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Pension Protection Act of 2006: Miscellaneous Highlights

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This is the third in a series of Client Alerts that we have issued on the Pension Protection Act of 2006 (PPA) passed by Congress on August 3, 2006. Our previous Client Alerts covered (1) the new rules on the provision of investment advice to participants in 401(k) plans, and (2) changes in the ERISA fiduciary responsibility requirements.

This Client Alert focuses on a variety of provisions in the legislation that will impact 401(k) plans, cash balance and pension equity plans, rabbi trusts, and other pension benefit arrangements. Although the PPA is principally designed to tighten the funding requirements for defined benefit pension plans, these other provisions could have a significant impact on the provision of retirement benefits to employees.

401(k) Plan Automatic Enrollment (PPA §902)

The PPA includes several new rules to simplify and encourage automatic enrollment features in 401(k) plans:

(a) ERISA Preemption of State Laws. The PPA amends ERISA to preempt any state law that directly or indirectly prohibits (or restricts) automatic contribution arrangements. DOL is authorized to publish regulations that establish minimum standards by which automatic contribution arrangements may qualify for this shield from state regulation. At a minimum, the arrangement must satisfy the notice and plan investment requirements described in paragraph (b) below.

> Comment: Current 401(k) plan regulations permit automatic elective deferrals through the use of "negative elections" (pursuant to which elective deferrals are automatically deducted from a participant's wages unless the participant affirmatively elects otherwise). Some states have asserted that this practice violates state wage payment laws. This new provision in the PPA effectively protects automatic contribution arrangements – including those involving negative elections -- from such state laws.

(b) Availability of ERISA §404(c) Protection for Deemed Investments. The PPA adds a new requirement that before a plan year begins, plan administrators must give automatically enrolled employees a written notice that explains (i) their right to opt out of contributing, (ii) the method for making or modifying their deferral election, and (iii) how a participant's contributions will be invested if the participant fails to make any investment election. Plan administrators who provide this notice and invest automatic contributions for which participants have not provided investment direction in accordance with final regulations to be issued by DOL will be treated as complying with Section 404(c) of ERISA, which furnishes limited protection against fiduciary liability. The PPA directs DOL to issue final regulations within six months after enactment.

(c) Withdrawals of Automatic Contributions. The PPA further provides that if a plan includes an automatic enrollment provision, the plan may establish a period of up to 90 days after the first contribution is made during which an employee may elect out of the plan and withdraw contributions made on his or her behalf (along with the associated earnings). The distribution is taxed in the year of receipt and is not subject to the 10-percent penalty that ordinarily applies to distributions before age 59½. The plan must also satisfy a notice requirement similar to the notice described in paragraph (b) above

(d) Nondiscrimination Safe Harbor. The PPA establishes an optional nondiscrimination safe harbor design for automatic enrollment plans. A plan is deemed to satisfy the ADP/ACP tests if it provides either –

> (i) a minimum match of 100% of elective deferrals up to one percent of compensation, plus 50% of elective deferrals between 1% and 6% of compensation, or
>
> (ii) a nonelective contribution of at least 3% of compensation.

Any matching or other employer contributions taken into account under the safe harbor must vest at least as rapidly as two-year cliff vesting. The safe harbor is only available if the contribution rate for automatic enrollees is at least 3% during the first year of participation, 4% during the second year, 5% during the third year, and 6% thereafter. The plan may specify a higher percentage up to 10%. The plan must also satisfy a notice requirement similar to the notice described in paragraph (b) above. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is made to make an election with respect to the contributions and investments.

Comment: The safe harbor described above is an alternative to the current ADP/ACP safe harbor, which involves full vesting and the contribution choices described in (i) and (ii) above. Plan sponsors who opt for the PPA's new safe harbor may impose a vesting schedule of up to two years on their employer contribution, provided that they automatically enroll employees at the levels noted above.

(e) Extended Period for Distribution of Excess Contributions. If an automatic enrollment plan does not rely on a safe harbor and performs nondiscrimination testing, refunds of excess contributions may be made within six months following the end of the plan year without penalty to the employer. The normal rule is that the employer must pay a 10% excise tax on excess contributions refunded later than 2½ months after the end of the plan year.

(f) Effective Date: The automatic enrollment rules are generally effective for Plan years beginning after December 31, 2007; the ERISA preemption provision is effective as of the date of the PPA's enactment.

Mandatory Diversification Rights for Investments in Employer Securities (PPA §901)

(a) General Rule. Under the PPA, defined contribution plans other than certain ESOPs must permit participants to diversify the portion of their account balance that is invested in publicly traded employer securities (or non-publicly traded stock related to the performance of a subsidiary of a publicly-traded company) into at least three materially different diversified investment options. All participants must be permitted to diversify the portion of their account that is attributable to elective deferrals and after-tax contributions, and participants with three or more years of service must be permitted to diversify the portion of their account that is attributable to any other contributions. This rule is phased in ratably over three years for securities acquired before 2007, except for participants who are age 55 or older and who have three years of service.

These rules do not apply to ESOPs provided they neither involve elective deferrals, after-tax employee contributions, or matching contributions, nor form part of another qualified plan.

Effective Date: Plan years beginning after December 31, 2006, with an extended effective date for collectively bargained plans and certain ESOPs.

(b) Notifying Participants about Diversification Rights (PPA §507). The PPA provides that if a participant has diversification rights with respect to employer securities held in a defined contribution plan, the plan administrator must provide the participant with a notice not later than 30 days before the first date on which the right arises. The notice must describe the diversification right and explain the importance of diversification.

Effective Date: Date of enactment, subject to a 90-day transition rule.

EGTRRA Permanence (PPA §811)

The PPA makes permanent the provisions of EGTRRA that implemented numerous changes to tax-qualified retirement plans, including Roth 401(k) contributions, the increased annual contribution limits for IRAs and qualified plans, the special catch-up rules for individuals age 50 and older, and the incentives for small employers to offer pension plans.

Cash balance and Pension Equity Plan Designs (PPA Art. VII)

Under the new PPA rules, cash balance and pension equity plan designs will not violate the age discrimination requirements of ERISA, the Internal Revenue Code or the Age Discrimination in Employment Act if the requirements set forth below are met. The PPA specifically provides that no inference may drawn from these new rules on the legality of hybrid plan designs implemented prior to June 29, 2005.

Note: On August 7, 2006, the Seventh Circuit Court of Appeals issued its much-anticipated decision in *Cooper v. IBM Personal Pension Plan*. The decision rejected, as whimsical, age discrimination arguments relating to IBM's cash balance plan. "Treating the time value of money as a form of discrimination is not sensible," explained the Seventh Circuit before remanding the case for judgment in favor of IBM. The decision is the first at the Circuit Court level to address this issue, and is important for existing plans because the PPA disavowed any impact on existing cash balance and other hybrid plans.

(a) Basic Design. Under the PPA, a participant's accrued benefit (disregarding subsidized early retirement benefit or retirement-type subsidies) "determined as of any date under the terms of the plan, must be equal to or greater than that of any similarly situated, younger individual". An individual is similarly situated to a participant if the individual and the participant are identical in every respect (including service, compensation, position, date of hire, work history) except for age.

(b) Interest Credits. Any interest credit (or an equivalent amount) for any plan year may not exceed a market rate of return. A plan does not fail to meet this requirement merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return. The Treasury Department is authorized to publish regulations governing the calculation of a market rate of return.

(c) Vesting. Full vesting is required after three years of service.

(d) Lump sums. Lump sum distributions may be based solely on the participant's hypothetical account balance. Under prior law, the so-called "whipsaw" effect sometimes required larger distributions.

(e) Conversions. The PPA imposes restrictions on converting a traditional defined benefit plan to a hybrid plan. First, each participant's benefit after the conversion must equal the sum of the pre-conversion benefit under the prior plan formula and the post-conversion benefit under the hybrid formula. This prohibits "wear-away" formulas that had been widely used in past conversions under which participants with substantial pre-conversion benefits might accrue no new benefits for a period after the switch to the hybrid plan.

In addition, a special conversion rule preserves the value of early retirement subsidies associated with benefits accrued under the prior formula. If at retirement the participant has met the eligibility conditions for the subsidy (e.g., no actuarial reduction for early commencement of benefits for participants who retire at or after age 55 with at least 10 years of service) and elects a lump sum distribution, the value of the subsidy must be included, even if the plan would not normally take it into account.

(f) Terminations. The plan must provide that upon plan termination, (1) if the interest credit rate (or equivalent amount) under the plan is a variable rate, the rate of interest used to determine accrued benefits under the plan shall be equal to the average of the rates of interests used under the plan during the five-year period ending on the termination date and (2) the interest rate and mortality table used to determine the amount of any benefit under the plan payable in the form of any annuity payable at normal retirement age is the rate and table specified under the plan for such purposes as of the termination date. For purposes of clause (2), if the rate of interest is a variable rate, then the rate is the average of such rates during the five-year period ending on the termination date.

(g) Effective Dates: In general, the hybrid plan provisions are effective for periods ending on after June 29, 2005, except for the whipsaw amendment, which is effective for distributions made after enactment, and the requirements relating to vesting and interest credits, which are effective for years beginning after December 31, 2007.

409A Penalties for Rabbi Trust Deposits (PPA §116)

Under this section of the PPA, if during a "restricted period" assets are set aside in a rabbi trust or other arrangement to fund nonqualified deferred compensation benefits for "covered employees" (or are subject to plan provisions specifying that they will be set aside in circumstances), the transfer is treated as taxable transfer of property under Section 83 of the Internal Revenue Code, even if the transferred amounts are otherwise subject to the claims of general creditors. Any tax gross-up payment provided by the employer to defray an individual's tax liability under this provision is treated as deferred compensation subject to a 20-percent additional tax.

A "restricted period" is any period that (1) a single-employer defined benefit maintained by the plan sponsor is considered "at risk" under the PPA's new pension funding rules[1], (2) the period that the plan sponsor is in bankruptcy, or (3) the 12-month period beginning six months before the termination of any underfunded single-employer defined benefit plan. The provision does not apply to assets set aside before a restricted period.

A "covered employee" is the chief executive office (or individual acting in such capacity), the four highest compensation officers for the taxable year (other than the chief executive officer), and individuals subject to Section 16(a) of the Securities Exchange Act of 1934. Any covered employee includes any (1) covered employee of a plan sponsor maintaining the single employer defined benefit plan, (2) covered employees of a member of a controlled group that includes the plan sponsor, and (3) former employees who were covered employees at the time of termination of employment with the plan sponsor or a member of a controlled group that includes the plan sponsor.

Effective Date: Date of enactment

Other Notable Provisions of the PPA

(a) Faster Vesting Required for Non-Elective Contributions (PPA §904). Under the PPA, non-elective contributions to defined contribution plans must vest not less frequently than either –

- 100% vesting after three-years of service, or
- graduated vesting of 20% per years 2 to 6 (i.e. 20% after 2 years, 40% after 3 years, 60% after 4 years, 80% after 5 years, and 100% after 6 years).

These maximum vesting conditions already apply to matching contributions, and the PPA merely extends them to non-elective contributions (with vesting credit required for service before the PPA's effective date).

Effective Date: The accelerated vesting rules apply to non-elective contributions made after December 31, 2006, with extended effective dates for collectively bargained plans and ESOPs with loans in place on September 26, 2005.

(b) Phased Retirement Distributions (PPA §905). The PPA allows defined benefit plans to make in-service distributions to participants who are age 62 or older. This is intended to enable older workers to become part-time employees and receive pension benefits to maintain their current earnings level.

Effective Date: Distributions in plan years beginning after December 31, 2006.

(c) Periodic Benefit Statements (PPA §508). The PPA requires the administrators of defined contribution plans to provide quarterly benefit statements to plan participants who have the right to direct the investment of their accounts. Benefit statements for other defined contribution plans are required annually.

Effective Date: Plan years beginning after 2006 (potentially later for plans maintained pursuant to collective bargaining agreements).

(d) Retroactive Plan Amendments (PPA §1107). Employers may make plan amendments relating to the PPA retroactive to its effective date, provided that they are made before the last day of the first plan year beginning in 2009 (2011 for governmental plans).

NOTES:

[1]A single-employer defined benefit plan is "at risk" if the plan's funding target attainment percentage for the preceding year was less than 60 percent.

If you have any questions or comments regarding this alert, please do not hesitate to contact any of the following members of the Paul Hastings ERISA Practice Group:

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