RETIREMENT PLAN OPPORTUNITIES IN THE PENSION PROTECTION ACT OF 2006

The defined contribution aspects of this legislation should provide new, and more certain, tax savings for business owners, ranging from Roth 401(k) plans, through hybrid plans and greater fiduciary protection for plan sponsors.

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We do not often think of major tax acts as being filled with opportunities to lower overall taxes and expand savings for owners and key employees, but the Pension Protection Act of 2006 (PPA)[1] does just that. This comprehensive retirement plan reform package, signed into law by President Bush on August 17, 2006, makes permanent many temporary, favorable reform aspects of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[2] confirms Congress' intent to make Roth 401(k) plan provisions permanent, removes state law issues associated with automatic enrollment 401(k) plans, resolves uncertainty issues for certain hybrid plan designs and provides opportunities for combined defined contribution/defined benefit plans, and provides more fiduciary protection for plan sponsors. This article will focus mainly on the defined contribution aspects of PPA.

EGTRRA permanency; contribution limits

When EGTRRA passed in 2001, it increased contribution and benefits limits and plan portability. But with these generous tax breaks came a limit; many provisions in EGTRRA that were employee favorable were due to "sunset," or expire, in 2010. The effect of this expiration would have been deeply felt by those maximizing their elective deferrals into 401(k) plans. Limits[3] that had been at $15,000—$20,000 per year for employees would revert back to pre-EGTRRA limits (adjusted for inflation) in the $13,000 range. "Catch-up" contributions,[4] elective deferral increases for participants age 50 or over, would have disappeared completely. Changes to the annual additions limit[5] for each employee in a plan, as well as the maximum compensation[6] that could be taken into account for contribution calculations, would have been diminished at the expiration of EGTRRA.

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HAVING PRE-TAX AND POST-TAX RETIREMENT ACCOUNTS GIVES A BUSINESS OWNER ADDED FLEXIBILITY TO EVEN OUT TAX BURDENS DURING RETIREMENT.

PPA 2006 provides certainty that these limits will not revert to previous levels,[7] but will continue to increase for inflation. This knowledge allows greater flexibility in planning through the ups and downs of compensation in the construction industry. Business owners with spouses who work in the business can pay the spouse fair compensation, and be assured that the annual additions limit (generally the sum of elective deferrals, employer contributions and forfeitures allocated to an individual for the plan year) will remain at the lesser of a specified dollar amount (currently $45,000 for 2007) or 100% of compensation, as opposed to the 25% limit prior to EGTRRA.

EGTRRA permanency; deduction limits

Employer deduction limits for profit-sharing plans,[8] including 401(k) plans, would have reverted to the pre-EGTRRA 15% level, including elective deferrals, instead of the post-EGTRRA rate of 25% without including elective deferrals. The EGTRRA change to 25% without including elective deferrals allowed much greater flexibility in funding profit-sharing contributions, and led to the creation of the so-called "solo 401(k) plans." These plans, for business owners and their spouses, where there are no eligible employees, allow for increased contributions since the elective deferrals are not included in the overall 25% deduction limit. If a construction business owner hires only employees covered by collective bargaining agreements, he may be eligible to set up a solo 401(k) for himself for maximum retirement plan contributions.

Confirmation of Roth 401(k) plans

EGTRRA established the concept of the Roth 401(k) plan, beginning for 2006 plan years. But employers were hesitant to adopt these provisions because of certain five-year holding requirement rules, and the 2010 sunset provisions of EGTRRA. It appeared that Roth provisions could sunset at just about the time plan participants could take advantage of the tax-free withdrawal. PPA permanently extends the Roth provisions of EGTRRA,[9] which allow participants to make after-tax elective deferrals that, along with earnings, qualify for tax-free distribution if certain conditions are met. PPA also removes the income limit for conversion of regular IRAs to Roth IRAs, but not until 2010.

Why consider adding a Roth provision to your 401(k) plan? If you think that tax rates are lower now than they will be when you are retired, having retirement savings in Roth is a wise choice to minimize overall taxes. But even if you don't know what your retirement tax rates will be, the tax-free earnings feature of Roth accounts can be very appealing. There are also no required minimum distributions associated with Roth accounts, since there is no tax due on qualifying distributions. Finally, having both pre-tax and post-tax retirement accounts gives a business owner added flexibility to even out tax burdens during retirement.

Automatic enrollment 401(k) plans

An automatic enrollment 401(k) plan, also known as a negative election plan, is a plan that has a stated level of elective deferrals that will be taken from an employee's pay, unless he or she affirmatively elects NOT to have the deferrals made. It forces employees to take an action in order to not make contributions to their plan. Auto enrollment plans have faced legal challenges from various states, under wage and withholding laws, since there is no election the employee signs to agree to the reduction of his or her current pay. PPA removes these challenges[10] by asserting ERISA,[11] the federal pension law, preempts the state wage withholding and minimum wage laws. Auto enroll plans now have a green light (effective in 2006), and an additional safe harbor (beginning in 2008). Certain requirements must be met, including an annual notice to employees, a uniform contribution rate, and "right to cancel with refund" for the first three months.

Employers who pay prevailing wage benefits have had the opportunity for a long time to use those benefits to offset other employer contributions to a profit-sharing plan, as long as Davis Bacon benefits are contributed to the plan for the benefit of the prevailing wage worker. This practice allows owners to maximize their own profit sharing at

a minimal incremental cost. The auto enrollment 401(k) can work in a similar way, but with deferrals instead of profit sharing. By making employees actually affirmatively opt out if they do not want to make a contribution, it is likely that the overall deferral rates for the non–highly compensated employees will increase, thus allowing the rates for the highly compensated employees and owners to also increase at no additional cost to the employer.

Hybrid plan designs

A cash balance plan is a plan under which a participant's benefit is defined as the balance in a hypothetical account, which is credited with annual contribution credits usually based on a percentage of pay, and earnings credits at a rate specified in the plan. Unlike a defined contribution plan, a cash balance plan does not allocate actual plan earnings to the participant's account, but uses a rate specified in the plan. Earnings above or below the specified rate affect the employer/plan sponsor's funding of the plan either as a benefit, reducing funding, or a detriment, causing additional funding.

Cash balance plans are defined benefit plans that have been around for a long time, but have been heavily litigated over the last several years. The main issue is age discrimination when a traditional defined benefit plan is converted to a cash balance plan. PPA clears the way for cash balance plans by protecting them from age discrimination claims as long as certain vesting (three year maximum) and interest crediting rates are used.[12] The law also removes the harmful whipsaw effect for lump sum distributions by allowing the same interest rate assumption to be used for calculating both the projected annuity and the lump sum equivalent.

Because cash balance plans are defined benefit plans, there is a special deduction limit for the employer. The employer is allowed the full funding requirement for the cash balance plan (or any traditional defined benefit plan) as long as it meets the compliance rules. This can be combined with a defined contribution plan (such as a safe harbor 401(k) plan) that has no more than a 6% employer funding without exceeding the deductibility rules.[13] For a 50-year-old business owner with $225,000 in compensation, the combination with the defined contribution plan could allow an additional $33,500 contribution on top of the cash balance contribution for any year. While the cash balance plan has a set allocation formula and is rather inflexible, the contributions to the safe harbor 401(k) plan can be totally discretionary, other than the 3% discretionary or safe harbor match contribution. This allows significant funding flexibility for the cyclical nature of the construction business.

A CASH BALANCE PLAN DOES NOT ALLOCATE ACTUAL PLAN EARNINGS TO THE PARTICIPANT'S ACCOUNT.

Expanded fiduciary protection

Plan sponsors are generally held responsible, as fiduciaries, for the management of their retirement plans and the investment of plan assets. They are given some fiduciary relief under ERISA section 404(c) when they give participants the opportunity to direct their own investments, and enough information for the participants to make informed investment decisions. But several situations arise in the normal operation of a plan that may cause participants to have account balances over which they have made no affirmative investment elections. Profit sharing money may be invested in a default fund because the participant failed to elect investments. Plan assets may be "mapped" from one investment platform to another when vendors change. And a participant may be barred from changing his elections during a transition, or "blackout" period of restricted activity. All these situations were addressed by PPA[14] to give the plan sponsor greater protection from fiduciary liability.

PPA mandated, at long last, a fiduciary safe harbor for default investments. The Department of Labor (DOL) has issued proposed regulations listing three types of investments that meet their criteria for default investments: age-based lifestyle funds, risk-based lifestyle funds and balanced funds, and managed accounts. PPA also directed the DOL to issue final regulations by February 2007 but those regulations have yet to appear. Fiduciary protection is also expanded to mapping situations and blackout periods, as long as proper notice is given to plan participants.

Why does this make a difference? If you are an employer with employees at multiple job sites, employee education and getting employees to make affirmative investment elections becomes increasingly difficult. High percentages of employees in default funds used to be a fiduciary issue for the plan sponsor. Plan sponsors can breathe a little easier now, even with many employees in default funds. Also, if an automatic enrollment feature is added to an existing 401(k) plan, the default investment will be given fiduciary protection, as long as it is described by one of the three options above.

While we are still awaiting regulatory guidance on many PPA provisions, it is clear that Congress has expanded plan design opportunities in many ways. This is a great time to explore the different opportunities that have either become available, or whose existence has become permanent due to PPA. ■

NOTES

[1] H.R. 4. See also Christina, "The Multiemployer Plan Provisions of the Pension Protection Act of 2006," 17 *Construction Accounting and Taxation* 5 (March/April 2007).

[2] P.L. 107-16.

[3] Internal Revenue Code (IRC) § 402(g) limits.

[4] IRC § 414(v).

[5] IRC § 415.

[6] IRC § 401(a)(17).

[7] PPA § 811.

[8] IRS § 404(a)(3)(A).

[9] PPA § 811.

[10] PPA § 902.

[11] The Employee Retirement Income Security Act of 1974.

[12] PPA § 701.

[13] IRC § 404(a)(7).

[14] PPA § §621, 624.