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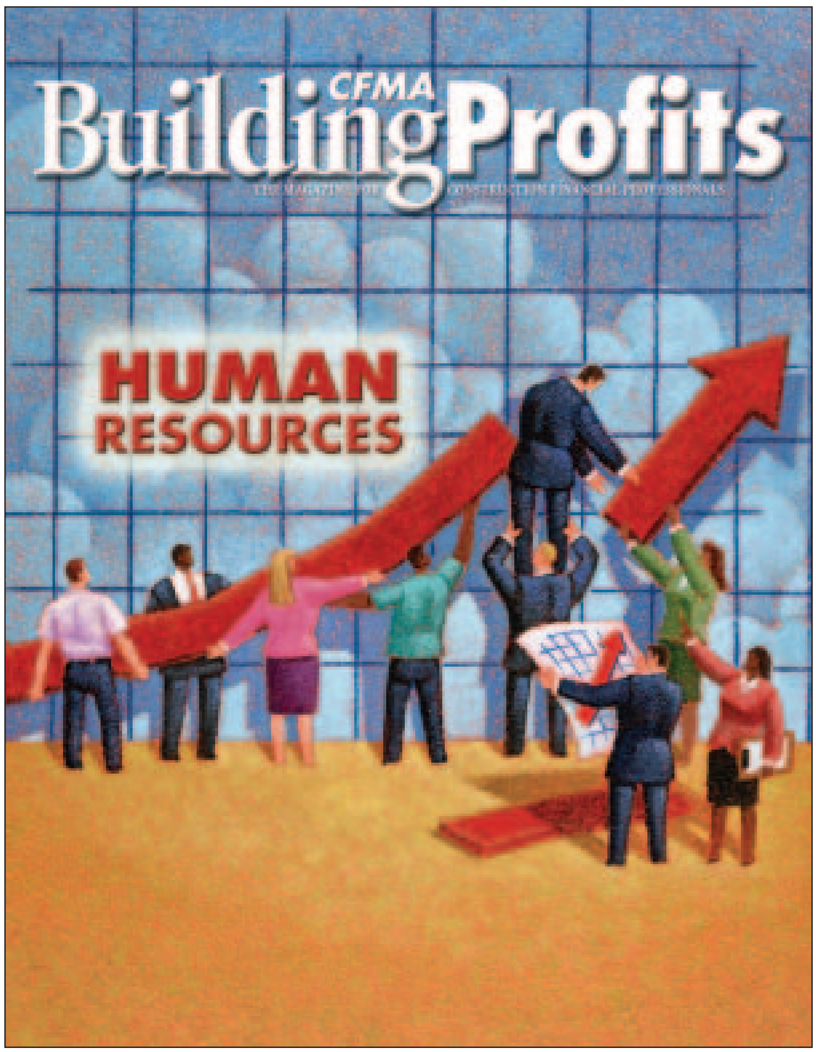

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Defined Contribution Plans & the Pension Protection Act of 2006

CFMs often have the difficult job of overseeing their companies' employee retirement plans. Compliance with federal and state requirements is complicated, and usually requires some level of oversight even when contractors outsource benefit administration. So, it makes sense that CFMs are interested in the ramifications of the *Pension Protection Act of 2006* (PPA 2006), one of the farthest-reaching pension reform undertakings in many years.

Signed into law on August 17, 2006, this Act will have a significant impact on defined contribution, non-qualified, IRA, 403(b), and 457 plans. It will also change some responsibilities that certain plan sponsors have to the Pension Benefit Guaranty Corporation (PBGC), a non-profit organization that insures participant benefits under some defined benefit plans.

The PBGC

Established by the *Employee Retirement Income Security Act of 1974* (ERISA), the PBGC has a three-point mission: **1)** to encourage the continuation and maintenance of private-sector defined benefit pension plans, **2)** provide timely and uninterrupted payment of pension benefits, and **3)** minimize pension insurance premiums.

The PBGC is not funded by general tax revenues. Instead, the PBGC collects premiums from insured pension plan sponsors, earns money from investments, and receives funds from pension plans when it assumes responsibility for them. Many plan sponsors of qualified defined benefit plans are subject to plan termination insurance rules, so this article mentions the PBGC where appropriate.

This article also focuses on several major provisions that will affect defined contribution plans, and discusses some significant optional provisions. Please note that this overview is not all-inclusive, and concentrates only on those provisions that have the greatest impact on plan sponsors and their participants. It is not intended to provide legal or tax advice.

Required Provisions for Defined Contribution Plans

A Sunset Provision Repealed

The pension provision of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) was set to expire after December 31, 2010. However, with the passing of PPA 2006, the EGTRRA pension provision became permanent, including increased contribution limits and tax deductions, distribution portability, and simplification of non-discrimination rules.

Saver's Credit

The Saver's Credit is a non-refundable tax credit available to qualifying low- and middle-income participants who contribute to an IRA or defined contribution plan. Originally set to expire at the end of 2006, it is now permanent as well.

Educating participants about the Saver's Credit may encourage more low- and middle-income employees to participate in the contractor's qualified plan. As a result, Highly Compensated Employees (HCEs) may be able to defer more of their salaries without additional cost to the plan sponsor.

State Payroll Deduction Laws for Automatic Enrollments

Automatic enrollment allows a percentage of employee wages to be automatically deposited in a defined contribution plan, even if employees do not fill out an enrollment form or make an affirmative election to participate in the plan.

In the past, some states required written consent from plan participants before employers could automatically deduct funds from wages. Since it was unclear whether ERISA pre-empted these state laws, many plan sponsors chose not to offer automatic enrollment.

PPA 2006 clarifies this issue: ERISA does pre-empt state payroll deduction laws related to automatic enrollment.

Fiduciary Provisions

In response to bankruptcy cases that have battered pension plan assets, Congress has put several self-correcting measures in place with PPA 2006. These procedures are designed to help fiduciaries fix breaches they may have been unable to correct in the past.

For example, a fiduciary may be able to avoid an excise tax in connection with a prohibited transaction if it is corrected within 14 days of discovery. Other changes clarify the responsibilities of plan sponsors and increase the penalties for mishandling plan assets.

Quarterly Benefits Statements

To promote a greater awareness of and appreciation for the importance of retirement savings, PPA 2006 requires plan sponsors to provide more frequent statements to participants.

For a plan year beginning in 2007, participants with directed investments must receive quarterly statements and be advised of the risks associated with holding more than 20% of their portfolio in any one entity. In addition, participants without directed investments must receive annual statements.

Vesting of Non-Elective Contributions

PPA 2006 calls for faster vesting of non-elective contributions, requiring that plan sponsors offer a three-year cliff or six-year graded vesting schedule.

In cliff vesting, participants become 100% vested in their account balance after a pre-determined amount of time. For example, three-year cliff vesting requires three years of employment before becoming vested. Prior to three years of employment, the participant has no vested interest.

In graded vesting, participants gradually become vested. For example, under a six-year graded vesting schedule, participants are 20% vested in their account balance in the second year of employment; then, vesting increases by an additional 20% each year until the account is 100% vested after six years.

Prior to their 2007 plan year, plan sponsors who offer a five-year cliff or seven-year graded vesting schedule on non-elective contributions need to decide whether to apply the new vesting schedule to all non-elective contributions or just to those made beginning in 2007.

Form 5500 Reporting

Plan sponsors of defined contribution plans must annually file Form 5500 – an annual return/report that provides information about defined contribution plans, as well as other employee benefit plans.

To simplify the reporting and administration of small plans, PPA 2006 instructs the Secretary of the Treasury to eliminate the filing requirement for One-Participant Plans where assets do not exceed $250,000 at the end of the plan year. Likewise, the law requires the Treasury to develop simplified 5500 reporting for plans with fewer than 25 participants.

Both changes are effective for plan years beginning on or after January 1, 2007.

Rollovers to Roth IRAs

Beginning in 2008 and subject to Roth IRA limits, eligible qualified plan distributions may be rolled directly to Roth IRAs. (This means that participants are no longer required to roll assets into a Traditional IRA before converting to a Roth IRA.) While the qualified plan distribution will be a taxable distribution at the time of the rollover, the 10% early distribution penalty will not apply in most cases.

Combined Plan Deductions

Previously, the deductible limit for an employer sponsoring both a defined contribution and a defined benefit plan was the greater of:

- Twenty-five percent of plan year compensation, or
- The contribution necessary to meet the minimum funding requirement, but not less than the plan's unfunded liability.

As a result of PPA 2006, only employer contributions to a defined contribution plan that exceed 6% of participant compensation – excluding 401(k) contributions – will be subject to the deductible limit.

Beginning in 2008, contributions to plans insured by the PBGC will not be taken into account in applying the combined plan limit. This change eliminates any tax deduction restrictions that once applied to plan sponsors with both defined benefit and defined contribution plans.

Additional Survivor Annuity Option

With the plan year beginning in 2008, pension plans subject to Qualified Joint and Survivor Annuity (QJSA) requirements must offer a qualified optional survivor annuity. If the survivor annuity provided under the plan by the QJSA is less than 75%, an optional annuity of 75% payable to the spouse is required. Plan sponsors must notify participants of the availability of the qualified optional survivor annuity.

Special Cases: 401(k) Plans & Rollovers

401(k) Plans

To increase participation in 401(k) plans, Congress has provided incentives for plan sponsors to encourage automatic enrollment in their plans' designs.

As such, provisions for automatic enrollment plans are *optional*, while the non-automatic enrollment provisions are *required*. All changes are effective for new hires in the plan year beginning in 2008, and include:

Automatic Enrollment Plans: Safe Harbor

Qualifying plans must offer automatic enrollment that does not exceed 10%, starting with at least 3% in Year 1 and increasing by 1% each year until it reaches 6% and includes a safe harbor contribution of:

- A 100% match on the first 1% deferred and a 50% match on the next 5% deferred, or
- A 3% non-elective contribution to all eligible non-highly compensated employees (NHCEs).

Safe harbor contributions must vest after two years of service and the annual safe harbor notice must be met. Automatic enrollment plans meeting specific conditions are not subject to certain non-discrimination testing.

Automatic Enrollment Plans: ADP Correction without Penalty

Actual Deferral Percentage (ADP) testing compares salary deferrals for HCEs to the average salary deferrals of NHCEs. Non-safe harbor automatic enrollment plans can return deferrals for a failed ADP test within six months of the close of the plan year without the standard 10% penalty.

Automatic Enrollment Plans: Corrective Distributions

If elected within the first 90 days, participants can have incorrect contributions returned to them. These corrective distributions are not subject to the 10% penalty and are excluded from ADP testing, but are included in the participant's income for the year in which the distribution was made.

Automatic Enrollment & Non-Automatic Enrollment: Corrective Distributions

Corrective distributions resulting from a failed ADP test will no longer be required to include gap income, the income earned between the last day of the plan year and the actual date of distribution. Again, corrective distribution amounts are included in the participant's income for the year in which the distribution was made.

Rollovers of After-Tax Amounts

For the plan year beginning in 2007, rollovers of after-tax amounts from one tax qualified plan to another, including a 403(b) plan, are permitted. This provision is optional for rollovers in and required for rollovers out.

On April 27, 2007, final regulations permitted the rollover of a designated Roth 401(k) to a designated Roth 403(b).

Maximum Bond Limits

For the plan year beginning in 2008, maximum bond limits for plans that include employer securities will increase from $500,000 to $1 million. This offsets the added risk of investing in employer securities when the employer is in financial distress. Plans that do not hold employer securities are exempt from this requirement.

Optional Provisions for Defined Contributions

ERISA §404(c) Protection

If employees are eligible for an annual profit sharing contribution, a plan sponsor must deposit the profit sharing contribution into a default fund when:

- The eligible employees do not participate in the company's 401(k),

  and

- They have not made any other investment elections under their defined contribution plan.

The DOL is expected to issue final guidance that provides a safe harbor default investment option for these participants in plan years beginning after December 31, 2006.

When certain notice requirements are met, plan sponsors will receive ERISA §404(c) protection when default investments are made based on DOL guidance.

Investment Advice

PPA 2006 includes a provision to protect plan sponsors that want to offer investment advice to plan participants through a qualified investment fiduciary adviser. This statutory exemption is valid when:

- The fiduciary adviser provides guidance to the plan participant and either charges a fee or uses a computer model to formulate a recommendation.
- The fee is the same regardless of the investment options selected.
- The advice considers all investment options under the plan.
- All appropriate disclosures and notices are met.

Plan sponsors are still required to select and monitor advisers as part of their fiduciary responsibility, but they are not required to monitor the actual investment advice.

Missing Participants of Terminating Defined Contribution Plans

Plan sponsors terminating defined contribution plans will be able to transfer assets for missing participants to the PBGC – allowing them to close out plans before locating all missing participants. However, the PBGC must issue guidance before plan sponsors can take advantage of this new approach.

Rollover to Non-Spouse Beneficiaries

For distributions made after December 31, 2006, non-spouse beneficiaries can roll over death benefits into an IRA, which will be treated as an inherited IRA. The owner of an inherited IRA is considered a decedent and must meet the minimum distribution requirements for IRAs.

For rollovers that take place before the minimum distribution age, the beneficiary must begin receiving benefits within five years from the date of death, or beginning the year following the death to be paid throughout the beneficiary's remaining life expectancy.

Hardship Rules

To provide same-sex partners with the hardship benefits afforded to other spousal beneficiaries, PPA 2006 expands the definition of hardship to cover non-dependent and non-spousal beneficiaries.

Defined contribution plans now permit hardship distributions related to medical, tuition, and funeral expenses for primary beneficiaries under the plan. (The primary beneficiary is a named beneficiary with unlimited rights to all or a portion of the participant's account upon the participant's death.)

Conclusion

As is clear from just this brief look at PPA 2006, many provisions in the legislation will affect defined contribution plans. The IRS, DOL, and PBGC will continue to issue guidance to clarify provisions, so plan sponsors need to remain informed. CFMs should consult with their advisors to determine how these provisions affect their existing plans. BP

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