

Legal Alert: Pension Protection Act of 2006 – Changes Affecting Defined Contribution Plans

August 16, 2006

A little more than half of the 907 pages of the [Pension Protection Act of 2006](#) deal with pension funding and related issues, but the Act also includes numerous provisions affecting defined contribution plans, including 401(k) plans. This Legal Alert discusses those changes, beginning with the new rules regarding diversification of employer securities, accelerated vesting requirements for all contributions, and enhanced automatic enrollment provisions, and continuing with distribution rule changes, ERISA and fiduciary changes, and other items relating to defined contribution plans.

Diversification of Employer Securities

Under the Act, defined contribution plans must permit participants, including beneficiaries, to diversify investments in publicly-traded employer securities. Although most plans permit diversification of salary deferral and after-tax employee contributions, some plans limit alternative investments for matching contributions and other employer contributions, and these plans (except for certain ESOPs, as discussed below) will need to be modified to comply with the new rules. The new rules are effective for plan years beginning after December 31, 2006, with delayed effective dates for collectively bargained plans and certain ESOPs, as discussed below.

Application to Types of Contributions. Once the new law becomes effective (generally, 2007), the diversification requirement will apply to all investments in publicly-traded employer securities that are attributable to salary deferral or after-tax employee contributions. With respect to all other amounts, such as employer profit-sharing and matching contributions, the diversification rules apply only to participants with three years of service, beneficiaries of such participants (e.g., alternative payees of such participants), and beneficiaries of deceased participants. A year of service for this purpose is based on years of service for vesting purposes, so years of service with the employer before becoming eligible for the plan are generally taken into account. Also, for employer securities acquired before the plan year beginning in 2007, the diversification rule for employer contributions phases in ratably over three years. The following chart illustrates the affect of the phase-in:

*Phase-In for 100 Shares of Employer Securities
 Acquired in 2006 Attributable to Employer Contributions*

<i>Plan Year</i>	<i>Phase-In Percentage</i>	<i>Shares Subject to Diversification</i>
2006	0%	0 shares
2007	33%	33 shares
2008	66%	66 shares
2009	100%	100 shares

There is an exception to the phase-in for participants with three years of service and who are age 55 by the beginning of the plan year starting in 2006 – these participants’ entire accounts are subject to the diversification requirements.

“Employer Securities.” The diversification requirements apply only to publicly-traded employer securities. As a general rule, these are securities issued by the employer or a member of the employer’s controlled group (applying a 50% ownership standard) that are readily tradable on an established securities market. However, employer securities that are not publicly traded are treated as publicly traded if the employer or a member of the employer’s controlled group has issued a class of stock that is publicly traded, unless neither the employer nor any parent company of the employer has issued a publicly-traded security or any other class of stock with particular rights or risks relating to another member of the controlled group that has issued a publicly-traded security. For example, if a plan holds non-publicly-traded employer securities, but the employer has issued tracking stock that is based solely on the performance of a publicly-traded subsidiary of the employer, the employer securities are treated as publicly traded for purposes of the diversification rule.

Exceptions to Diversification Requirement. Certain ESOPs are not subject to the diversification requirements. To qualify for the exception, an ESOP must not hold any section 401(k) or 401(m) contributions (*i.e.*, elective deferrals, after-tax employee contributions, employer matching contributions, or other employer contributions used to satisfy the ADP or ACP nondiscrimination tests). The ESOP must also be a separate plan from any other qualified retirement plan of the employer. For ESOPs that are subject to the new diversification requirements, the current law diversification rules will not apply, since they are narrower than the new requirements. Also, an ESOP subject to the new diversification requirements will not be considered, as a result of participant-directed diversification, to violate the rule that an ESOP must be designed to invest primarily in employer securities.

There is also an exception to the diversification requirements for one-participant retirement plans. A one-participant retirement plan is a plan that:

- covers only one individual (or an individual and the individual's spouse) who owns 100% of the employer sponsoring the plan (whether or not incorporated), or covers only one or more partners in the plan sponsor;
- meets the minimum coverage requirements without being combined with any other plan of the business;
- does not provide benefits to anyone except that individual (and the individual's spouse) or the partners (and their spouses);
- does not cover a business that is a member of an affiliated service group, a controlled group or group of businesses under common control; and
- does not cover a business that uses leased employees.

Diversification Mechanics. The diversification rules require that a plan provide a choice of at least three investment options other than employer securities. The investment options must each have materially different risk and return characteristics, and they must each be diversified. The Joint Committee on Taxation's [Technical Explanation](#) indicates that it is intended that investment options generally offered under the plan (e.g., under the 401(a) feature) must also be offered with respect to employer securities.

Although a plan can limit diversification opportunities to quarterly election periods, the Technical Explanation states that individuals must generally be given the same investment election opportunities as apply to other investment changes under the plan, except in unusual circumstances. In addition, except as provided in regulations, a plan may not impose restrictions or conditions on employer securities investments that are not imposed on other plan assets (except as required by securities laws).

Notice Requirements. At least 30 days before the first date on which a participant has a right to diversify with respect to any type of contribution, the plan administrator must provide the participant with a notice explaining the right to diversify and the importance of diversifying the investment of retirement account assets. If a participant becomes entitled to diversify different types of contributions at different times, separate notices are required each time a participant is first entitled to diversify a particular type of contribution. The IRS will publish a model notice that plans may use.

Effective Date. As noted above, the diversification requirements are generally effective for plan years beginning after December 31, 2006. For collectively bargained plans, however, the requirements are not effective until the plan year beginning after the earlier of (1) the later of December 31, 2007 or the date on which the last relevant collective bargaining

agreement expires (without regard to any extensions), or (2) December 31, 2008. Thus, no collectively bargained plan will need to come into compliance with the diversification requirements before December 31, 2007.

A delayed effective date also applies to employer matching and nonelective contributions invested in employer securities that, as of September 17, 2003, (1) were held in the form of preferred stock and (2) were subject to a guaranteed minimum value under the ESOP terms. In this case, the diversification requirements do not apply until the plan year beginning after the earlier of December 31, 2007 or the date on which the value of the preferred stock exceeds the guaranteed minimum.

Accelerated Vesting Requirements

Before EGTRRA was enacted in 2001, all contributions to defined contribution plans were required to vest under either a five-year cliff vesting schedule or a seven-year graded schedule. EGTRRA changed the law to require accelerated vesting for matching contributions – such contributions are required to vest under either a three-year cliff or a six-year graded schedule.

The Act subjects all employer contributions 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. However, the requirements do not apply to a participant until the participant has an hour of service after the effective date. Also, for collectively bargained plans, the requirements are not effective until plan years beginning after the earlier of (1) the later of the date on which the collective bargaining agreement expires (without regard to any extension) or December 31, 2006, or (2) December 31, 2008.

Leveraged ESOPs with a loan outstanding on September 26, 2005 also have a delayed effective date, with the provisions not applying until plan years beginning on or after the earlier of (1) the date the loan is fully repaid or (2) the date the loan was, as of September 26, 2005, scheduled to be repaid.

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 ADP/ACP nondiscrimination testing safe harbor arrangement for plans that provide for automatic enrollment and meet other requirements. Currently, 401(k) and 403(b) plans that provide for certain non-elective or matching contributions and meet notification requirements are deemed to satisfy the ADP and ACP tests, and plans that consist solely of assets contributed under this safe harbor arrangement are exempt from the top-heavy requirements of Internal Revenue Code (Code) section 416. Effective for plan years beginning after December 31, 2007, plans that provide for automatic contributions and meet certain other requirements will also be deemed to pass the ADP and ACP tests. Plans with assets that consist solely of assets contributed under any of the safe harbor arrangements will be exempt from the top-heavy requirements.

To satisfy the requirements of the ADP portion of the new safe harbor, a 401(k) or 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 non highly compensated participant in the plan. 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 employee's contributions that do 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 that 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 non highly compensated employee.

To satisfy the ACP portion of the new safe harbor, matching contributions 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). 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) 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 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, 401(k), 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 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 is not taken into account for purposes of the ADP or ACP tests.

Expansion of Corrective Distribution Period. For plans with automatic deferrals, the new legislation also extends the period during which excess contributions and excess aggregate contributions resulting from non-discrimination 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 defined contribution plans.

Hardship Distributions. The Act provides that the Secretary of Treasury must issue regulations within 180 days of the date of enactment providing that hardship or unforeseeable emergency distributions from a section 401(k), 403(b), 457, or 409A 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 401(k) 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 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 tax-sheltered annuity under section 403(b). 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.

Safest Annuity Rule. Some plan sponsors have been concerned that DOL Interpretive Bulletin 95-1 requires defined contribution plans offering an annuity distribution option to use the "safest available annuity." This may have led some plan sponsors to not offer an annuity as an optional form of benefit. The Act directs the DOL to issue final regulations within one year of enactment that clarify that the selection of an annuity contract under a defined contribution plan is not subject to the safest available annuity standard, but is instead subject to the normal fiduciary standards of ERISA.

Availability of PBGC Missing Participant Program. The Act permits plan administrators of defined contribution 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 many changes made by EGTRRA relating to defined contribution plans and other plans. These changes would otherwise have sunset at the end of 2010. One short-term impact of permanency may be to promote the establishment of Roth

401(k) accounts, since many employers may have been discouraged from adding these accounts given the possibility of having to eliminate them in a few years as a result of the sunset and the challenge of communicating the possible sunset to employees. The changes made permanent include:

- Catch-up contributions for participants age 50 and over;
- Expanded rollover options;
- Increases to the limit on the amount of compensation that can be taken into account under a qualified plan (*i.e.*, the Code section 401(a)(17) limit);
- Increases to the amount that can be deferred each year under a cash or deferred arrangement (*i.e.*, the Code section 402(g) limit);
- Increases to the maximum amount that can be contributed under a defined contribution plan (*i.e.*, the Code section 415(c) limit);
- Increases to contribution limits for Code section 403(b) and 457 plans; and
- Increases to the deduction limits.

ERISA §404(c) Changes

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 provided with 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, with a delayed effective date for collectively bargained plans.

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 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. 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 “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 defined contribution plans 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);
- The participant’s vested accrued benefit or the earliest date on which the accrued benefit will become vested; and
- If relevant, an explanation of any permitted disparity or floor-offset arrangement that may apply in determining accrued benefits under the plan.

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 Department of Labor website for information on investing and diversification. The Act requires the Department of Labor 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.

Combination Defined Benefit and 401(k) Plans – “DB/K”

Small employers (*i.e.*, that have less than 500 employees) will be permitted to combine a defined benefit plan and a 401(k) plan in a single trust, filing a single Form 5500, effective in 2010. The defined benefit plan must meet certain minimum accrual and vesting requirements, and the 401(k) plan must include an automatic enrollment feature and satisfy minimum matching contribution and vesting requirements.

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 Secretary of the Treasury 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.



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