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ERISA NEWS BRIEF
(ACTION REQUIRED)

TO: CLIENTS AND COLLEAGUES
DATE: OCTOBER 2006
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PENSION PROTECTION ACT OF 2006

You might be required to take action immediately to meet deadlines relative to the newly enacted Pension Protection Act of 2006. Please review this briefing to determine the items that might apply to you.

1. **Introduction**. The Pension Protection Act of 2006 (PPA) makes numerous changes to ERISA and other laws affecting retirement plans, IRAs and other plans. All employers must review their plans this fall to determine the impact of the new rules. As with every pension act that has preceded PPA:

- some changes are retroactively effective or effective now
- some changes are effective with the beginning of the next plan year (January 1, 2007 for most plans)
- some changes are effective in subsequent years
- some of the changes are mandatory requiring your compliance
- other changes are optional for you to utilize or not as you deem appropriate.

Comment. *Employers should consult with their ERISA counsel and recordkeepers to ensure they comply with the changes and protect the plan's fiduciaries and participants.*

PPA SEMINAR

THE ERISA LAW GROUP, P.A. WILL PRESENT A SEMINAR ON NOVEMBER 14, 2006 IN BOISE, 8:00 – 10:00 A.M. FOCUSING ON THE PENSION PROTECTION ACT AND THE IMMEDIATE ACTIONS YOU MAY NEED TO TAKE. JEFF WILL NOT BLANDLY REPEAT THIS OUTLINE. INVITATIONS AND REGISTRATION FORMS WILL BE SENT SEPARATELY. FOR OUR OUT-OF-STATE CLIENTS, STAY POSTED.

2. **<u>Defined Benefit Plans and Cash Balance Plans</u>**. A disproportionate number of the PPA changes establish new rules for defined benefit plans, particularly new funding requirements. Cash balance plans are defined benefit plans that are structured to look like defined contribution plans, and which in the right circumstances can be quite attractive to the employer. Legal uncertainties undermined the viability of these plans for certain employers, and the PPA resolved those uncertainties in favor of such plans, legitimizing them.

Comment. *Employers with defined benefit plans should immediately contact their actuaries to discuss the potential impact of the PPA on their plans, particularly reviewing the material issue of how the new rules may affect the employer's obligations to make annual contributions to the plan.*

3. **<u>Default Investments</u>** – *<u>Effective in 2007</u>*. The PPA expands the scope of available fiduciary protection. This provision, including for plans that provide for automatic pay-deduction enrollment (see No. 5 below), applies to plans that permit participants to direct investments of their plan benefits.

(a) ERISA § 404(c) relieves plan sponsors, trustees and others of some (<u>not all</u>) fiduciary liability if participants make affirmative elections directing the investment of funds in their accounts, <u>provided certain requirements are met</u>. However, when participants have not affirmatively exercised control over their investments, Section 404(c) has not protected fiduciaries when plan sponsors have invested participant accounts in so-called default funds.

(b) Effective for plan years beginning in 2007, § 404(c) is amended to provide that participants who fail to make affirmative investment elections will be treated as exercising control over the assets in their accounts -- thereby relieving fiduciaries of some liability -- if certain requirements are met. These include --

- The accounts must be invested in accordance with Department of Labor (DOL) guidelines. The DOL on September 27, 2006 issued proposed regulations, and these are to be finalized by February 2007.
    - The proposed regulations contemplate three different types of default investments that will be acceptable. The alternatives exclude the use of a capital preservation investment product (e.g., money market fund) as a default fund.
- The plan must give notice to employees before the beginning of <u>each year</u> which explains their rights to make investment elections and how amounts will be invested in the absence of participant affirmative investment instructions.
- A number of additional requirements will apply in order for the fiduciary to claim an exemption from some (not all) investment responsibility for funds over which participants do not exercise control.

Comment. *Employers soon should plan to make the appropriate changes to their default funds when the DOL issues its final regulations early next year. Employers should consult with counsel before or after hearing from their custodians and investment advisors. Employers also should become informed of the fiduciary liability they retain in all circumstances, and what steps they should take to mitigate same.*

4. **<u>Faster Vesting</u>** – *<u>Effective in 2007</u>*. Under current law, employer contributions to ERISA defined contribution plans are required to vest at least as fast as under either a five-year cliff vesting schedule or a

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seven-year graded schedule. Faster vesting is required for matching contributions and for top-heavy plans.

(a) The PPA will subject all defined contribution employer contributions to faster vesting requirements. Contributions must vest at least as fast as under either a three-year cliff vesting schedule or a six-year graded schedule. All years of service, including those before the effective date of the new requirements, must be taken into account.

(b) The faster vesting schedules apply to contributions for plan years beginning on and after January 1, 2007. The new requirements apply only to participants who have an "hour of service" under ERISA on or after the PPA effective date. The following vesting schedules illustrate the current and new laws.

Years of Service	*Current Law Cliff*	*PPA Law Cliff*	*Current Law Graded*	*PPA Law Graded*
0-1	0%	0%	0%	0%
2	0%	0%	0%	20%
3	0%	100%	20%	40%
4	0%		40%	60%
5	100%		60%	80%
6			80%	100%
7			100%	

Comment. *Employers with plan vesting schedules that are not as fast, at every year of service, as the new vesting schedules must take immediate action. Otherwise, participants who receive payment in 2007 may receive less than what the new law will require. Also, an employer must make several key decisions to implement the new vesting. As one example, will the employer want to apply the new schedule to just new contributions, or also to old monies (and earnings)?*

5. **Automatic "Negative" Enrollment 401(k) or 403(b) Plans** – *Effective in 2008*. Currently, § 401(k) and § 403(b) plans that provide for certain employer nonelective or matching contributions and that meet notification requirements are deemed to satisfy the ADP and ACP nondiscrimination tests (and plans that consist solely of assets contributed under a safe harbor arrangement are exempt from the top-heavy requirements of Internal Revenue Code § 416).

(a) Effective for plan years beginning on or after January 1, 2008, plans that provide for automatic employee contributions and meet certain other requirements will also be deemed to pass the ADP and ACP tests (and in some cases be exempt from the top-heavy requirements).

(b) *First* -- To satisfy the new safe harbor, a 401(k) or 403(b) plan must provide automatic deferrals for all employees eligible to participate in the plan. The automatic deferrals must be at least –

- 3% of compensation for the first plan year beginning after the safe harbor applies to the employee;
- 4% during the second year;
- 5% during the third year; and
- 6% during the fourth year and thereafter, not to exceed 10% of an employee's compensation.

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(c) *Second* -- In addition, the employer must make a minimum contribution on behalf of each nonhighly compensated plan participant. The contribution may be either --

- A nonelective contribution equal to 3% of the employee's compensation; or

- A matching contribution equal to –

  - 100% of the participant's contributions that do not exceed 1% of compensation, and
  - 50% of the participant's contributions that exceed 1% but do not exceed 6% of compensation.

  Matching contributions cannot be made on deferrals that exceed 6% of compensation.

- The employer contributions must be 100% vested after two years of service (unlike current safe harbor plans requiring immediate vesting).

(d) *Third* -- Before each plan year, the plan must provide each eligible employee with a written notice that explains the employee's right to not make elective contributions (or to elect contributions in a different amount). In a plan allowing employees to choose investment options, the notice must also explain how contributions will be invested in the absence of an election.

(e) *Fourth* – The automatic contributions over which participants do not make investment decisions may have to be invested in DOL-approved default funds (see No. 3 above).

(f) *Fifth* -- Participants may withdraw their automatic contributions within 90 days of the employee's first automatic contribution (including earnings thereon).

(g) Despite ERISA's existing, broad preemptive reach, some advisors incorrectly asserted the position that state wage and payroll laws prohibited automatic contributions to plans in the absence of a salary deferral agreement. The PPA explicitly provides that these state laws are preempted for arrangements subject to ERISA that meet the automatic contribution requirements.

Comment. *One can argue whether this new provision is laudable or laughable. Its intent is to make automatic 401(k) plans more popular, relying upon individuals' inertia, in order to increase our country's savings. Will automatic passage of ADP and ACP outweigh the costs of the required employer contributions? Employers should warily view the new opportunity. Employers still may have automatic pre-tax pay-reduction plans without satisfying these rules – that may be the upshot.*

6. **Nonspouse Beneficiary Rollovers** – *Effective in 2007*. Under current law, a spouse beneficiary receiving a plan benefit upon a participant's death generally is permitted to roll over the benefit to the spouse's IRA or other qualified plan. Nonspouse beneficiaries have not been permitted to roll over or otherwise move the death benefits they receive into their IRAs or other plans.

(a) Effective for distributions after December 31, 2006, the PPA permits nonspouse beneficiaries who receive death benefits from a qualified retirement plan, a governmental § 457(b) plan, or a § 403(b) plan to make a direct transfer to an IRA.

- Unlike spouses, nonspouse beneficiaries may not move the funds by rollover, but instead must do a trust-to-trust transfer.

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- Nonspouse beneficiaries may move funds to a newly established IRA only, not to their retirement plans.

- The amounts transferred to an IRA may never be rolled over again, and the nonspouse beneficiary will be subject to the same minimum required distribution rules that would apply to a nonspouse beneficiary of an IRA or plan.

Comment. *This change may tremendously benefit nonspouse beneficiaries, such as domestic partners. It allows them to delay distributions and taxation, accumulating significantly greater after-tax amounts. Employers that want to extend this opportunity need to review and modify their plan documents, forms and other plan materials. Employees and beneficiaries who want to utilize the provision need to consult with qualified ERISA counsel.*

7. **New and More Frequent Benefit Statements** – *Effective in 2007*. The new law materially expands the reporting and disclosure requirements with respect to retirement plans, effective for plan years beginning in 2007.

(a) Under the PPA, a defined contribution plan must furnish a pension benefit statement –

- at least once each calendar quarter to a participant or beneficiary who has the right to direct the investment of his or her plan account;

- at least once each calendar year to a participant or beneficiary who does not have the right to direct investments; and

- upon written request to another plan beneficiary.

The defined contribution statement must include –

- the value of each investment in which the account has been invested; and

- in the case of participant-directed investment plans –

    - an explanation of any limitations or restrictions on any right of the participant or beneficiary under the plan to direct an investment;

    - an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement regarding the risk of holding more than 20 percent in the security of one entity; and

    - a notice directing the participant to the DOL website for sources of information regarding investing.

(b) Under the PPA, a defined benefit plan must furnish a pension benefit statement –

- at least once every 3 years to each participant with a nonforfeitable accrued benefit and who is employed by the employer maintaining the plan at the time the statement is furnished (this requirement is met if at least once each year the administrator provides a notice of the availability of the statement and the ways in which the participant may obtain it); and

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- to a participant or beneficiary of the plan upon written request.

(c) The statement for both defined contribution and defined benefit plans must indicate the total benefits accrued, and the nonforfeitable (i.e., vested) benefits which have accrued, or the earliest date on which benefits will become nonforfeitable.

(d) The statement must be delivered in a DOL-approved medium and form.

(e) By August 16, 2007, the DOL will develop one or more model benefit statements that plan administrators may use to comply.

Comment. *The new rules add a (semi-hefty) challenge to plan sponsors, particularly for small employers that already labor under ERISA's burdensome requirements. Most employers will need to prepare and provide the new statements by March 31, 2007. Given the penalties for noncompliance, employers should consult ERISA counsel either before or after discussing this matter with their plan providers.*

8. **EPCRS Enhanced**. Through various remedial programs such as the Self-Correction Program, the Voluntary Correction Program, or Audit CAP, the IRS Employee Plans Compliance Resolution System allows the sponsor of a qualified plan, a § 403(b) plan, a SEP or a SIMPLE IRA (and on a provisional basis, § 457(b) governmental plans) to voluntarily correct failures that may otherwise result in severe adverse tax and other consequences.

The PPA clarifies that the IRS has (and had) the authority (a) to continuously update and improve EPCRS, giving special consideration to issues relating to small employers, and (b) to waive income, excise, or other taxes to ensure that the EPCRS penalties bear a reasonable relationship to the failure.

Comment. *EPCRS (and its predecessors) is one of the best things (among few) that has happened to ERISA. Before employers and fiduciaries sadly are forced to know about EPCRS, they should keenly become familiar with it and change their plan habits accordingly. Of everything in this News Brief, nothing is more important to you.*

9. **Partial Relief from Fiduciary Liability During Blackout Periods** – *Effective (kind of) in 2008*. Sometimes participants are not allowed to direct the investment of their accounts; for example, when the plan's investment funds or providers are changed. During these times, some of which qualify as "blackout" periods which require certain specific employer action under ERISA, fiduciaries are legally responsible for the investments of their plans' assets.

(a) Under the PPA, a "qualified change in investment options" means a change in the investment options by which plan accounts are reallocated among new investment options that are reasonably similar in risk and rate of return characteristics to the options offered prior to the change.

(b) If a qualified change in investment options is made to a participant-directed plan, the fiduciary will be relieved from most investment responsibility so long as:

- at least 30 and not more than 60 days prior to the effective date of the change, the administrator furnishes written notice of the change to participants and beneficiaries containing a comparison of the existing and new investment options and a description of the default investments that will be made absent contrary participant instructions;

- the participant or beneficiary has not provided the plan, prior to the effective date of the change, investment instructions that are contrary to the proposed reallocation of investments in their account; and

- immediately before the effective date of the proposed reallocation of investments, the participant or beneficiary exercised control over the investment of assets in the account.

Comment. *This new PPA provision applies to plan years beginning after December 31, 2007. However, the PPA changes merely reflect the good practices a well-advised and dutiful employer would have observed in any previous blackout period. Does the government here add a new layer of regulations to a problem and fiduciary risk that is more perceived than real (again burdening small and mid-sized employers while the larger employers can afford the burden).*

10. **Investment Advice to Participants** -- *Effective in 2007*. Existing rules relating to ERISA prohibited transactions make it difficult for fiduciaries to provide investment advice to participants in defined contribution plans.

(a) Effective for advice provided on and after January 1, 2007, the PPA establishes a framework of rules enabling selected institutional fiduciaries to provide investment advice to participants. Under these rules:

- Fees the advisor receives cannot vary based on the investment option the participants select, or the advice must be provided under a computer model that is certified by an independent party;

- Before the initial provision of investment advice, and annually thereafter, the fiduciary advisor must provide the participant with a host of information on the investment program;

- Transactions may occur only at the direction of the participant;

- The compensation received by the investment advisor must be reasonable and the terms of transactions must be at least as favorable to the plan as arm's length transactions; and

- The investment program must be authorized by a fiduciary other than the fiduciary providing the investment advice, and the program must be subject to an independent annual audit.

(b) The plan sponsor must prudently select and monitor fiduciary advisors but does not have a duty to monitor the specific advice given to specific participants.

Comment. *Employers and other fiduciaries of the plan continue to be subject to existing ERISA fiduciary and prudence requirements, including with respect to the selection and periodic review of investment advisors, the menu of investments, fees and compliance with § 404(c). Plans, as opposed to the employer -- meaning the participants -- may be charged the fees for the investment advice. Who will this new complex law help the most? And, employers should think twice (and then some) and seek ERISA counsel before deciding to utilize this opportunity.*

11. **EGTRRA "Sunset" Provision** – *Effective Now*. The Economic Growth and Tax Relief Reconciliation Act of 2001 overhauled many retirement plan and IRA rules. Among the changes were higher maximum annual salary deferrals to §§ 401(k), 403(b) and 457(b) deferred compensation plans; increased IRA contribution limits; allowance of Roth-type contributions to employer plans; additional

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plan and IRA contributions for those individuals age 50 or older ("catch-up contributions"); and a tax credit for lower-income individuals who save for retirement (the so-called "Saver's Credit").

Most of the EGTRAA pension changes were set to expire after 2010, while the Saver's Credit was due to expire at the end of 2006. PPA makes the EGTRRA provisions relating to retirement plans and IRAs permanent.

Comment. *If EGTRRA had sunseted, not that I worried about it, it would have created a mess. But, will Congress ultimately pass legislation that severely changes EGTRRA? And PPA? And congratulate themselves? And then you will get an invoice? Need you ask?*

12. **Disclosures and Forms to Participants Receiving Payment of Plan Benefits** – *Effective in 2007*. ERISA contains no less than four separate disclosures that must be provided to participants receiving a distribution of their plan benefits. The documents must be provided to the distributee between the 30-to-90 day period preceding the date of payment. The PPA extended the 90-day period to 180 days, such that the disclosures must be provided no earlier than 180 days preceding the distribution. In addition, the PPA requires that the disclosures be modified to enhance certain information.

Comment. *Employers will need to revise their payout forms without delay to comply with the new requirements. Employers should ensure their forms and disclosures are compliant, because the failure of same jeopardizes the tax-qualification of the plan and risks lawsuits by employees and their spouses. The disclosures provided by most employers are legally insufficient. When challenged in a court of law, they are struck down creating losses to the employer.*

13. **Miscellaneous**. The PPA discussed above represents just a slice of PPA's provisions. Additional issues mentioned below may warrant your immediate attention if they pertain to your plan or seem to be something you may be interested in implementing. Innumerable other PPA changes are not mentioned in this *News Brief,* particularly regarding Roths and IRAs. Please contact us for additional detail.

(a) Hardship of Participant's Beneficiary. The IRS is directed to issue regulations regarding a participant's hardship or unforeseen emergency under a plan as the result of a hardship experienced by the participant's beneficiary, thereby allowing in-service distributions. This PPA change raises a handful of obvious practical questions needing IRS clarification.

(b) Section 457(b) Plan Participation after Cash-Out. A new provision is added providing relief for participants who elected to receive certain lump sum distributions.

(c) In-Service Distributions at Age 62. Certain pension plans may provide for distributions to employees who attain age 62 and have not separated from employment.

(d) Simplified Annual Reporting. One-participant plans will be exempt from filing Form 5500 if plan assets are $250,000 or less. Under certain conditions, a plan with less than 25 participants will be able to file a simplified annual return.

(e) Diversification Rights. The PPA expands the rights participants have to diversify employer securities held by a plan (i.e., the stock of the company sponsoring the plan).

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NEW PLAN LIMITATIONS FOR 2007

Various retirement plan limits are subject to annual cost-of-living and/or statutory adjustments. Here are some of the more commonly applicable new limits as issued by the IRS on October 18, 2006.

1. **Maximum Contribution to 401(k), Profit Sharing and other Defined Contribution Plans**. Increases from $44,000 to $45,000 for 2007. For most plans, the limit will apply for the plan year January 1 to December 31, 2007. ***Warning***. *Participants of small employers may not be able to receive the $45,000 allocation.*

2. **Pre-Tax 401(k), 403(b) or 457(b) Employee Contribution Limit**. Increases from $15,000 to $15,500 for 2007.

3. **Age 50 Catch-up Contribution**. Remains unchanged at $5,000 in 2007.

4. **Maximum Annual Recognized Compensation**. Increases from $220,000 to $225,000 for 2007. To limit retirement plan accumulations for high paid employees, as well as to increase contributions for non-high paid employees, retirement plans generally may only recognize compensation up to this limit.

5. **Highly Compensated Employee Threshold**. Remains unchanged at $100,000 for 2007. Under ERISA's nondiscrimination rules, the employee population is divided into two groups – the highly compensated employees and the nonhighly compensated employees. A highly compensated employee generally is an employee who owns more than 5% of the employer sponsoring the plan or whose compensation in the preceding year exceeds the dollar threshold.

6. **Defined Benefit Plan Limit**. Increases from $175,000 to $180,000 for 2007. In a defined benefit plan, the law limits the annual pension payable to the participant upon retirement (as opposed to limiting the annual additions going into a defined contribution plan). If you desire to accumulate possibly significant retirement benefits over and above the $45,000 annual defined contribution limit, a defined benefit plan should be explored.

7. **Social Security Tax Wage Base**. Increases from $94,200 to $97,500 for 2007. This change in the wage base will affect the way in which employer contributions are allocated to participants in "integrated" plans.

FIRM ACHIEVEMENTS

Jeffery Mandell of The ERISA Law Group, P.A. has been named to BEST LAWYERS IN AMERICA 2007. Jeff has garnered this prestigious award for 12 years in a row, making him among a select group of attorneys nationwide. BEST LAWYERS is a peer-review of 18,500 U.S. attorneys on the legal abilities of attorneys. (Jeff should get a life.)

The ERISA Law Group, P.A. authored an article published in the *Journal of Pension Benefits*, Autumn 2006 edition, entitled "A Roadmap to Spinning Off a Defined Contribution Plan." For a copy, please email sam@erisalawgroup.com.

This update is intended to provide general information only and does not provide legal advice. The application of ERISA laws can be complex and you are advised to consult with ERISA counsel. For information regarding the impact of these developments under your particular facts and circumstances, please call.

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