. There are no changes for rollovers of pretax amounts from retirement plans except that, starting in 2008, pretax accumulations in retirement plans can be converted directly into Roth IRAs without having to be first rolled over into a Traditional IRA. Starting in 2007, ordinary after-tax accumulations in any qualified retirement plan are eligible to be rolled over (by a direct rollover) to any 403(b) or qualified plan (including defined benefit plans) that agrees to accept the rollover and track it separately.

Non-spouse beneficiaries can roll over inherited 403(b), qualified, or public 457(b) accumulations into their own IRA starting in 2007. The new IRA will be subject to the same rule as an IRA inherited by a non-spouse beneficiary. To the extent provided by Treasury regulations, this will also apply to benefits payable to a trust maintained for a designated beneficiary. However, in Notice 2007-7, the IRS made clear that plans are not required to make direct rollovers available to non-spouse beneficiaries and that a required minimum distribution payment is not eligible for these rollovers. Even if a plan elects to make rollovers available to non-spouse beneficiaries and amends its plan document accordingly, it is not required to provide beneficiaries with 402(f) notices of their rights to defer a distribution or roll it over and 20% mandatory withholding does not apply.

IN-SERVICE DISTRIBUTIONS. Under EGTRRA, 401(k) plans and other profit-sharing plans can allow in-service distributions. But in-service distributions were generally not permitted under federal law from defined benefit plans or money purchase plans. Starting in 2007 these plans are allowed to start permitting in-service withdrawals to participants who have reached age 62.

IRA CHANGES. Prior to enactment of the PPA, individuals with adjusted gross income above a specified amount were not permitted to make tax deductible IRA contributions if they (or their spouse) participated in an employer-sponsored retirement plan. The AGI limits for making deductible IRA contributions had been gradually increasing in recent years, but the limit for single filers reached its scheduled cap of $60,000 in 2005 and the limit for married joint filers was scheduled to reach a cap of $100,000 in 2007. The AGI limit for making contributions to Roth IRAs had remained at $110,000 for single taxpayers ($160,000 for married joint filers) since 2002. There were currently no further scheduled adjustments or cost-of-living provisions for any of these limits. But a PPA provision included cost-of-living adjustments for the AGI limits for deductible Traditional IRAs and Roth IRAs (in $1,000 increments) starting in 2007.

The PPA also allowed IRA owners who are age 70½ or older, to make tax-free distributions of up to $100,000 to tax-exempt charities in 2006 and 2007.

EARLY OR DELAYED RETIREMENT INCENTIVE PLANS. The PPA contains a provision allowing public boards of education or teachers unions to create early retirement incentive plans that will be treated as severance plans not subject to the limits on contributions to 457(b) plans or certain ERISA and Age Discrimination in Employment Act requirements. Alternatively, public boards of education and teachers unions are permitted to create incentive plans to

promote the retention of experienced teachers. Contributions of up to two times the 457(b) limit, can be made to these retention plans and these plans will also be exempt from various ERISA and ADEA restrictions. These provisions were effective as of August 17, 2006.

PUBLIC SAFETY WORKERS. The PPA contained a special provision for participants in public retirement plans who are retired public safety workers, such as campus police at state universities. Distributions of up to $3,000 a year from a governmental 401(a), 403(a), 403(b) or 457(b) plan to an eligible retired public safety officer (including law enforcement officers, firefighters, rescue squad workers or ambulance crew members) are tax-exempt starting in 2007 if used to pay health or long-term care insurance premiums. The exclusion only applies if the distribution is made directly to the insurance carrier.

PLAN AMENDMENTS. The effective dates for various PPA provisions vary as indicated above. But plan documents generally do not need to be amended to conform with PPA requirements until the last day of the first plan year beginning after December 31, 2008. Public plans have until 2011 to amend plan documents.

The tax information contained herein is not intended to be used and cannot be used by any taxpayer, for the purposes of avoiding tax penalties that may be imposed on the taxpayer. It was written to support the promotion of the products and services addressed herein. Taxpayers should seek advice based on their own particular circumstances from an independent tax advisor.

©2007 Teachers Insurance and Annuity Association-College Retirement Equities Fund, New York, NY 10017

FINANCIAL SERVICES
FOR THE GREATER GOOD®

MMD 005189 (6/07)