



FBA NEWS NOTES

Special Edition

NEWS AND INFORMATION ON EMPLOYEE BENEFIT PLANS

Pension Protection Act of 2006 Signed into Law

On August 17, 2006, President George W. Bush signed into law H.R. 4, the "Pension Protection Act of 2006." The PPA makes numerous amendments to ERISA and the Code. Among other changes, the PPA includes rules designed to increase participant in employer-sponsored defined contribution plans and new funding rules for defined benefit plans. The PPA also makes permanent a number of favorable provisions relating to pension plans and individual retirement accounts that were due to expire in 2010. This summary covers key changes for defined contribution plans, but is not all inclusive, other provisions apply. A small section summarizing the changes for defined benefit plans has also been included.

SUMMARY of the DEFINED CONTRIBUTION RELATED PROVISIONS of the PPA of 2006

I. PERMANENCE of RETIREMENT SAVINGS INCENTIVES

EGTRRA Provisions Impacting Retirement Plans. The PPA makes permanent EGTRAA retirement plan provisions that were scheduled to expire in 2010. Beneficial changes like higher contribution limits for 401(k) plans, catch-up contributions for age 50 and older, higher deduction limits for profit sharing plans, and the "Roth" option for 401(k) contributions are now here to stay.

Tax Saver's Credit. The Act makes the Saver's Credit permanent. The Saver's Credit is a non-refundable tax credit available to eligible taxpayers who satisfy certain adjusted gross income limits and make contributions to a defined contribution plan or IRA. Instead of expiring, the Saver's Credit income limits will be indexed for inflation after 2006.

II. AUTOMATIC ENROLLMENT

Studies have indicated that automatic enrollment can boost plan participation between 85 to 95 percent of all eligible employees. Despite these studies, employers have been reluctant to implement automatic enrollment due to perceived legal risks. The PPA addresses these risks and provides incentives for employers to add an automatic enrollment feature to their 401(k) plan.

Creation of Automatic Enrollment Safe Harbor.

Effective Date: Plan years beginning after December 31, 2007.

The Act provides a new nondiscrimination safe harbor for plans with a "qualified" automatic contribution arrangement. Under the Act, plans that satisfy certain requirements for the new automatic enrollment safe harbor would (1) not be subject to the top-heavy plan rules, and (2) would be deemed to satisfy the ADP/ACP testing. To qualify:

Automatic Deferrals - Each eligible employee must be treated as electing to make elective contributions in an amount equal to a qualified percentage of compensation. The "qualified percentage of compensation" is no more than 10 percent of compensation and at least: 3% of compensation the first year; 4% the second year; 5% the third year; and 6% thereafter. The automatic election must cease to apply if the employee makes an affirmative election or elects out of the deferrals.

This automatic enrollment need not apply to current employees with an election in effect, or those that elected not to participate. However, a plan sponsor could elect to cover such existing employees under a new automatic enrollment program.

Safe Harbor Contributions and Vesting - To qualify, an employer must either make (i) a non-elective contribution equal to at least 3% of each eligible non-HCE's compensation, or (ii) a 100% match on non-HCE elective contributions up to 1%, plus a 50% match on non-HCE elective contributions that exceed 1% up to 6% of compensation. In addition employer contributions must vest within 2 years.

Notice Requirement - An employee subject to the automatic enrollment program must receive the notice within a reasonable period of time before each plan year. The provided notice should explain the employee's right under the plan to designate how contributions and earning will be invested and explain how they will be invested in default of an affirmative election. The employee must have a reasonable period of time after receiving the notice and before the first elective contribution is made to make an affirmative election.

Other provisions have been included to encourage automatic enrollment that do not adopt the automatic enrollment safe harbor but satisfy certain notice and other requirements.

Corrective Distribution of Automatic Enrollment Contributions.

Effective Date: Date of Enactment.

Plans have been provided with a new correction option that allows for the return of deferrals that were made in error during the first 90 days after the employee was automatically enrolled. The amount distributed would be exempt from the 10% penalty tax and not included in the ADP test. Any matching contributions made on the amount withdrawn will be forfeited. These amounts would need to be distributed by April 15th of the following year.

Timing of Corrective Distributions of ADP/ACP Refunds.

Effective Date: Date of Enactment.

Plans with an eligible automatic enrollment arrangement may make ADP and ACP corrective distributions up to six months after the end of the plan year (rather than the normal 2 ½ -month period) without incurring the 10% excise tax.

ERISA Preemption from State Law for Automatic Enrollment.

Effective Date: Date of Enactment.

Certain states have minimum wage and labor laws that require employers to receive authorization from employees before any amount can be withheld from employee wages. The PPA clarified that Federal law under ERISA preempts any state laws that would prohibit or restrict an automatic enrollment arrangement.

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The preemption provision provides much-needed certainty regarding the impact of state laws on automatic enrollment arrangements, especially because it can apply not just to “qualified automatic contribution arrangements,” but also to the larger arena of automatic enrollment plan designs, so long as the plan meets the specific notice and other requirements.

III. INVESTMENT RELATED ISSUES

Employer Securities

Effective Date: Plan years beginning after December 31, 2006. (Special effective dates apply to collectively bargained plans and certain ESOP arrangements).

A DC plan that holds publicly-traded employer securities, must allow participants to divest elective deferrals and after-tax employee contributions invested in the employer stock and to reinvest those assets in alternative investment options at any time. There must be at least three alternative investment options, besides employer securities, where each is diversified and has materially different risk and return characteristics.

Participants are allowed to diversify employer contributions after three years of service. Participants must be provided a written notice at least 30 days before they are eligible to diversify out of employer securities. The notice must describe the rights and importance of diversification.

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Traditional employee-ownership ESOPs are exempt from these rules, but the more typical K/MSOPs are not.

Default Investments

Effective Date: Plan years beginning after December 31, 2006.

A question that comes up in conjunction with automatic enrollment is how to invest contributions where there is no affirmative participant election. Some sponsors default to balanced, diversified, low-cost vehicles. The DOL is directed to issue guidance “on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.” The PPA provides that in this situation, ERISA Section 404 (c) protection (under which fiduciaries are generally not liable for the asset allocation decisions of participants) is available with respect to such a default provision so long as a notice requirement and certain requirements as to the default investment are met.

Mapping Investment Options

Effective Date: Plan years beginning after December 31, 2007.

A question related to the default investment issue is the extent to which ERISA Section 404 (c) protection is available when there is a “qualified change” in investment options. For instance, a “qualified change” could be when a fund is eliminated or replaced, and participant assets are automatically reallocated to remaining or new funds when the participant doesn’t affirmatively direct a reallocation. To qualify for continued protection:

- a) Participants’ accounts are reallocated to other investment options (either existing or new) that have reasonably similar risk and return characteristics.
- b) At least 30 days and no more than 60 days prior to the effective date of the change, participants must receive written notices of the change (including a comparison of investment options and an explanation that the change will occur unless the participant instructs otherwise.
- c) The investment options in place prior to the change were the product of the participant’s control, and the participant has not provided affirmative investment instructions contrary to the change.

Investment Advice

Effective Date: Applies to investment advice provided after December 31, 2006.

The current law restricts the ability of financial service providers from offering “advice” about what funds to invest in to participants in 401 (k) plans or IRAs. Doing so would (or may) be a prohibited transaction. Under the new pension law, the DOL has provided exceptions to ERISA’s prohibited transaction rules for advice provided by a “fiduciary advisor” under an “eligible investment advice arrangement”. The exemption would cover advice provided to a participant in the plan, but not advice to the plan. In order to qualify for the exception, the eligible arrangement must be either:

(i) *Fee-Based.* The fee-based arrangement requires that any fee (including commissions and other compensation) received by a fiduciary advisor for investment advice (or for investment transactions) must not vary depending on the basis of any investment option selected; *or*

(ii) *Computer Model.* The computer model arrangement must apply generally accepted investment theories, use relevant information about the participant (e.g., retirement age, risk tolerance), and not favor investments offered by the fiduciary advisor (in addition to other requirements). An independent investment expert must certify that the computer model satisfies the qualification criteria, and the computer model must generate the only advice provided under the program.

Disclosures. For either a fee-based or computer model arrangement, the fiduciary advisor must, among other requirements, make numerous disclosures to the participants and beneficiaries (e.g., past performance of investment options, fees and compensation received by the fiduciary advisor, and a recipient’s right to obtain advice from another advisor).

The Definition of a “Fiduciary Adviser.” The advice would have to be provided by a “fiduciary adviser,” which may include a registered broker-dealer, a registered investment adviser under the Investment Adviser Act of 1940, a bank or similar financial institution, or an insurance company. The bill defines an “adviser” to include all affiliates or registered representatives of the fiduciary adviser.

In addition, the fiduciary adviser must specifically acknowledge in writing that it is a fiduciary of the plan with respect to the provision of the advice.

Fiduciary Responsibility of Sponsor. Importantly, even under an eligible investment advice arrangement, the plan sponsor (or other fiduciary) has a continuing duty of prudent selection and periodic review of fiduciary advisors (although a fiduciary is not required to monitor the fiduciary advisor’s specific investment advice).

IV. ACCELERATED VESTING

Effective Date: For contributions made for plan years beginning after December 31, 2006. There is a separate later effective date for collectively bargained plans and certain employee stock ownership plans.

Under PPA, all employer contributions, including match, profit-sharing, or money purchases, must vest based on either a 3-year cliff schedule or a 6-year graded vesting schedule beginning with 20% in the 2nd year and increasing 20% per year until the 100% vesting is reached in the 6th year.

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These changes are identical to the current top heavy vesting requirements.

V. PLAN DISTRIBUTIONS AND PORTABILITY

Rollover by Non-Spouse Beneficiaries

Effective Date: Plan years beginning after December 31, 2006.

Currently, only participants and surviving spouses may rollover distributions from qualified retirement plans, 403(b) plans, and government 457 to IRAs. Under the new law, a non-spouse beneficiary for a deceased participant may roll over the benefits they receive from a retirement plan to an IRA. The receiving IRA would be treated as an inherited IRA and subject to the minimum distribution rules that apply to inherited IRAs.

Direct Rollovers to Roth IRAs

Effective Date: Plan years beginning after December 31, 2007.

Rollovers may be made directly from a qualified plan, 403(b) plan or governmental section 457 plan to a Roth IRA, and the rollover will be treated as a Roth conversion if all other conversion requirements are met (e.g. income is less than \$100,000 before 2010). Just as with a rollover from a traditional IRA to a Roth IRA, the distribution is taxable to the extent it represents pre-tax dollars and it is not subject to the 10% early withdrawal penalty.

Rollover of After Tax Amounts

Effective Date: For tax years beginning after December 31, 2006.

Under current law, after-tax contributions may be rolled over from a qualified retirement plan to a defined contribution plan, or from a 403(b) plan to another 403(b) plan, if the rollover is a direct rollover and if the receiving plan separately accounts for such after-tax contributions. Under the provisions of the Act, after-tax contributions can be rolled over to a defined contribution plan, a defined benefit plan, or a 403(b) plan. It must be a direct rollover and the receiving plan must separately account for the after-tax contributions.

Expansion of Hardship Withdrawals

Effective Date: Date of Enactment.

The Act requires the IRS to issue regulations permitting hardship withdrawals on account of hardships or unforeseeable emergencies of a person who is designated as the participant's beneficiary under the plan, even if that beneficiary is not the participant's spouse or dependent.

Distributions to Qualified Reservists

Effective date: For distributions made after September 11, 2001.

Plans may permit individuals called to duty for a minimum 179-day period to take "qualified reservist distributions" during their period of active duty. The 10% penalty on early distributions would not apply, and the reservists would be allowed to repay the distribution during the two-year period that begins after active duty ends. The provision applies to individuals called to active duty after September 11, 2001 and before December 31, 2007, and to distributions made after September 11, 2001.

Missing Participants

Effective date: For distributions made after the PBGC regulations are finalized.

Terminating defined contribution plans will be permitted to transfer the accounts of missing participants to the PBGC. The amounts transferred will be distributed in accordance with the PBGC missing participant program that previously only applied to defined benefit plans.

VI. REPORTING and DISCLOSURE

Electronic Reporting/Display of Form 5500 Information

Effective Date: Plan years beginning after December 31, 2007.

The Department of Labor will be required to display 5500 information in an electronic form within 90 days of receipt. In addition, plan sponsors with their own Intranet Web Site will be required to post the plan's Form 5500 for their employees. The DOL believes that a wholly electronic system will result in reduced errors, more timely enforcement (which will increase protection for participants), and lower annual reporting costs.

Periodic Benefit Statements

Effective Date: Plan years beginning after December 31, 2006. (Collectively bargained plans are subject to a delay of up to two years).

Plans must provide quarterly benefit statements to active participants/beneficiaries who have the right to direct their investments. The statements must indicate total account balances, the amounts that are vested (or the earliest date they will become vested), and information about how the accounts are invested. The quarterly benefit statements must also explain the risk of holding more than 20% of a portfolio in one entity.

Participants in plans where employers direct the investments must receive an annual statement containing the same information.

SUMMARY of the DEFINED BENEFIT RELATED PROVISIONS of the PPA of 2006

Funding Requirements.

The PPA completely overhauls the funding rules for defined benefit plans in an attempt to make them more secure. The new rules, which are quite complicated, generally apply to plan years beginning in 2008, although transition rules apply to the 2006 and 2007 plan years. The new rules include the following changes:

- A plan's funding target has been increased to 100% of the plan's accrued liabilities.
- After a phase-in period, the interest rate used for plan funding purposes will be based on the high-quality corporate bond yield curve, averaged over 24 months. Plan sponsors may elect to use the full yield curve without averaging.
- In determining the funded status of a plan, asset values can be based on the prior and current year asset values.
- Unfunded liabilities must be amortized over a 7-year period.
- If a plan is "at-risk", it will be subject to higher required contributions and PBGC premiums.
- There are new restrictions on the ability of under-funded plans to increase benefits.

Deduction Limits.

Plan contributions in excess of the deductible limits are subject to a 10% excise tax. The PPA encourages plans to create a funding cushion by increasing the limits on deductible contributions. Special transition rules apply to plan years beginning in 2006 and 2007.

Phased Retirement.

Current rules prohibit defined benefit plans from distributing retirement benefits to active employees before the plan's normal retirement age. The PPA allows plans to distribute retirement benefits to active employees who have reached age 62, even if the plan's normal retirement age is later than age 62. This change generally applies to distributions made in plan years beginning after 2006.

The PPA has extensive and far-reaching effects on employee benefit plans and only a few of the provisions set forth in the 900-page law are addressed here. If you would like additional information about the PPA, or if you need assistance in bringing your plans and operations into compliance with the new law, please contact Steve Cranfield or Dick Watson. ♦

*This summary is intended for information and educational purposes only and does not constitute financial, tax, or legal advice. Further, this information is general in nature and is not intended to address the particular needs of any specific plan. Please contact your financial, tax, or legal advisor for information about your specific situation.