

**Pension Protection Act of 2006:
Legislative Changes of Interest to Church Plans**

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The House and Senate recently passed comprehensive pension reform legislation. The Pension Protection Act of 2006 (“PPA”) was signed by the President on August 17, 2006. In addition, the Internal Revenue Service (“IRS”) and the Department of Labor (“DOL”) have both recently issued guidance with respect to various provisions of the PPA.

As is apparent from the numerous news accounts in recent days, the primary focus of this legislation is pension funding reform and, to a lesser extent, issues related to hybrid plans (such as cash balance plans). Because these issues are not relevant to most church plans, we are not focusing on them in this outline. Instead, the following discussion covers other provisions in the PPA that are of interest to church retirement plans.

Provisions Applicable Only to Church Plans

The following provisions, though narrow in scope, are of particular interest to church plans:

- Change in Maximum Limitation on Benefits. Under current law, section 415(b) of the Internal Revenue Code of 1986, as amended (“Code”) limits the maximum benefit that participants can receive from a defined benefit plan to the lesser of \$160,000 (as adjusted by the IRS for cost of living) or the participant’s highest-three year average compensation. For years beginning after 2006, the PPA eliminates the compensation test under the 415(b) limit for non-highly compensated employees employed by churches and church elementary or secondary schools. As currently written, this relief does not apply to either qualified church controlled organizations (QCCOs) or non-QCCOs. However, it is our understanding that the relief provided by this provision was intended to cover QCCOs (but not non-QCCOs) and that this oversight will likely be corrected through a technical correction.¹
- Exemption for Income from Leveraged Real Estate Held by Church Plans. Under current law, qualified 401(a) plans that invest in leveraged real estate deals are generally exempt from unrelated business income tax (UBIT). The PPA extends this

¹ Another provision in the PPA provides that for purposes of calculating the 415(b) limit, average compensation may be calculated by taking into account years of service for which the employee was not an active participant in the plan. This change is applicable to all defined benefit plans, not just church plans, and is effective immediately.

same exemption to church 403(b) retirement plans, effective for taxable years after enactment of the PPA.

- Grandfather Rule for Church Plans that Self-Annuitize. The PPA provides that a qualified 401(a) defined contribution retirement plan that is a church plan will not fail to meet the minimum distribution requirements under Code section 401(a)(9) if the plan self-annuitizes. This provision affords church 401(a) defined contribution plans the same ability to self-annuitize benefits that is currently provided to church 403(b)(9) plans under the applicable regulations. This provision only applies to qualified 401(a) defined contribution church plans that were in existence on April 17, 2002, which is the date the final 401(a)(9) regulations were issued.
- Definition of Convention or Association of Churches. The PPA amends the definition of “convention or association of churches” in Code section 7701 to allow the voting membership of such an organization to include not just churches and church entities, but also individuals. It is our understanding that this provision is not intended to change the church plan requirements in any way. It merely clarifies that a church convention or association can allow individuals to be voting members. However, it will have the effect of allowing conventions or associations of churches that include individuals as voting members to maintain a church plan.

Provisions of General Applicability

In addition to those special church plan provisions, the PPA includes the following provisions of more general applicability. Except as otherwise indicated, all of these provisions are effective beginning in 2007.

- EGTRRA Permanence. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) which included numerous changes affecting retirement plans. For example, EGTRRA significantly increased contribution limits for all types of retirement plans; permitted participants who are age 50 or older to make catch-up contributions, eliminated the maximum exclusion allowance limitation that applied to 403(b) plans, expanded rollover rights, and created Roth 401(k) and 403(b) plans,. All of these provisions were due to expire at the end of 2010. The PPA now makes permanent the EGTRRA provisions affecting retirement plans and IRAs.²
- After-Tax Rollovers. The PPA permits rollovers of after-tax amounts between different types of retirement plans. Thus, it permits a 401(a) plan to rollover after-tax amounts to a 403(b) plan that agrees to separately account for such after-tax contributions, and 403(b) plans can rollover after-tax amounts to a 401(a) plan that agrees to separately account for such after-tax contributions. Prior to this change, after-tax amounts could only be rolled over to similar plans or to an IRA.

² The PPA also makes permanent the EGTRRA provisions that established section 529 college tuition programs.

Note: This provision should also apply to the direct rollovers of designated Roth accounts. Currently, the IRS proposed regulations require that such rollovers be made between similar plans (401(k) to 401(k) and 403(b) to 403(b)). However, in light of this statutory change, the IRS could modify this provision to allow direct rollovers of Roth accounts from 401(k) plans to 403(b) plans, and vice versa.

- Rollovers by Nonspouse Beneficiaries. Effective for distributions after 2006, nonspouse beneficiaries will be allowed to rollover accounts to an inherited IRA.
 - Guidance Update. In IRS Notice 2007-7, the IRS made the following clarifications:
 - Plans are not required to offer direct rollovers to nonspouse beneficiaries but if they do, it must be on a nondiscriminatory basis;
 - The IRA will be treated as an inherited IRA and it must identify both the deceased participant and beneficiary by name;
 - The rollover is not subject to most of the eligible rollover rules, including the automatic rollover requirement, the 402(f) notice requirement, or the mandatory withholding requirement;
 - The minimum distribution rules applicable to distributions from the IRA are generally the same as those that would have applied to a nonspouse beneficiary under the plan.
- Rollovers to Roth IRAs. Effective for distributions after 2007, eligible participants will be allowed to rollover distributions from their retirement plans (401(a), 403(b) or governmental 457(b) plans) into a Roth IRA without having to pay any early withdrawal tax. However, because only after-tax amounts are permitted to be contributed to Roth IRAs, any such rollovers will be subject to normal income taxation at the time of the rollover.
- Hardship Distributions. The PPA directs the IRS to modify the hardship distribution rules so that an event that would be treated as a hardship if it occurred to the participant's spouse or dependents would be considered a hardship if it occurred to, or involved, the participant's beneficiary. The IRS is also directed to make a similar change to the definition of "unforeseeable financial emergency" under Code sections 409A and 457(b).
 - Guidance Update. In IRS Notice 2007-7, the IRS made the following clarifications:
 - Hardship distributions may be made for medical, tuition, and funeral expenses for a primary beneficiary under the plan;
 - Rules are applicable to 401(k) and 403(b) plans;

- A participant's beneficiary under a 409A or 457(b) plan may be treated in the same manner as a participant's spouse or dependent in determining whether a participant has suffered from an "unforeseeable financial emergency."
- Automatic Enrollment. The PPA includes the following provisions to encourage the use of automatic enrollment:
 - Preemption of the application of state wage withholding laws.
 - A requirement that the Department of Labor ("DOL") issue regulations to provide safe harbor guidance on the selection of default investment options. These regulations must be issued within six months after the PPA's enactment.
 - Fiduciary relief for plan fiduciaries that provide automatically-enrolled employees with proper notice of their right to opt out of the plan, as long as these employees' contributions are invested in default investment funds that meet the DOL regulatory requirements.
 - Retirement plans with the automatic enrollment feature are permitted to pay out an employee's account balance if the employee opts out of the plan retroactively within 90 days of first becoming enrolled in the plan. (Any such distributions are taxable in the year of the distribution.)
 - New safe harbors for satisfying certain 401(k) nondiscrimination requirements for plans with automatic enrollment features.

The state law preemption provision is effective immediately, and all other automatic enrollment provisions are effective for plan years beginning after 2007.

Note: Both the preemption provision and the fiduciary protection provision are ERISA amendments. Therefore, they do not provide any relief to church plans that have not made the election under Code section 410(d) to become subject to ERISA.

- Investment Advice. The PPA provides a prohibited transaction exemption for investment advice provided to participants by a "fiduciary advisor" (i.e., an investment company, registered broker-dealer, bank or similar financial institution, or an insurance company) under an "eligible investment advice arrangement." An eligible investment advice arrangement is one that either: (1) uses a computer model (certified by an independent party) that takes into account all investment options under the plan and is not biased in favor of investments provided by the fiduciary adviser, or (2) provides that the investment adviser's compensation will not vary depending on which investment options are selected. An eligible investment advice arrangement must also comply with certain other requirements such as annual audits, adequate notification to participants, and recordkeeping.

A plan sponsor will not be treated as failing to meet ERISA's fiduciary rules with respect to any advice provided through an eligible investment arrangement, provided

that the plan sponsor is prudent in the selection of the investment advice arrangement, the advice is provided by an authorized fiduciary adviser, and the terms of the arrangement meet certain statutory requirements (including a requirement that the fiduciary adviser provide written acknowledgement that it is a fiduciary of the plan with respect to providing investment advice).

Note: These investment advice provisions are incorporated in the prohibited transaction provisions of ERISA and section 4975 of the Code. They are therefore not applicable to non-electing church plans that are not subject to ERISA.

- Guidance Update: The DOL recently issued guidance which makes the following three clarifications:
 - The exemption does not affect arrangements previously approved by the DOL;
 - All investment advice arrangements, whether covered by the above exemption or not, are generally subject to the same basic fiduciary rules;
 - The requirement that fees not vary based on the selection of certain investment options only extends to an affiliate of a fiduciary advisor if the affiliate is providing investment advice to a plan.
- Penalty-Free Withdrawals for Participants Serving in the Military. The PPA provides an exception from the early withdrawal penalty tax for distributions made to reservists called up for service between September 11, 2001 and December 31, 2007. To be eligible for this penalty-free withdrawal, the participant must be called up for service for a period of more than 179 days (or for an indefinite period of time). In addition to the exception to the 10% penalty tax, the PPA permits the participant to pay the distribution back to the plan within the two years after the end of active duty service, without regard to the normal contribution limits.
- Saver's Credit. The Saver's Credit is a non-refundable tax credit for low income individuals. This credit was otherwise due to expire at the end of 2006. However, the PPA makes the Saver's Credit permanent. In addition, the PPA provides that the Saver's Credit can be indexed for inflation. (Note: Because of the way the income limits are calculated for the Saver's Credit, ministers who can claim a substantial portion of their compensation as excludable housing allowance may be eligible for this credit.)
- Distributions for Working During Phased-Retirement. The PPA allows defined benefit plans to make in-service distributions to participants who have attained age 62. This provision allows older workers to receive their pension benefits even if they continue to work.
- Voluntary Correction Programs. The PPA directs the IRS to continue to update and improve the Employee Plans Compliance Resolution System ("EPCRS"), which is

the IRS' voluntary compliance program. Specifically, the PPA directs the IRS to focus on the concerns of small employers; expand the duration of the correction period for significant compliance failures under the Self Correction Program ("SCP"); expand the ability to correct insignificant compliance failures under SCP during audit; and assure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the compliance failure.

- Mapping Investment Options. The PPA provides that the safe harbor rules under ERISA section 404(c), which relate to participant-directed investments, apply to a "qualified change in investment options." A qualified change in investment options is a change in investment options under which the participant's account is reallocated to one or more remaining or new investment options whose characteristics are reasonably similar to those of the previous investment options. A qualified change in investment options must meet certain requirements, including prior participant notification. This provision is effective for plan years beginning after December 31, 2007.

Note: Because this provision is included as an amendment to ERISA, it is not applicable to non-electing church plans that are not subject to ERISA.

- Direct Payment of Tax Refunds to IRAs. The PPA directs the IRS to establish procedures to enable taxpayers to deposit all or a portion of their tax refunds directly into an IRA.
- Tax-Free IRA Distributions for Charity. IRA owners who are over age 70½ are allowed to exclude up to \$100,000 in IRA distributions from income, provided that such distributions are made directly to a charitable organization. This provision applies only to distributions made in 2006 and 2007.
 - Guidance Update. In IRS Notice 2007-7, the IRS made the following clarifications:
 - The annual exclusion limit of \$100,000 is the maximum amount that may be excluded in any year by an IRA owner even if the IRA owner owns multiple IRA accounts;
 - The exclusion is available for IRAs maintained after the death of an IRA owner if the beneficiary is over age 70½;
 - The amount of a qualified charitable distribution that is excludable from gross income is not deductible;
 - Qualified charitable distributions are not subject to the mandatory withholding requirements;
 - The amount distributed in a qualified charitable distribution will be taken into account in determining whether the required minimum distribution requirements are satisfied with respect to the IRA;

- If a distribution fails to qualify as a qualified charitable distribution, it will be treated as a distribution to the IRA owner followed by a contribution from the IRA owner to the charity;
- A qualified charitable distribution may be made by the IRA trustee directly to the charitable organization or by check from the IRA delivered to the charity by the IRA owner.

If you have any questions about the provisions in the PPA or guidance issued in response thereto, please contact us at 202-887-5711.