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The New Pension Protection Act: More Work for Plan Administrators

Anne E. Moran and Karen Tucker

The Pension Protection Act of 2006 (the Act)¹ was passed by Congress just before its August 2006 recess. But since the Act was signed by the President, plan administrators do not have the luxury of a recess. They must now review and understand how the hodgepodge of changes contained in this Act affects day-to-day plan operations.

Although most of the public debate about the Act involved underfunded plans and the role of the government in supporting them through the Pension Benefit Guaranty Corporation (PBGC) and the Act's effect on cash balance plans, the Act's scope is broader than that. The Act changes plan limits and reporting rules for all types of qualified plans. This column discusses first, the changes made by the Act that will affect defined contribution plan administration; second, some special changes to the defined benefit rules that could create challenges for plan administrators; and third, important reporting and disclosure changes.²

Changes Affecting Defined Contribution Plans

Overview of the Changes

The provisions in the Act affecting defined contribution plans reflect Congress's recognition that, because of the decline in defined benefit plan sponsors, defined contribution plans are not mere supplemental benefits, but the major source of retirement income for many employees. In recognition of this fact, the changes in the Act discussed herein:

1. Make permanent the increased contribution levels for retirement plans passed in 2001;
2. Accelerate required vesting;

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3. Encourage use of elective deferral (401(k)) opportunities by decreasing technical barriers to automatic enrollment;
4. Assist participants with the investment opportunities available in such plans through diversification rules and elimination of barriers to the provision of investment advice; and
5. Encourage participants to retain money in retirement arrangements by enhancing the ability to transfer between plans.

Permanent Increases in Contribution Levels Under Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)³

The Act makes permanent certain pension and IRA provisions of EGTRRA that were scheduled to lapse after 2010. These provisions include the increased 401(k) and IRA contribution limits that are now in place, as well as catch-up contributions (at \$5,000 for 401(k) plans in 2006) for participants age 50 or older, and Roth 401(k) plans. The increased portability rules in EGTRRA (more rollover flexibility) and the accelerated vesting of matching contributions (discussed below) are also made permanent. Further, the Act permanently extends the saver's credit (set to expire December 31, 2006), allowing eligible individuals contributing to a 401(k) plan, qualified pension plan, or an IRA to claim a nonrefundable tax credit for the first \$2,000 of their annual contribution, based on income and filing status. There is also a new provision that requires the IRS to develop a form to accommodate direct deposit of income tax refunds to IRAs.

Accelerated Vesting for Defined Contribution Plans

In a little-noticed but potentially expensive change for some employers, the Act accelerates the minimum vesting requirements for all employer contributions to defined contribution plans. Employees with an hour of service after December 31, 2006, must vest completely in employer contributions to defined contribution plans after three years of service, or alternatively must vest at the rate of 20 percent per year beginning no later than the second year, with 100 percent vesting after six years. (Prior law generally permitted five-year cliff vesting, and a slightly longer graduated vesting schedule.) Pre-2007 service must be counted for this purpose. Employers can decide whether to apply the faster vesting only to contributions made beginning in 2007 or to participants' entire accounts. For collectively bargained plans, the effective date is postponed until the current bargaining agreement expires, but not later than 2009. The faster vesting requirement had applied on a temporary basis to matching contributions under EGTRRA, and those temporary rules are now made permanent, as discussed above, and applied to all employer contributions to defined contribution plans.

Incentives to Encourage Participant Enrollment

The new law provides incentives for employers to use automatic enrollment for retirement plans. Automatic enrollment features provide that the employer withholds money from participants' pay and contributes it to a 401(k) plan unless the participants opt out. The theory is that inertia will result in more people being covered by retirement plans if individuals must "elect out" rather than "elect in." There are two separate sets of rules that apply: an exemption from state wage garnishment laws for an eligible "automatic contribution arrangement" (ACA) and, in addition, a new 401(k) safe harbor alternative for a "qualified automatic contribution arrangement" (QACA). Automatic enrollment is not required; these rules are intended to encourage its use. Finally, default investment safe harbors are authorized to give employers protection with respect to certain investments selected for automatic enrollment contributions.

Preemption of State and Wage Garnishment Laws for Automatic Contribution

Many employers had not instituted automatic enrollment in the past for fear that state wage and garnishment laws might prohibit automatic deductions from paychecks without an employee's affirmative consent, even if the deducted amounts were placed in the participant's 401(k) plan account. Under the Act, effective immediately, ERISA preempts state wage and garnishment laws for ACAs that make use of safe harbor investment options, making the state rules inapplicable to plans subject to ERISA. (Plans subject to ERISA include most qualified plans except government and certain church plans.) This preemptive relief applies to ACAs, which are defined as arrangements that are cash or deferred arrangements, under which the participant is treated as having elected to contribute a uniform deferral rate provided under the plan in the absence of a different affirmative election. If the participant does not make an investment election, contributions are invested according to safe harbor 404(c) default investment rules specified by the Department of Labor (DOL) (discussed below), so as to protect plan fiduciaries from liability for those contributions.

Effective for plan years beginning after December 31, 2007, an ACA must distribute a notice before the beginning of each plan year that advises participants of the right to opt out or to defer at a rate other than the default rate. Additionally, the notice must explain the right to direct investment of contributions and earnings, and describe how contributions will be invested absent a participant's election. The participant must have a reasonable amount of time after the notice to make deferral and investment elections.

The ACA's rules provide that participants opting-out will have a 90-day window after the first deferral to withdraw automatic enrollment.

Automatic elective contributions that are designated by an employee as made erroneously and distributed before April 15 of the year following the year contribution was made, are treated as compensation to the employee in the year of distribution and are not subject to the 10 percent early withdrawal tax or to the otherwise applicable nondiscrimination rules. The withdrawal must be for 100 percent of amounts deferred (and earnings) through the payroll period beginning before the effective date of withdrawal election. Plans will have six months after the close of the plan year to distribute excess contributions resulting from automatic enrollment without the employer being subject to the 6 percent penalty tax that would ordinarily apply to excess contributions.

New Safe Harbor for Qualified Automatic Contribution Arrangements (QACAs)

The Act authorizes a new safe harbor plan for plans with an automatic enrollment feature that avoids nondiscrimination testing but which is potentially less costly than the currently permitted safe harbor. It is *potentially* less costly because, although the amount of employer contributions required per participant is lower and vesting in some cases is slower than under the current 401(k) safe harbor, it is anticipated that more people will participate due to automatic enrollment, thus increasing the number of participants who receive contributions.

Under the new safe harbor, the automatic default deferral percentage must be 3 percent in the first year of participation, 4 percent in the second year, 5 percent in the third year, and 6 percent in each year thereafter. Plans *may* provide for automatic increases in the default deferral percentage up to 10 percent of pay. This rule may present a recordkeeping challenge for some employers, since contributions will vary by a participant's service.

The required employer contribution must be either a 3 percent non-elective contribution for nonhighly compensated employees (NHCEs) (like the current safe harbor) or a matching contribution of 100 percent of the first one percent of compensation and 50 percent of the next 5 percent of compensation, with a minimum required total match of 3.5 percent (potentially lower than the current safe harbor matching contribution, which is 100 percent of the first 3 percent and 50 percent of the next 2 percent of pay). There is two-year cliff vesting required for employer contributions rather than the immediate vesting rule applicable to the current safe harbor plans, although immediate vesting would be permitted. For purposes of measuring service, the first year ends on the last day of the first full plan year following the participant's eligibility date. The second and subsequent plan years begin on the first day of each later plan year.

Eligible employees who must be automatically enrolled include all employees eligible to participate in the plan other than employees who

were eligible to participate prior to the date a QACA becomes effective *and* who had an election either to participate or not to participate in effect. These eligibility limitations do not preclude inclusion of current employees in automatic enrollment. It should be noted that the QACA can require a waiting period of up to one year before an employee becomes eligible, just like other 401(k) safe harbor plans.

Default Investment and Reallocation Safe Harbors

Effective January 1, 2007, the Act provides “Section 404(c) protection” for plans that utilize a safe harbor default fund for participants who do not make an investment election. This generally means that if the requirements of the Act are met, an employer that uses a default fund will be protected from an argument by a participant who had a default investment that an alternative investment would have better suited the participant’s needs. On September 26, 2006, the DOL issued a proposed safe harbor rule for these ACAs. The rule provides relief for plans that make available a broad range of investment alternatives that otherwise satisfy Section 404(c), and that use a qualified default investment alternative (QDIA) for amounts contributed without investment instructions. Advance notice (30 days) of the participants’ rights must be given in order to retain this relief. These QDIAs or default options, must be either (1) a lifestyle or targeted retirement date fund; (2) a balanced fund; or (3) a professionally managed account.

The DOL makes it clear that a QDIA safe harbor cannot be a money market fund or a stable value fund. This is based on the policymakers’ view that a “safe” fixed income fund (where principal is guaranteed, but earnings are not particularly high) may not be appropriate for all employees, particularly younger employees who have many years until retirement. If the DOL maintains this view in final regulations, plans that currently use a fixed income fund as a default investment (on the theory that principal must be protected at the cost of increased earnings potential) will have to change.

For plan years after 2007, the new law eliminates Section 404(c) protection during blackout periods unless the plan has complied with the blackout notice requirements enacted by the Sarbanes-Oxley Act⁴ and meets certain other stipulated requirements. Generally, the notice must be provided at least 30 days but no more than 60 days in advance of the effective date of the change, and explain the changes to investment options, the new options, and how the participants’ investments will be made absent an election. The notice must also explain how the participants’ accounts will be “mapped” to new investments in connection with a change in investment options. For collectively bargained plans, these changes are delayed until the current bargaining agreement expires but not later than 2010. At some point before the effective date of the new rules, it is hoped that the DOL will provide guidance to make sure that these new requirements are consistent with the current requirements for

a blackout notice. For example, ERISA currently requires notice at least 30 but no more than 60 days before the effective date of a blackout period, but the new rules require notice of investment changes 30 to 60 days before the effective date of the change.

It will take some time before the practical effect of these rules has been thoroughly tested. While plan administrators are certainly advised to follow these rules to obtain the maximum protection possible, the DOL still holds the employer responsible for prudent fund selection procedures and for monitoring the funds selected.

Increased Investment Opportunities and Education

These provisions reflect Congress's view that participants need to take an active role in their savings plan investments in order for such investments to generate enough income to provide for retirement. Therefore, the new rules require that most contributions made in employer stock be allowed to be diversified. The Act also eliminates barriers to employers and plans that want to make participant investment education more accessible.

Diversification Rules

Effective for plan years starting in 2007, the Act provides that defined contribution plans must meet new diversification requirements for employee contributions or employer contributions to a plan that are invested in publicly traded employer securities.⁵ These new diversification rules do not, however, apply to (1) ESOPs that contain *no* elective deferrals, employee contributions, and matching contributions; and (2) one-participant plans. They would, however, apply to KSOPs (401(k) plans with ESOP features). There is a delayed effective date for collectively bargained plans.

All participants must be allowed to diversify the investment of their own elective deferrals and after-tax contributions. Plans must allow diversification of other contributions (including employer contributions) invested in employer securities as follows. For post-2006 employer contributions, plans must permit 100 percent diversification no later than after the completion of three years of service (or immediately for the beneficiary of deceased participants). For pre-2007 employer contributions, plans must permit 100 percent diversification for participants with at least three years of service who are age 55 and older by the beginning of the first plan year after December 31, 2005. Participants under age 55 with at least three years of service must be allowed, at a minimum, the following diversification schedule for pre-2007 employer contributions: 33 percent available for diversification for the first year, 66 percent the second year, and 100 percent the third year.

Investment elections to allow such diversification must be permitted at least quarterly. At least three different investment alternatives other than the employer stock must be made available.

A participant who has a right to diversify out of employer securities must be given 30 days' advance notice before the first date that he or she is eligible to exercise diversification rights and the notice must describe the importance of diversifying the investment of retirement assets. There is a \$100-per-day civil penalty for noncompliance. As discussed below under Reporting and Disclosure, notices of investment rights must be provided to all participants.

Individualized Investment Advice

Many employers hesitated to provide employees with access to individual investment advice due to concerns that they would be held accountable for investments that did not perform as projected using the advice. There were also technical "prohibited transaction" concerns under ERISA regarding the use of investment advisors. Beginning in 2007, under a new prohibited transaction exemption (PTE), "fiduciary advisors" are allowed to provide personally tailored professional investment advice to employees to assist them in managing their 401(k) plan, IRAs, and other plans. A "fiduciary advisor" is a person who is a plan fiduciary by reason of giving investment advice and who is a registered investment advisor, bank, or similar institution, insurance company, or registered broker-dealer, or an employee, agent, or registered representative of such organization.

A "fiduciary advisor" will be allowed to give investment advice if either its fee does not vary based on the participant's investment choices or its recommendations are based on a computer model certified and audited by an independent third party. Before dispensing advice (and then annually), the "fiduciary advisor" must provide written notice to participants explaining services provided, fees to be charged, and how information obtained from the participant will be used. The participant directs all investment transactions. "Fiduciary advisors" may be compensated for giving participant investment advice rendered after December 31, 2006, but the compensation must be reasonable. Whether employers will take advantage of this opportunity remains to be seen. In particular, the audit requirement may be expensive.

Other Special Rules

The Act contains a variety of other new rules that will affect plan administration.

Hardship Distributions and Rollovers for Nonspouses

The Act recognizes a more diversified workforce whose employees have domestic partners or other nontraditional partners, including two additional benefits for nonspouse beneficiaries.

First, the Act expands the types of benefits eligible for “safe harbor” hardship distributions for expenses like medical costs and tuition even if the affected recipient of the funds is not a “dependent” as defined in the Internal Revenue Code. Obviously, this expands the use of hardship withdrawals beyond traditional dependents and even beyond same sex partners. Plans are not required to adopt this rule, but many are likely to do so.

Also, under current law, only a spouse can roll over his or her deceased spouse’s retirement benefit into an IRA or to another qualified plan or 403(b) plan. The law expands this opportunity to all beneficiaries, but only for rollovers to an IRA. This IRA will still have to apply the minimum distributional rules that “would have” applied to the participant.

Information About Effect of Deferral

Generally, plans allow participants the option to defer receipt of their benefits until age 65 (or later, in some cases). The Act directs the IRS to require plans to explain the effect of failing to defer plan payouts. This quite vague directive is effective for years after 2006. It is not clear when plans have to amend their election forms under this effective date, and what the explanation should say.

Distributions to Qualified Reservists

The Act provides for special rules applicable to National Guard and Reserve members called to active duty between September 12, 2001 and December 31, 2007, for a period of at least 179 days. The new law permits (but does not require) plans to make distributions to eligible members while on active duty without regard to applicable restrictions. This rule applies to distributions made after September 11, 2001. The distributions would be exempt from the 10 percent early withdrawal penalty and could be re-contributed to an IRA at any time within the two-year period following the end of active duty without regard to the annual contribution limit.

Fiduciary Bonds

Currently, fiduciaries and other service providers that handle plan funds must be bonded for at least \$500,000 (this may be more depending on the amount handled). The Act increases this minimum amount to \$1 million after 2007 for plans holding employer securities.

Portability

As noted above, the EGTRRA rules that are now permanent had taken some initial steps to increase the ability to transfer between differ-

ent types of retirement plans (commonly known as portability). Under EGTRRA, for example, distributions could be rolled over from 401(k) to 403(b) plans and certain government-sponsored deferred compensation plans and vice versa, and an employee's surviving spouse could roll over distributions to qualified plans and 403(b) plans. But rollovers by non-spouses and certain after-tax contributions were still limited.

The Act provides that effective in 2008, 401(k) plan distribution can be rolled over directly to Roth IRAs. The taxable portion of the rollover amount is taxed at the time of rollover and subject to the Roth IRA conversion rules. After-tax amounts will also be able to be rolled over after 2006. Additionally, as discussed above, effective for distributions made after 2006, a nonspouse beneficiary is permitted to roll over benefits to his or her own IRA. However, the IRS is expected to issue regulations that will require the transferee IRA to comply with minimum distribution rules applicable to the participant. These rules will expand rollover opportunities but may result in more recordkeeping and reporting issues for retirement plans.

Changes Affecting Defined Benefit Plans

Funding and Deduction Rules

The changes most widely discussed under the Act involve changes to minimum funding and deduction rules for defined benefit plans. While significant, these changes are more likely the focus of the plan's actuaries and accountants. However, some special non-funding rules that could affect the operation of defined benefit plans are discussed below.

Lump-Sum Payments

The Act changes the interest rate assumptions used to convert annuity benefits to lump sums. It is not expected that the mortality rate change will have a significant effect, but the interest rate change could be important.

The interest rate assumption affects the amount of lump sums a participant can receive. It also affects a participant's decision as to when to retire. If the interest rate appears to be increasing, a participant may retire early so that his or her lump sum does not decrease.

Once it is fully phased in, the interest rate will be based on the corporate bond yield curve during the one-month period before the distribution date. Unless IRS regulations provide more flexibility for determining the date (and the Act does provide some authority for the IRS to do that), the rate is set on that monthly date. The plan administrator will be required to track these rates.

The yield curve rate is expected to be higher than the current 30-year Treasury rate, thus *decreasing* potential lump sums. However, that rate

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is phased in over a five-year period, and the 30-year Treasury rate is used in 2006 and 2007. The rates are phased in as follows:

<i>Year</i>	<i>Rate</i>
2006 and 2007	30-year Treasury rate
2008	30-year Treasury (80 percent) and corporate bond yield curve (20 percent)
2009	30-year Treasury (60 percent) and corporate bond yield curve (40 percent)
2010	30-year Treasury (40 percent) and corporate bond yield curve (60 percent).
2011	30-year Treasury (20 percent) and corporate bond yield curve (80 percent)
2012	Corporate bond yield curve

Some plan administrators are concerned that participants will be tempted to retire early if it appears that the rates will change and decrease lump sums. Most observers believe that the Act will result in higher rates and lower lump sums generally. A dramatic change in lump-sum values is more likely to occur in plans where the lump-sum rate is set once a year (as is currently permitted).⁶ If the IRS does not allow use of an annual date but requires a determination of the interest rate each month, this effect will be decreased. However, other problems, like trying to estimate a lump sum quickly based on rates that change monthly, may cause difficulties for plan administrators.

Possible Effects on Executive/Nonqualified Plans

Some of the funding changes may indirectly affect plans and arrangements for executives. Two such changes are discussed below.

Section 415 Limits

The so-called 415 limits on defined benefit plan payments are the lesser of a participant's average compensation over his or her highest three years of compensation⁷ or \$175,000. These maximum limits are expressed as a life annuity, so an interest rate is needed to convert that annuity to a lump sum in plans that authorize lump sums. The law allowed a temporary rate of 5.5 percent but that expired. Beginning for distributions starting in 2006, the Act provides that this rate must be at least the greatest of (1) 5.5 percent; (2) the rate providing a benefit of 105 percent of the benefit using the required rate for determining lump

sums; or (3) the rate stipulated in the plan. There are some technical issues with this provision. For example, it applies to 2006 distributions, some of which may have been made before the law was signed.

If these rates are higher than the current rate used in the plan, the practical effect will be to decrease qualified plan benefits for certain highly paid participants. This could shift more plan benefits for highly compensated employees to a nonqualified plan, if the employer sponsors a “mirror” nonqualified plan.

Restrictions on Executive Plans if Plan “at Risk”

If the company’s defined benefit plan is deemed to be “at risk” under the new funding rules, the Act would restrict the ability of an employer to set aside amounts in a nonqualified deferred compensation trust for (1) the period the defined benefit plan is at risk; (2) the period the employer is in bankruptcy; and (3) the 12-month period beginning six months before an underfunded plan is terminated. The executive will be taxed on any amounts set aside during these periods (but not on amounts set aside beforehand) and any “gross-up” provided to compensate the executive will be nondeductible and subject to a 20 percent excise tax. These provisions apply as of the date of enactment.

New Required Survivor Annuity Option

In what some might see as a new level of government micro-management of retirement plan design, the Act provides that plans that are required to have a qualified joint and survivor annuity (a benefit providing an annuity to the participant with a survivor benefit of at least 50 percent of the annuity amount paid during the participant’s life) must offer as an option a joint and 75 percent (or more) survivor option as well as a joint and 50 percent survivor option. This requirement is effective in 2008.

Phased Retirement

Beginning in 2007, the Act allows plan distributions at age 62 (rather than age 65) if the plan so provides. It is not clear how many employers will take advantage of this feature. Proposed IRS regulations allowed for certain early distributions, but they were fairly complex and many employers did not use them.

Reporting and Disclosure Requirements

Plan administrators will have to comply with a number of new reporting and disclosure requirements generally effective for post-2007 plan years. Some of the key provisions of the Act include:

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- Requiring plan Form 5500 annual reports to be made available in electronic form on the company's Intranet Web site in accordance with DOL regulations as well as on the DOL's Web site. Additional information is required for Form 5500 annual report for certain defined benefit and multiemployer plans. (DOL to issue regulations within one year.)
- Requiring a notice of the right to diversify (*see* prior discussion of Diversification Rules). Plan participants must be notified of their right to divest employer securities no later than 30 days before the date diversification is first available. Separate notice is required for different types of contributions. (DOL to issue model notice within one year.)
- Requiring defined benefit plans to provide an annual funding notice to participants, the PBGC, beneficiaries, unions (and for multiemployer plans to employers contributing to the plan) 120 days after the beginning of the plan year. The notice must include detailed plan funding information and additional information on whether the plan is in an endangered or critical status. The summary annual report (SAR) requirement is eliminated for defined benefit plans.
- Requiring periodic benefit statements. Defined benefit plans are required to issue a benefit statement every three years or upon written request. The statements must include total benefits, vested benefits (or earliest date amounts will be vested) and the value of each investment held by the participant including those investments in employer securities. Alternatively, the defined benefit statement requirement can be met by annual notification to participants on how to obtain the information. Defined contribution plans generally will have to provide annual notices or notices upon request; however, where there is individual investment direction, quarterly notice is required. Defined contribution notices will also have to include additional disclosure about investment restrictions and risks, and a reference to the DOL Web site.
- Imposing new requirements for notices to workers, retirees, or beneficiaries for plan terminations and blackout periods.
- Requiring that for post-2007 years, within 30 days of a written request, plan administrators of a multiemployer plan must provide participants and other affected parties with the plan information. (The DOL must issue regulations within one year.)

Conclusion

The Act provides challenges as well as opportunities for plan administrators. Although the law appears to allow a delay in formal plan amendments, there are notices and system changes that need to be in place almost immediately, as well as decisions to be made as to whether to implement some of the optional changes. These decisions are harder to make given that certain important guidance from the IRS and the DOL has yet to be issued. It is hoped that the regulatory agencies will provide flexible transition rules so that plan sponsors can implement these changes in a reasonable manner.

Notes

1. Pub. L. No. 109-280.
2. This column does not discuss the changes made by the Act to pension funding rules, multi-employer plan rules, hybrid (cash balance) plans, and ERISA's prohibited transaction rules as applied to plan investments and plan fiduciaries.
3. Pub. L. No. 107-16.
4. Pub. L. No. 107-204.
5. In some cases, non publicly traded securities of a subsidiary of companies that are part of a controlled group in which a publicly traded company is a member will be subject to this rule.
6. See Treas. Reg. § 1.417(e)-1(d)(9)(ii).
7. For years after 2005, the high three years need not be years in which the employee was both a participant and employee. Depending on circumstances, this may decrease or increase the limits for certain terminated employees.