DEFINED CONTRIBUTION PROVISIONS OF THE PENSION PROTECTION ACT OF 2006

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The Pension Protection Act of 2006 ("PPA") is a colossal 907 page statute, 779 of which relate to retirement plans. The primary purpose of the legislation is to shore up the faltering defined benefit ("DB") pension system that is insured by the Pension Benefit Guaranty Corporation ("PBGC"), and 429 pages of the statute relate to those provisions. However, most employers now provide defined contribution ("DC") plans to their employees. DC plans include 401(k) plans, profit sharing retirement plans and ESOPs. Most of the coverage in the press has been of the DB provisions of the PPA. Therefore, this article will concentrate on the provisions of the PPA that relate to DC or both DC and DB plans and their consequences to employers.

As you will note while reading below, many of the DC provisions of the PPA are affect self-directed 401(k) plans. These provisions include allowing employers to automatically enroll their employees in 401(k) plans and, combined with certain contributions requirements, automatically satisfying the non-discrimination tests for 401(k) plans. The PPA also provides additional relief from fiduciary duties in self-directed plans and permits the provision of investment advice without engaging in prohibited transactions and possibly breaching fiduciary duties.

Following are many of the key provisions in the PPA applicable to DC Plans:

- *Automatic Contributions Arrangements*. First, PPA now makes it clear that automatic contribution provisions in DC plans pre-empt state laws that prohibit involuntary withholding of funds from an employee's wages (in Delaware, the Wage Payment and Collection Act), clearing any impediments to negative election or "automatic contributions arrangements" for DC plans.

  As to the *automatic contributions arrangements*, PPA provides that a participant will be treated as having elected to make salary deferral contributions in an amount equal to a *uniform percentage* of compensation, as provided under the terms of the plan, until the participant makes an affirmative election of another percentage or not to contribute at all. Such contributions will be invested in accordance with the default safe-harbor rules to be enacted by the DOL. The employer must also provide notice to the employees that describes the participant's right not to participate in the plan or to elect to have a different contribution made to the plan, how the contributions will be invested, and a reasonable time frame for making affirmative elections before the automatic deferrals commence. This provision is effective for plan years beginning after December 31, 2007 except that the ERISA preemption of state laws provisions is effective on August 17, 2006, the date of enactment.

  Impact for employers: In an age where many employers sponsor only DC retirement plans, employers need to encourage participation of their employees in 401(k) plans. Automatic enrollment will get employees contributing earlier and aid those procrastinators who always intend to enroll in the next payroll period. It will also ensure that participants take advantage of any employer matching contributions. Getting more participation by the

rank and file employees may also assist in passing the ADP test for those non-safe-harbor plans.

- *Qualified Automatic Contributions Arrangements – Non-discrimination safe-harbor*. Under the PPA, the automatic enrollment feature coupled with other requirements will result in the plan satisfying the ADP/ACP nondiscrimination requirements for 401(k) plans and the general top heavy requirements. To satisfy the safe-harbor, (i) the automatic deferral percentage for the first year must be at least 3% of compensation; (ii) the automatic deferral percentage must increase from 3% to 6% of compensation each year over four years with a maximum of 10% of compensation; (iii) the plan must provide either (a) a 100% match on deferrals up to 1% of compensation and 50% match on deferrals between 1% and 6% of compensation, or (b) a non-elective contribution equal to 3% of compensation; (iv) the employer matching or non-elective contributions must fully vest within two years; and (v) the participants must receive initial and annual notices regarding the safe-harbor features. The automatic enrollment feature may be limited to newly eligible employees. The provision is effective for plan years beginning after December 31, 2007.

  Impact for employers: In addition to increased participation in the plan, safe-harbor provisions ensure that the highly compensated employees can defer as much as they want, up to the maximum, without fear of receiving a refund of a portion of their contributions due to failure of the non-discrimination testing. Safe-harbors also save the employer on the costs of administering the plan because non-discrimination testing need not be done.

- *Permissible withdrawals of certain elective deferrals*. The PPA permits certain withdrawals of automatic elective contributions and earnings. A "permissible withdrawal" is a withdrawal from a contribution arrangement that (i) is made at the employee's election, provided that the election is made within 90 days after the date the first salary deferral contribution is made for the employee; (ii) consists of all of the automatic elective contributions made on behalf of the employee, and earnings thereon; and (iii) includes all automatic elective contributions (and earnings thereon) for all payroll periods beginning before the effective date of the election. The withdrawal is included in the employee's taxable income for the year in which the withdrawal is made and the 10% early distribution penalty tax is not applicable. Any employer matching contributions made on account of the withdrawn contribution must be forfeited and the withdrawn amounts are not taken into account for the ADP test. These rules apply for plan years beginning after December 31, 2007.

  Impact on Employers: Employers may be more willing to adopt the automatic enrollment features if employees can decide within 90 days to opt out and receive refunds of the automatic contributions.

- *Corrective Distributions to Satisfy ADP/ACP Tests*. Under provisions of the PPA, corrective distributions for failure to satisfy ADP or ACP tests are taxable in the year of distribution and no longer need to include gap period income if distributed within the period prescribed to avoid the 10% excise tax. If the corrective distribution occurs in a plan that provides for automatic enrollment, the distribution may occur within 6 months after the end

of the plan year (instead of 2 ½ months) to avoid the 10% excise tax. These rules apply for plan years beginning after December 31, 2007.

Impact on Employers: The corrective distribution features will save money on plan administration and make it less likely that excessive contributions will be untimely distributed.

- *Investment Advice*. The PPA provides relief from fiduciary liability and prohibited transaction restrictions to plan sponsors and fiduciaries that appoint qualified fiduciary advisers for individual account plans with participant-directed investments. Under the provisions of the PPA, the employer and the fiduciaries will not be liable for investment advice given by fiduciary advisers or for investment performance based on that advice. Those that can be fiduciary advisers include banks, insurance companies, broker dealers, registered investment advisers, and their employees and representatives.

  To qualify for the relief, the investment advice must be given pursuant to an "eligible investment advice arrangement", which is an arrangement under which either (i) any fees received by the adviser do not vary on the basis of investment options selected, or (ii) the adviser uses a computer model that is certified by an eligible investment expert (i.e., someone without a material affiliation or contractual relationship with the adviser who also satisfies any additional requirements the DOL imposes). The computer model must apply generally accepted investment theories that use relevant individualized participant information (retirement age, life expectancy, risk tolerance), must not be biased in favor of investments offered by the adviser or its affiliates, and must take into account all investment options available under the plan. An independent auditor must certify annually that the model is appropriate, the only advice given must be pursuant to the computer model, and all transactions must result solely from participant decisions.

  Certain disclosures regarding the investment advice to be provided must be given to the participants before investment advice is provided. The DOL will issue a model form for these disclosures. The investment advice provisions are effective for advice given after December 31, 2006.

  Notwithstanding this relief afforded by the PPA, the employer or other plan fiduciary will still be responsible for the prudent selection and periodic monitoring of the investment adviser, but will not be responsible to monitor the specific investment advice given by the fiduciary adviser. This is similar to the relief provided under section 404(c) of ERISA under which fiduciaries are relieved of liability for investment losses in self-directed plans that meet the requirements of ERISA but remain liable for the prudent selection of the investments in the plan.

  Impact on Employers: These rules will make it easier for employers to ensure that their employees are getting proper investment advice in their self-directed plans so that they can maximize retirement benefits.

- *Safe-Harbor Default Investment Option*. In a self-directed plan, the employer must provide for a default investment option for those employees who do not direct the investment of

their benefits in the plan. Because this option is selected by the employer, it may not (according to the DOL, is not) be subject to the relief of liability afforded to the employer by section 404(c) of ERISA. PPA now provides a safe-harbor default investment option to relieve the employer from liability for participants' investments in the default investment option. PPA does not specify the requirements for the default investment but instead, directs the DOL to issue regulations within six months of the enactment of PPA describing such safe-harbor default investment options. The PPA does, however, contain provisions regarding participant notice of the default investment. Specifically, within a reasonable time before the beginning of each plan year, each participant must be provided a notice explaining the participant's rights under the plan to designate the investment of contributions and earnings. The notice must also explain how the contributions and earnings will be invested if the participant does not make an affirmative direction. The notice must inform the participants that they have a reasonable period of time after receipt of the notice to make a designation of how contributions and earning should be invested. This provision is effective for plan years beginning after December 31, 2006.

Impact on Employers: No matter how hard employers try, there are always those individuals who, for whatever reason, do not self-direct their investments and leave the funds in the default option selected by the employer. Now, employers will receive guidance on appropriate default investments and relief from fiduciary responsibility. Perhaps the ability to offer investment advice will result in fewer funds in the default investments.

- *Diversification of Employer Securities Investments*. For plan years beginning after December 31, 2006, DC plans must allow participants to diversify amounts invested in publicly traded employer securities. Participants will have an immediate right to diversify elective deferrals invested in employer securities, and a right after three years of vesting service to diversify employer non-elective contributions and company match. Plans must provide at least three diversified investment options other than employer securities. The diversification provisions of PPA for employer non-elective and matching contributions under existing plans is subject to a three year phase-in period. The new diversification requirements do not apply to ESOPs that have no elective deferrals or matching contributions.

  Impact on Employers: The ability of employees to diversify out of employer stock will relieve some of the fiduciary liability pressures on employers that have employer securities in their plans.

- *Combined DB/401(k) Plans*. A small employer (employs an average of at least two but not more than 500 employees) can offer a combined DB plan and a 401(k) plan (a "DB/K" plan). The assets of the DB/K plan must be held in a single trust and must be clearly identified and allocated to the DB plan and the 401(k) plan to the extent necessary for the separate application of the Code and ERISA. The DB part of a DB/K plan must provide each participant with a benefit of one percent of a participant's final average pay multiplied by the participant's years of service for up to 20 years of service or a cash balance formula that increases with the participant's age. This benefit must be 100% vested after 3 years of service. The 401(k) portion of the plan must provide for automatic enrollment at the rate of 4% of pay and provide a fully vested matching contributions of 50% on the first 4%

deferred. The plan will not be subject to the top heavy rules or the ADP testing and will be permitted to file just one Form 5500. The plan will however, be subject to the other nondiscrimination and coverage requirements. These plans can be offered for plan years beginning after December 31, 2009.

- *Limitations on Deductibility of Contributions to Both a DC and DB Plan*. Currently, if an employer sponsors one or more defined benefit plans in addition to one or more defined contribution plans, the contribution deduction for a year is limited to the greater of (i) 25% of the compensation paid for that year to the participants in all such plans or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year. Effective for years after 2005, the 25% deduction limitation for contributions to combination plans applies to contributions to DC plans only to the extent that the contributions exceed 6% of the compensation under the plans for the tax year. Effective for years after December 31, 2007, the limitation will apply only to DB plans that are not insured by the PBGC and contributions to DC plans that exceed 6% of compensation.

  Impact on Employers: This provision will likely benefit mostly small employers whose ability to maintain both a DB and DC plan is hampered by the limitation due to less compensation upon which the 25% limitation is computed.

- *Safe-Harbors for Fund Mapping and Blackouts*. A new safe-harbor for protection from fiduciary liability applies to the mapping of investments when investment options are changed in a plan where the participants self-direct their investments. Under the PPA, a "qualified change in investment options" will provide protection from fiduciary liability. A "qualified change in investment options" occurs when assets are reallocated to new investment options with characteristics, including risk and rate of return, that are similar to the characteristics of the corresponding investment options that were available before the reallocation. The safe-harbor requires notice to participants between 30 and 60 days before the change, comparing the old and new investment options and explaining that, absent a participant investment direction to the contrary, the participant's account will be invested in new options with characteristics reasonably similar to the old options. A second safe-harbor applies to losses that occur during blackout periods. The fiduciaries will be relieved of liability for such losses if the ERISA notice requirements for blackouts are followed. These new rules generally apply to plan years beginning after December 31, 2007.

  Impact on Employers: This provision will make it easier for employers to change investment providers when the current provider may not be meeting expectations.

- *Vesting Requirements in DC Plans*. EGTRRA, enacted in 2001 imposed accelerated vesting requirements on matching contributions to DC plans. The accelerated vesting schedules were known as the "top heavy" vesting requirements and, for plan years beginning after December 31, 2006, the top heavy vesting requirements apply to all employer contributions to DC plans. The alternative schedules are (i) cliff vesting of 100% after three years of service or (ii) graded vesting of 20% after 2 years of service and 20% each year thereafter until the participant is fully vested after 6 years of service. Deferred effective dates apply to collectively bargained plans.

Impact on Employers: More rapid vesting means that DC plans may become a bit more costly for employers. Forfeitures can be used to pay plan administration expenses or to reduce future contributions. With more rapid vesting, fewer forfeitures will be available for such purposes.

- *Participant Statements*. Effective for plan years commencing after December 31, 2006, plan administrators are require to provide quarterly benefits statements to participants for participant-directed DC plans and annual statements for other DC plans. Statements must also be provided to participants in DB plans. The benefit statement must include certain information, and the DOL has been directed to issue model benefit statements.

  Impact on Employers: This provision could be viewed as an additional burden on the employer. However, most employers currently meet or exceed the statement requirements.

- *Missing Participants*. The PPA permits plan administrators of terminated DC plans to take advantage of the PBGC missing participants program, which was previously available only to DB plans. Under this program, plan administrator may, after making reasonable efforts to locate a missing participant, transfer a missing participant's account to the PBGC as trustee until the PBGC locates the missing participant. This provision will not be effective until after the PBGC issues final regulations.

  Impact on Employers: This provision will permit plans to distribute to the PBGC the benefits of those inactive participants who have reached retirement age but cannot be located. It will also help with the wrap up of terminated plans.

- *Form 5500-EZ Exemption*. One-participant plans with assets not in excess of $250,000 (rather than the present-law $100,000 threshold) would be exempt from filing the Form 5500-EZ. This provision is effective for plan years beginning after 2006.

  Impact on Employers: Fewer single participant plans will be required to file forms 5500. With the current $44,000 limitation on annual benefits in DC plans, it will take 4 - 5 years before the first Form 5500 will be due.

- *EGTRRA Provisions Made Permanent*. The provisions of EGTRRA that were set to expire in 2010 have been made permanent. These include the maximums on (i) elective deferrals and catch-up contributions; (ii) benefits under DB and DC plans; and (iii) compensation that may be considered by the plan in calculating benefits and satisfying various regulatory requirements; and (iv) the availability of Roth 401(k) accounts under 401(k) plans.

  Impact on Employers: The extension of the EGTRRA provisions generally benefit the plan participants. However, the extension of the Roth 401(k) feature may prompt more employers to now adopt them.

- *Coercive Interference with ERISA Rights*. PPA increases the penalty to $100,000 and imprisonment for up to ten years for willful acts of coercive interference in violation of Section 510 of ERISA. This is provision is effective for violations occurring on or after August 17, 2006.

Impact on Employers: It now becomes more costly for employers to interfere with participants rights under ERISA.

- *Hardship Distributions*. The IRS is required to issue regulations permitting hardship distributions for expenses of the participant's beneficiary under a plan even if the beneficiary is not the spouse or child of the participant. These provisions are not mandatory.

  Impact on Employers: These provisions expand the class of individuals whose expenses can be considered when making hardships. If an employer adopts theses rules, hardship distributions may be made for domestic partners if the participant claims the domestic partner as a dependent on the participant's tax return.

- *Rollovers By Non-spousal Beneficiaries*. Qualified retirement plans that are not required to offer annuities can force the beneficiaries of a deceased participant's benefits to take an immediate (but no later than 5 years after the year of the participant's death) lump sum distribution of the benefits. This would result in the immediate taxation of those benefits to the beneficiary. Under current law, spousal beneficiaries of qualified plan benefits can roll those benefits over to an IRA and withdraw the benefits over the life expectancy of the spouse. Effective for distributions made after December 31, 2005, non-spousal beneficiaries can roll their benefits into IRA. The rollover IRA is treated as an inherited IRA, which means that it cannot be rolled over to another IRA.

  Impact on Employers: This provision will permit employers to require lump sum distributions to non-spousal beneficiaries without the resulting adverse tax consequences.

The following provisions of PPA affect mostly participants and beneficiaries and have little or no impact on employers:

- *QDROs*. Under the PPA, the DOL has been directed to issue regulations that provide that a domestic relations order will not fail to be a QDRO solely because the order is issued after or revises another domestic relations order or QDRO; or due to the time that the order was issued.

- *Qualified Joint and Survivor Annuities*. Plans that are required to provide joint and survivor annuities must offer options for 75% survivor annuities. This provision is effective for plan years beginning after December 31, 2007.

- *Participants Called to Active Duty*. Reservists called up for active duty between September 11, 2001 and December 31, 2007 for a period greater than 179 days may take a distribution of elective deferrals from an employer plan or from an IRA without incurring the 10% early distribution tax. Amounts withdrawn from an IRA may be re-contributed within two years following the end of active duty.

- *Matching Contributions Consisting Of Employer Stock By Employers That Go Bankrupt*. Participants in 401(k) plans in which the employer matched at least 50% of the employees contributions with employer stock would have the right to make additional IRA

contributions of three times the normal deduction limit if they were receiving matching contributions within the six-month period before the employer goes into bankruptcy and the employer is subject to indictment or conviction resulting from business transactions related to the bankruptcy. These "catch up" IRA contributions could be made only in 2007, 2008 and 2009.

- *Direct rollovers to Roth IRAs*. Distributions from eligible retirement plans made after December 31, 2007, can be rolled over directly into a Roth IRA. In addition to traditional IRAs, eligible retirement plans include qualified trusts, tax-sheltered annuities and governmental 457 plan. For tax years 2008 and 2008, the income limitation on conversions to Roth IRA (adjusted gross income not in excess of $100,000) continues to apply. This limitation is lifted on January 1, 2010.

- *Direct Rollovers Of After-Tax Contributions To DB And 403(B) Plans*. Effective January 1, 2007, after tax contributions can be rolled over from a qualified plan to a DB plan or a 403(b) annuity. Previously, after-tax contributions could be rolled over only to DC plans or IRAs. The rollovers must be done in a direct trustee to trustee transfer.

- *Unemployment Compensation*. States are now prohibited from reducing unemployment compensation for plan distributions that are rolled over. This provision was effective upon enactment.