

Legal Alert: Pension Protection Act of 2006 – IRAs, 403(b) Plans, and 457 Plans

August 21, 2006

The [Pension Protection Act of 2006](#), despite its focus on pension funding rules, touches in various ways on many other aspects and types of retirement arrangements, including IRAs, 403(b) plans, and 457 plans. This Legal Alert first discusses the changes that apply to IRAs, followed by the provisions that apply to 403(b) and 457 plans. Because many of the same provisions apply to both 403(b) and 457 plans, these arrangements are discussed together, and we have noted where there are differences in treatment between the two. Further information is provided by the [technical explanation](#) published by the staff of the Joint Committee on Taxation.

IRAs

The Act includes a number of changes that will directly or indirectly impact individual retirement arrangements (IRAs).

Nonspouse Beneficiary Rollovers. Under current law, upon a participant's death, a spousal beneficiary under a qualified plan is permitted to roll over the benefit to the spouse's IRA or other qualified plan. Nonspouse beneficiaries, however, have not been permitted to roll over or otherwise move funds into their IRAs or other plans.

Effective for distributions after December 31, 2006, the Act permits nonspouse beneficiaries to make a direct transfer to an IRA from a qualified retirement plan, a governmental section 457 plan, or a 403(b) plan. Unlike spouses, nonspouse beneficiaries are not permitted to move the funds by a rollover, but instead must utilize a trust-to-trust transfer mechanism. Also, nonspouse beneficiaries may not move funds to their retirement plans other than IRAs. The amounts transferred to an IRA will be treated as amounts held in an inherited IRA, and the beneficiary will be subject to the same minimum required distribution rules as would apply to the nonspouse beneficiary of an IRA.

Qualified Plan Conversions to Roth IRAs. Under current law, if a participant in a qualified plan, 403(b) plan, or 457 plan wants to convert his or her account to a Roth IRA, the participant must first roll over the funds into a traditional IRA, and then convert the traditional IRA into a Roth IRA. Effective for distributions after 2007, the Act allows a rollover directly

from a qualified plan, 403(b) plan, or 457 plan into a Roth IRA. Such rollovers are subject to the current law rules for conversions from traditional IRAs to Roth IRAs:

- The taxpayer must include the distribution in taxable income (except for distributions of after-tax funds);
- The conversion is not subject to the 10% early withdrawal tax; and
- For 2008 and 2009, only taxpayers with gross income less than \$100,000 are eligible for conversions.

Under the Tax Increase Prevention and Reconciliation Act of 2005, the \$100,000 income limitation on conversions is eliminated for conversions after 2009.

New Early Withdrawal Exception for Military Personnel. A new exception to the 10 percent early withdrawal tax applies to “qualified reservist distributions.” This is a distribution that is made:

- From an IRA or attributable to elective deferrals under a 401(k) or 403(b) plan;
- To a reservist who is called or ordered to active duty for a period in excess of 179 days or for an indefinite period; and
- During the period beginning on the date of such call or order to duty and ending at the close of the active duty period.

A taxpayer who receives such a distribution can, for the two-year period after close of the active duty period, make non-deductible contributions to an IRA equal to such distributions without regard for the usual IRA contribution limits.

The new exception applies only to taxpayers ordered or called to duty between September 11, 2001 and December 31, 2007, although it applies to distributions taken by these taxpayers at any time after September 11, 2001, apparently even if the distribution date is after 2007.

For taxpayers who took refunds before the date of enactment, the two-year period for recontributions to an IRA does not end before the date that is two years after enactment. Also, if a statute of limitations or other rule would normally prevent such a taxpayer from receiving a refund or credit for any early withdrawal tax paid for years before enactment, the new law overrides such a rule if the claim for refund or credit is filed within one year of enactment.

Tax Exemption for Distributions Donated to Charity. As one of several provisions in the legislation intended to offer incentives for charitable giving, the Act provides an exemption from taxation for certain distributions in 2006 and 2007 from a traditional IRA or

Roth IRA (but not a SIMPLE IRA or SEP) that are donated to charitable organizations. The exemption is available only if the taxpayer is at least age 70 ½ at the time of the distribution. The exemption is limited to \$100,000 per taxpayer per year, and it only applies if the entire contribution would be deductible without taking into account the percentage limitations based on the taxpayer's adjusted gross income.

The following additional rules apply:

- Amounts distributed and donated to charity are taken into account as minimum required distributions;
- A special rule applies to IRAs that contain both deductible and nondeductible amounts, under which amounts attributable to deductible contributions (and which consequently would otherwise be included in income) are deemed to be distributed first;
- Distributions exempt under this provision are not taken into account in determining the taxpayer's deduction under Internal Revenue Code (Code) section 170; and
- Certain charitable organizations are not eligible, including donor advised funds and certain private foundations.

Indexing of IRA Limits. The Act provides that the income phase-outs for deductible traditional IRAs and Roth IRAs will be indexed for inflation. Under current law, taxpayers with income above certain limits are permitted only reduced deductible traditional IRA and Roth IRA contributions, and are not permitted to make such contributions at all above certain income levels. These income limits did not increase under current law, but the Act provides that the existing limits are indexed for inflation for 2007 and future years, with increases based on the nearest multiple of \$1,000.

Direct Deposit of Tax Refunds. The IRS is directed to develop a form that will permit tax refunds to be deposited directly to a taxpayer's IRA (or to a spouse's IRA in the case of a joint return). The form would apply for the 2007 tax year and thereafter.

Limited IRA Make-Up Contributions for Bankruptcy/Criminal Acts. A very narrow provision of the Act permits make-up IRA contributions of up to \$3,000 per year for 2007-2009 for individuals meeting the following criteria:

- The individual participated in a 401(k) plan with an employer match in employer stock on at least 50 percent of employee contributions;
- In an earlier tax year, the employer was a debtor in a bankruptcy case and the employer or another person was subject to indictment or conviction resulting from business transactions relating to the bankruptcy; and

- The individual participated in the 401(k) plan on the date six months before the bankruptcy case was filed.

A taxpayer cannot take advantage of both these make-up contributions and catch-up contributions for individuals age 50 and older.

EGTRRA Permanence. The Act makes permanent the IRA-related changes made by EGTRRA, including the following:

- Increased IRA contribution limits, including catch-up contributions;
- Deemed IRAs under employer-sponsored retirement plans; and
- Increased rollover opportunities, including rollover of after-tax contributions.

Saver's Credit. EGTRRA added a temporary nonrefundable tax credit for IRA and other qualified plan contributions. The credit applies to up to 50 percent of the first \$2,000 of contributions, and the credit percentage phases out depending on taxpayer income levels. For example, single filers earning over \$25,000 and joint filers earning over \$50,000 are not eligible for the credit. The credit was set to expire at the end of 2006.

The Act makes the saver's credit permanent. Effective January 1, 2007, the Act also permits a taxpayer to elect that a saver's tax credit refund be directly deposited by the Federal government into a qualified retirement plan or IRA identified by the taxpayer (provided the plan or IRA accepts such direct deposits). In addition, the Act provides that the income limits for the saver's credit will be indexed for inflation.

Prohibited Transaction Exemptions. The Act provides a number of statutory exemptions for prohibited transactions, although in some cases these exemptions expand on existing relief already provided by the Department of Labor. The exemptions, including one for investment advice that closely follows existing relief, are described below in the section on 403(b) plans and 457 plans, and are also described in detail in our Legal Alert entitled "[Pension Protection Act of 2006 – Investments, Insurance, and Services](#)." Note, however, that the investment advice exemption for advice driven by a computer model is *not* available to IRAs, pending a Department of Labor study on the feasibility of expanding the exemption to cover such advice.

403(b) and 457 Plans

Accelerated Vesting Requirements

Before EGTRRA was enacted in 2001, all contributions to a 403(b) plan subject to ERISA were required to vest under either a five-year cliff vesting schedule or a seven-year graded schedule. EGTRRA changed the law to require that matching contributions vest under either a three-year cliff or a six-year graded schedule.

The Act subjects all employer contributions to ERISA-covered 403(b) plans to the same vesting requirements as now apply to matching contributions. Accordingly, employer contributions must vest under either a three-year cliff vesting schedule or a six-year schedule providing for 20 percent incremental vesting after two years of service through six years of service. All years of service, including those before the effective date of the new requirements, must be taken into account. The vesting requirements are effective for contributions for plan years beginning after December 31, 2006, although the requirements do not apply to a participant until the participant has an hour of service after the effective date.

Automatic Enrollment Enhancements

The Act includes a number of provisions designed to encourage automatic enrollment programs. Except as noted below, these provisions are effective for plan years beginning after December 31, 2007.

Automatic Enrollment Safe Harbor. The new legislation adds another ACP nondiscrimination testing safe harbor arrangement for 403(b) plans that provide for automatic enrollment and meet other requirements. Currently, 403(b) plans that provide for certain non-elective or matching contributions and meet notification requirements are deemed to satisfy the ACP test. Effective for plan years beginning after December 31, 2007, 403(b) plans that provide for automatic contributions and meet certain other requirements will also be deemed to pass the ACP test.

To satisfy the requirements of the new safe harbor, a 403(b) plan must provide for certain automatic deferrals for all employees eligible to participate in the plan. The automatic deferrals may not exceed 10% of an employee's compensation but must be at least 3% of compensation until the end of the first full plan year beginning after the safe harbor applies to the employee; that percentage increases to 4% during the second year; 5% during the third year; and 6% during the fourth year and thereafter. These requirements, however, do not apply to employees who are hired before the plan adopts the safe harbor arrangement and who have an affirmative election in

place either to make contributions or not to make contributions. Each employee must have an opportunity to change (or cancel completely) any automatic contribution.

In addition, the employer must make a minimum contribution on behalf of each nonhighly compensated participant in the plan. The contribution may be either:

- A nonelective contribution equal to 3% of the employee's compensation.
- A matching contribution equal to 100% of the employee's contributions which does not exceed 1% of compensation and 50% of the employee's contributions that exceed 1% but do not exceed 6% of compensation. The matching contribution requirement can be satisfied by an alternate formula provided it results in matching contributions at each rate of contribution which are at least equal to the matching contributions that would be made under the formula specified in the Code and the rate of match for any highly compensated employee is not greater than the rate of match for any nonhighly compensated employee.

Matching contributions, however, cannot be made on deferrals that exceed 6% of a participant's compensation.

Before the beginning of each plan year, a safe harbor plan must also provide each employee who is eligible to participate in the arrangement with a written notice that explains the employee's right under the arrangement not to make elective contributions (or to elect contributions in a different amount). In a plan that allows employees to choose among two or more investment options, the notice must explain how contributions will be invested in the absence of an election.

ERISA Section 404(c) Protection. The Act expands the scope of fiduciary protection under ERISA section 404(c) for 403(b) arrangements (and IRA arrangements) subject to ERISA. Although this provision primarily affects plans that provide for automatic enrollment, it is not limited to these plans and is generally applicable to all plans that permit participants to direct their investments. In the past, ERISA section 404(c) has relieved plan sponsors, administrators, and others of fiduciary liability if plan participants make affirmative elections directing the investment of funds in their accounts, provided certain notice and other requirements are met. Plans providing for automatic enrollment and automatic contributions, however, have faced problems because participants who fail to make affirmative contribution elections frequently fail to make affirmative investment elections, and ERISA section 404(c) has not provided explicit protection for plan fiduciaries when participants have not actually exercised control over the investment of their accounts. As a result, plan sponsors wanting the protection of ERISA section 404(c) may have been reluctant to adopt automatic enrollment and contribution arrangements.

Effective upon enactment, the Act amends ERISA section 404(c) to provide that participants who fail to make an affirmative investment election will be treated as exercising control over the assets in their accounts if certain requirements are met.

- The plan must provide that automatic contributions will be invested in accordance with guidelines to be issued by the Department of Labor (DOL). The new legislation directs the DOL to issue regulations within six months providing guidance on default investments for participants who fail to make an affirmative investment election. The default investments will be required to include a mix of asset classes consistent with capital preservation or long-term capital appreciation or both. The DOL has been working on a similar project for some time and is expected to issue proposed regulations shortly.
- The plan must also give notice to employees before the beginning of each plan year explaining their rights to make investment elections under the plan and how contributions will be invested in the absence of affirmative investment elections.

Explicit ERISA Preemption of State Wage Laws. Despite ERISA's broad existing preemption provisions, several states have taken the position that their wage and payroll laws prohibit automatic contributions to an employer-sponsored retirement plan in the absence of a salary deferral agreement, discouraging some employers from adopting automatic contribution arrangements. The Act explicitly provides that these state laws are preempted for 403(b) arrangements subject to ERISA if the automatic contribution arrangement meets certain requirements.

- The contributions must be invested in accordance with the regulations to be issued by the DOL under ERISA section 404(c); and
- The plan must give notice to participants before the beginning of each plan year explaining that participants have a right not to make contributions (or to change the amount of their contributions) and how the contributions will be invested in the absence of an affirmative investment election.

This new rule is not applicable to 403(b) arrangements or other plans that are not subject to ERISA.

Withdrawal of Contributions During First 90 Days. Under the Act, 403(b) and governmental 457(b) plans may allow participants to withdraw automatic contributions within a 90-day window period. Although plans generally notify participants about automatic contributions procedures, some employers have been concerned that employees do not pay attention to the notices until amounts have been deferred from compensation and that new employees may not receive notice of the arrangement sufficiently far in advance to change or

stop an automatic contribution if they want to do so. As a result, some employees stop automatic contributions shortly after they commence, leaving plan sponsors with a large number of small accounts that are costly to maintain.

The Act authorizes 403(b) and governmental 457(b) plans to allow the withdrawal of automatic contributions without an early withdrawal or other penalty under certain circumstances. To permit early withdrawals, the following requirements must be met:

- The plan must be amended to permit an early withdrawal. (Plans are not required to permit early withdrawals.)
- The plan must implement the new ERISA section 404(c) provisions described above.
- The plan must provide a notice to each eligible employee before the beginning of each plan year explaining the employee's right not to make automatic contributions (or to make such contributions in a different amount) and how contributions under the plan will be invested in the absence of an affirmative investment election.
- The withdrawal must be made at the election of the employee within 90 days of the first automatic contribution made for the employee and must include all of the employee's automatic contributions. The amount withdrawn is included in income in the year of withdrawal and, for 403(b) plans, is not taken into account for purposes of the ACP test.

Expansion of Corrective Distribution Period. For 403(b) plans with automatic deferrals, the new legislation also extends the period during which excess aggregate contributions resulting from ACP test failures can be distributed before incurring the 10% excise tax under Code section 4979. Currently, the period is 2 ½ months from the end of the plan year. The Act extends that to one year and requires the distribution of income on excess amounts only through the end of the year in which the amounts were contributed (*i.e.*, "gap period" income need not be distributed). Amounts distributed are includible in income in the year of distribution. Only automatic contribution arrangements that comply with the requirements for expanded protection under ERISA section 404(c) and meet the notice requirements described in connection with the 90-day window period for early withdrawals are eligible for the expanded corrective distribution period.

Distribution Changes

There are several provisions of the Act that make changes relating to distributions from 403(b) and 457 plans.

Hardship Distributions. The Act provides that the Treasury Department must issue regulations within 180 days of the date of enactment providing that hardship or unforeseeable emergency distributions from a section 403(b) or 457 plan apply not only to certain hardships or

unforeseeable emergencies of the participant's spouse and the participant's dependents, but also of the participant's beneficiary under the plan. Under the regulations, if a hardship or unforeseeable emergency of a spouse or dependent would permit a distribution, then the hardship or unforeseeable emergency of the participant's beneficiary would also permit a distribution. For example, if the participant's domestic partner is the participant's beneficiary in a 403(b) plan, the participant could receive a hardship distribution based on the domestic partner's hardship. Plans will be permitted to make such a change, but it is not mandatory. This change will be effective following the issuance of regulations by Treasury.

Rollovers to Nonspouse Beneficiaries. Under current law, upon a participant's death, a spousal beneficiary under a 403(b) or governmental 457(b) plan is permitted to roll over the benefit to the spouse's IRA or other qualified plan. Nonspouse beneficiaries, however, have not been permitted to roll over or otherwise move funds into their IRAs or other plans.

Effective for distributions after December 31, 2006, the Act permits nonspouse beneficiaries to make a direct transfer to an IRA from a 403(b) plan or governmental 457(b) plan. Unlike spouses, nonspouse beneficiaries are not permitted to move the funds by a rollover, but instead must utilize a trust-to-trust transfer mechanism. Also, nonspouse beneficiaries may not move funds to their retirement plans other than IRAs. The amounts transferred to an IRA will be treated as amounts held in an inherited IRA, and the beneficiary will be subject to the same minimum required distribution rules as would apply to the nonspouse beneficiary of an IRA.

Many plans permit beneficiaries to keep assets in the plan until distribution is required under the applicable minimum required distribution rules, particularly in light of the current law rule prohibiting nonspouse beneficiary rollovers to other plans upon distribution. With the law change, some plan sponsors may wish to consider requiring distributions to beneficiaries at an earlier date to simplify plan administration.

Rollovers of After-Tax Contributions to 403(b) Annuities. Currently, employee after-tax contributions can be rolled over from a qualified plan to another qualified plan, and employee after-tax contributions can be rolled over from a 403(b) plan to another 403(b) plan, provided the rollover is a direct rollover and the recipient plan or annuity accounts separately for the amounts rolled over (and the earnings thereon). Current law does not permit after-tax funds to be moved from qualified plans to 403(b) plans, or vice-versa.

Beginning after December 31, 2006, after-tax contributions can be rolled over from a qualified plan to a 403(b) plan, as well as to a qualified plan. The new law does not appear to permit after-tax funds held in a 403(b) plan to be rolled over to a qualified plan, however.

Conversions to Roth IRAs. As explained in more detail above in connection with IRAs, the Act allows distributions from 403(b) plans and governmental 457 plans to be rolled over directly into a Roth IRA, subject to the rules that apply to rollovers from a traditional IRA into a Roth IRA.

New Early Withdrawal Exception for Military Personnel. As described in more detail in the IRA discussion, a new exception to the 10 percent early withdrawal tax applies to “qualified reservist distributions” from elective deferrals made to a 403(b) plan. Such distributions will not be treated as violating the usual restrictions against in-service distributions in a 403(b) plan. The exception applies to reservists who are called or ordered to active duty for a period in excess of 179 days or for an indefinite period. Distributions are permitted during the active duty period for taxpayers ordered or called to duty between September 11, 2001 and December 31, 2007. Recontributions to IRAs of amounts distributed under this rule are allowed, generally for two years following the end of active duty.

Distributions from Governmental Plans for Health and Long-Term Care Insurance. The Act provides that annual distributions of up to \$3,000 from a governmental 403(b) plan or 457 plan to pay for qualified health insurance premiums for eligible retired public safety officers are excludable from income if the amounts are paid directly to an insurer.

Availability of PBGC Missing Participant Program. The Act permits plan administrators of certain nongovernmental 403(b) plans to take advantage of the PBGC missing participants program upon termination of the plan. Under this program, if a plan administrator has terminated a plan and cannot locate a participant, the benefit can be transferred to the PBGC as trustee until the PBGC locates the missing participant. This rule is effective after the PBGC issues final regulations implementing the provision.

EGTRRA Permanence

The Act makes permanent the changes made by EGTRRA relating to 403(b) and 457 plans, including increased contribution limits, catch-up contributions for participants age 50 and over and expanded rollover options. The saver’s credit (as described in more detail in the IRA discussion above) also continues to be available with respect to elective deferrals to a section 403(b) annuity and a governmental 457 plan.

ERISA §404(c) Changes

For 403(b) plans that are subject to ERISA, section 404(c) generally provides that plan fiduciaries are not subject to liability for individual participant investment choices in participant-directed plans, provided the participant is given adequate information regarding the investments

and other procedures are followed. The Act contains a number of provisions that clarify the scope of ERISA section 404(c) relief for plans in certain situations. These provisions are also discussed in our Legal Alert entitled “[Pension Protection Act of 2006 – Investments, Insurance, and Services.](#)”

Default Investments. As discussed in more detail above in the section headed “Automatic Enrollment Enhancements,” the Act directs the DOL to issue regulations within six months of enactment providing standards for default investment options for participants who fail to make an investment election. Plan fiduciaries who follow these standards are relieved of fiduciary liability in connection with these investment allocations.

Investment Mapping. The Act provides that when a plan changes investment choices and automatically maps participant choices to “reasonably similar” investments, ERISA section 404(c) relief will continue to apply with respect to the mapped investments if advance notice to participants is provided and other requirements are satisfied. This change is generally effective for plan years beginning after 2007, with a delayed effective date for collectively bargained plans.

Blackout Period. The Act specifies that section 404(c) relief does not apply with respect to a “blackout period” during which participants cannot change their investment elections unless the blackout period is implemented in accordance with standards to be issued by the DOL within one year following enactment. As with the investment mapping changes, this change is generally effective for plan years beginning after 2007.

ERISA Investment Changes

The Act includes various changes to ERISA that are intended to facilitate the provision of investment advice to participants and expand the ability of plans to utilize certain investments within the limitations of the prohibited transaction rules. These changes, which apply to 403(b) plans subject to ERISA, are briefly summarized below, and they are discussed in more detail in our Legal Alert entitled “[Pension Protection Act of 2006 – Investments, Insurance, and Services.](#)”

Investment Advice. A new statutory exemption, ERISA section 408(b)(14), provides relief for the provision of investment advice to participants in participant-directed plans subject to ERISA. The exemption essentially provides that an investment advice arrangement will not give rise to a prohibited transaction if it is (1) based on a computer model certified by an independent expert; or (2) an arrangement in which the advisor’s fees do not vary depending on the investment selected. The exemption builds on previous DOL interpretive guidance, with certain changes and clarifications. From the plan sponsor and plan fiduciary perspective, the

provision is also significant in that it provides specific relief for the sponsor and other fiduciaries (other than the advisor) from liability for any individual advice provided to participants. The change will be effective for advice provided after 2006.

Other Prohibited Transaction Rule Changes. The Act modifies the ERISA “plan asset” rules and prohibited transaction provisions in ways that will generally allow:

- Non-publicly traded investment funds, including hedge funds, to accept more ERISA plan funds;
- Non-fiduciary service providers to engage in certain transactions with plans to which they provide services, superseding some existing class exemptions issued by the DOL;
- Plan fiduciaries to effect large block trades on behalf of multiple plans;
- Purchases and sales of securities through certain electronic trading networks and alternative trading systems;
- Certain transactions on foreign exchanges; and
- “Cross-trading” by an investment manager in a wider variety of circumstances than currently permitted under an existing DOL class exemption.

Reporting

Quarterly Benefit Statements. The Act requires administrators of 403(b) plans subject to ERISA to provide a benefits statement to each participant at least quarterly if the participant has a right to direct the investment of assets in his or her account. Other participants must receive a benefits statement at least annually. The benefits statement must include the following information:

- The total value of benefits accrued;
- The value of each investment to which assets in the participant’s account are allocated (including the value of investments in employer securities); and
- The participant’s vested accrued benefit or the earliest date on which the accrued benefit will become vested.

The benefits statement of a participant who has the right to direct investments must also include an explanation of any limits or restrictions on the participant’s right to direct investments; an explanation of the importance of a well-balanced, diversified investment portfolio, including a statement of the risk of holding more than 20% of a portfolio in the security of one entity; and a notice directing the participant to the DOL website for information on investing and diversification. The Act requires the DOL to develop a model benefits statement within a year of enactment.

Proposed Form 5500 Changes. In July 2006, the Department of Labor, together with the IRS and PBGC, proposed significant changes to the Form 5500 and related schedules that affect defined contribution plans. In brief, the highlights of these changes include:

- A new short-form 5500 filing would be available for small plans that cover less than 100 participants and are invested exclusively in easy-to-value investments, such as mutual funds;
- All service providers receiving fees in excess of \$5,000 would be required to be listed, rather than only the 40 receiving the most compensation; and
- Service providers receiving compensation from third parties in excess of \$1,000 in connection with plan services would be required to so indicate, including listing the payor of the compensation and the amount of the compensation – most significantly, this would appear to require information to be disclosed with respect to service providers who receive 12b-1 and other fees with respect to plan investments.

Under current DOL rules, many 403(b) plans are exempt from Form 5500 reporting, including governmental plans and nongovernmental plans that offer only salary reduction contributions and have limited employer involvement. All other 403(b) plans currently have only limited Form 5500 reporting requirements. In a significant change, the limited reporting for these plans would be eliminated, and these plans would be required to report on the same basis as 401(k) plans (including the short form reporting for smaller plans). The proposal, which may contemplate at least some measure of centralized recordkeeping for 403(b) plans, raises a number of concerns driven by differences in the operation and administration of 403(b) and 401(k) plans.

EPCRS Enhancements

The Act clarifies that the IRS has the authority to establish and implement its Employee Plans Compliance Resolution System (EPCRS), including waving income, excise, or other taxes. The Treasury Department is directed to continue to update and improve EPCRS, including (1) taking into account the special concerns of small employers; (2) extending the self-correction period for significant compliance failures; (3) expanding the ability to self-correct insignificant errors during audit; and (4) assuring that taxes, penalties, and sanctions under the program are not excessive.

Voluntary Early Retirement and Retention Plans Exempt from Section 457 Limits

The Act provides that certain voluntary early retirement incentive plans and retention plans maintained by local educational agencies or tax-exempt education associations that

principally represents employees of local educational agencies are not subject to the limits under Code section 457.

A voluntary early retirement plan that makes payments or supplements as an early retirement benefit, a retirement-type subsidy, or a social security supplement in coordination with a defined benefit plan maintained by a state, local government, or local educational agency is treated as a bona fide severance plan to the extent the payments or supplements could have otherwise been made under the defined benefit plan. As a result, the payments are not subject to the limits under section 457. The Act further provides that this type of plan is treated as a welfare plan for purposes of ERISA (to the extent ERISA applies) and is exempt from restrictions under the Age Discrimination in Employment Act that could otherwise apply.

The Act also provides that a retention plan providing compensation payable on termination of employment will be treated as a plan that does not provide for a deferral of compensation to the extent benefits do not exceed twice the applicable dollar limit on deferrals under section 457 (\$14,000 for 2006). The benefits under the plan must be paid for the purpose of retaining the services of an employee or rewarding an employee for service with a local educational agency or a tax-exempt educational association that principally represents employees of local educational agencies. This type of plan is also treated as a welfare plan for purposes of ERISA (to the extent ERISA applies).

Expansion of Participation Rules under Section 457

The Act provides that an individual is not precluded from participating in an eligible deferred compensation plan under Code section 457 by reason of having received a distribution of up to \$3,500 under section 457(e)(9) as in effect before the Small Business Job Protection Act of 1996.



Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

George H. Bostick	202.383.0127	george.bostick@sablaw.com
Daniel M. Buchner	202.383.0869	daniel.buchner@sablaw.com
Adam B. Cohen	202.383.0167	adam.cohen@sablaw.com
Ian A. Herbert	202.383.0644	ian.herbert@sablaw.com
Alice Murto	404.853.8410	alice.murto@sablaw.com
Robert J. Neis	404.853.8270	robert.neis@sablaw.com
W. Mark Smith	202.383.0221	mark.smith@sablaw.com
William J. Walderman	202.383.0243	william.walderman@sablaw.com
Carol A. Weiser	202.383.0728	carol.weiser@sablaw.com