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EGTRRA Changes Made Permanent

INTRODUCTION

This article highlights the impact of certain provisions of the Pension Protection Act of 2006 on defined contribution plans. Many of the changes will encourage broader use of defined contributions plans and provide greater opportunities for employees to save for retirement.

EGTRRA CHANGES MADE PERMANENT

Certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were scheduled to expire or "sunset" on December 31, 2010. Defined contribution plans should note that the Pension Protection Act ("PPA") extended many provisions of EGTRRA including the following provisions.

- The maximum permissible annual contribution on behalf of a participant is \$40,000 indexed for inflation (\$45,000 in 2007).
- The maximum compensation that can be taken into account is \$200,000 indexed for inflation (\$225,000 in 2007).
- The maximum deferral amount to a 401(k), a 403(b), or a 457(b) plan is \$15,000 indexed for inflation (\$15,500 in 2007).
- Employees age 50 or older may continue to make catch-up contributions to 401(k), 403(b) and 457(b) plans. The dollar limit is \$5,000 in 2007. This amount may be adjusted for inflation in subsequent years.
- Individuals are not required to coordinate the maximum annual deferral amount for a section 457(b) plan with contributions to other plans.
- The limit on deductible contributions for employers is 25% of compensation and elective deferrals are not excluded from this calculation.
- The rules for eligible rollover distributions from retirement plans are expanded to allow direct rollovers to Roth IRAs and rollovers by nonspouse beneficiaries.
- 401(k) and 403(b) plans can accept Roth contributions by participants.

AUTOMATIC ENROLLMENT

The PPA includes modifications to ERISA and the Internal Revenue Code (the "Code") which should make automatic enrollment a more attractive design feature. These modifications include (1) the ERISA preemption of state laws that may directly or indirectly prohibit automatic enrollment provisions, (2) rules allowing automatic contributions to be withdrawn by participants within a limited period of time after they are first deducted, and (3) a safe harbor design that eliminates nondiscrimination testing. In addition, the safe harbors for default investment vehicles, which may be used to limit a fiduciary's liability for investment decisions when a participant does not direct the investment of his or her account, support the implementation of automatic enrollment.

The rules for preemption, protection for default investments, special withdrawal rights and the nondiscrimination test safe harbor all require advance notice to participants and a reasonable period within which an employee can opt out of automatic enrollment.

A. Preemption of State Laws to Enable Automatic Enrollment

Plans that automatically enroll participants reportedly increase the number and level of employee contributions. However, employers have been reluctant to implement automatic enrollment. In some states, including California, a deduction from an employee's paycheck without the employee's express written authorization may violate state labor laws. Before PPA, it was not entirely clear whether such state laws were preempted by ERISA for auto-enrollment plans.

The PPA clearly removes this barrier by amending ERISA to specifically preempt state laws which directly or indirectly restrict the use of an "automatic enrollment arrangement." This preemption is effective as of August 17, 2006.

An "automatic enrollment arrangement" is one in which (1) deferrals are deducted from pay unless the participant elects to receive cash in lieu of deferrals, (2) the deferral is a uniform percentage of compensation, (3) the deferrals are invested in qualified default investment alternatives in the absence of employee investment directions, and (4) participants receive comprehensive disclosures.

In order to take advantage of the ERISA preemption provision, employers must comply with the disclosure requirements. The disclosures must provide participants with advance notice of the automatic deduction, the right to opt out before the first automatic deduction is made, the right to direct the investment of withheld amounts, and information about how funds will be invested if the participant does not provide investment directions. The importance of the participant notice requirement is underscored by the potential \$1,000 per day penalty under ERISA for each failure to satisfy the notice requirement.

Governmental plans, which are not governed by ERISA, cannot assert ERISA preemption of state laws that restrict automatic enrollment.

B. Permissive Withdrawals of Automatic Contributions

For plan years beginning on or after January 1, 2008, a 401(k), a 403(b) and a governmental 457(b) plan may allow an employee to make immediate "permissible withdrawals" of erroneous contributions from an "eligible automatic contribution arrangement." The definition of "eligible automatic contribution arrangement" under the Code tracks the definition of "automatic enrollment arrangement," the term used and discussed above in the ERISA preemption context. The withdrawn amount and the earnings thereon will be includible in compensation in the year of the distribution. The 10% early withdrawal penalty tax will not apply to such withdrawals.

The election to withdraw contributions and earnings must be made within 90 days of the first automatic contribution for the employee under the automatic contribution provisions of the plan. Any matching contributions with respect to the automatic contribution are forfeited.

The availability of permissive withdrawals is dependent, in part, upon notice to eligible employees. The notice, which must be given before the beginning of each plan year, must explain the employee's right to opt-out of automatic enrollment or to change the deferral percentage and how contributions will be invested if the participant does not provide investment directions. In addition, the notice must give the employee a reasonable period of time to make contribution and investment decisions before the first automatic deduction.

C. A Safe Harbor Design Avoids Nondiscrimination Testing

Some employers may be encouraged to adopt automatic enrollment by the availability of a safe harbor design which frees certain plans from nondiscrimination testing beginning with the first plan year on or after January 1, 2008. Plans that contain the requisite features including, but not limited to, minimum deferral and matching contributions, will satisfy a nondiscrimination safe harbor and the top-heavy rules. Automatic employee deferrals must be at least 3% of pay or more during the first plan year of automatic enrollment, with annual increases of 1% for each plan year thereafter until the contribution reaches at least 6% of pay (with automatic deferrals capped at 10% of pay). Automatic matching contributions for non-highly compensated employees must be at least 100% of deferrals up to 1% of compensation plus 50% of deferrals from 1%-6% of compensation (or the employer can contribute 3% of compensation for all eligible employees regardless of deferrals by such participants.) Employer contributions must be 100% vested after two years.

A plan must satisfy notice requirements, substantially similar to the notice requirement for permissive withdrawals and ERISA preemption, to qualify as a safe harbor plan for nondiscrimination purposes.

Plan sponsors may adopt automatic enrollment without the safe harbor contributions and continue testing under the 401(k) nondiscrimination tests. Plans that fail the nondiscrimination tests will have six months after the end of the plan year to distribute excess contributions and earnings if made from "eligible automatic contribution arrangements" as described above.

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

A. PPA and DOL's Proposed Regulations

Many plans which provide for individually directed investments currently use money market or similar funds designed to preserve capital as their default investment when the participant does not provide investment instructions. However, plan fiduciaries have not been relieved of fiduciary responsibility in these situations until the participant subsequently directs the investment of his or her funds.

The PPA amended ERISA section 404(c) to provide that effective January 1, 2007, the participant will be treated as having exercised control over the funds if the funds are invested in default investments in accordance with regulations issued by the Department of Labor ("DOL"). The DOL promptly issued Proposed Regulations outlining three classifications of investment that may qualify as a "Qualified Default Investment Alternatives" and serve as a safe-harbor; thereby limiting fiduciary liability for the default investment. The Qualified Default Investment Alternatives are:

1. "Life-cycle" or "targeted-retirement-date funds" which are based on the individual participant's age, target retirement date (e.g., normal retirement age under the plan) or life expectancy.
2. "Balanced Funds" which are designed to provide long-term appreciation and capital preservation with a target level of risk appropriate for the participants of the plan as a whole. Under this approach, the fiduciary takes into account the plan's demographics and other factors which would be considered in managing an individual account plan that does not allow for participant direction.
3. "Managed Accounts" under which an investment management service allocates the assets of each individual's account amongst the other investment alternatives offered by the Plan, taking into account the participant's age, target retirement date or life expectancy. The allocations will become more focused on capital preservation with increasing age.

Nothing in the PPA or the Proposed Regulations relieves plan fiduciaries from their obligations to prudently select and monitor the Qualified Default Investment Alternative and the investment managers for those funds. The Proposed Regulations are consistent with prior DOL guidance requiring plan fiduciaries to consider fees and expenses of investment alternatives in the selection and monitoring process.

The usage of Qualified Default Investment Alternatives is not limited to the automatic enrollment feature of a plan, but also applies if default investments are used under other circumstances.

Plan amendments may be required to implement the Qualified Default Investment Alternatives.

B. Required Notice to Participants

Regular and timely notice to participants is a key condition which must be met in order to secure the fiduciary relief associated with the Qualified Default Investment Alternative. A participant or beneficiary must receive a notice at least 30 days in advance of the first directed investment and at least 30 days before the first day of each subsequent plan year. The notice must address the following:

- a description of when monies will be directed into the default investment alternative;
- a description of the default investment alternative, including its investment objectives, and its risk and return characteristics;
- a description of the participant's right to re-invest the monies in any other investment alternative under the plan without financial penalty; and
- an explanation of where and how participants can obtain information about their other investment alternatives under the plan.

Important Caveat for Governmental Plans: The relief from fiduciary liability for investment of funds, discussed above, applies only to ERISA plans—not to governmental plans.

OTHER PROVISIONS APPLICABLE TO DEFINED CONTRIBUTION PLANS

REQUIRED BENEFIT STATEMENTS

The PPA recognizes the continuing shift to participant invested defined contribution accounts and establishes additional requirements for the issuance of benefit statements to participants in defined contribution plans.

Effective for plan years beginning in 2007, the benefit statement must be provided at least once each calendar quarter to each participant or beneficiary who has the right to direct the investment of his or her plan assets. If the participant or beneficiary does not have the right to direct the investment of his or her plan assets, the benefit statement must be delivered at least once per year.

The benefit statement must address:

- the total benefits accrued;
- the vested percentage of the accrued benefit or the earliest date on which benefits will become vested;
- the value of each investment account;
- the value of assets held in company stock or employer securities;
- an explanation of any restrictions on the participant's right to direct the investment of their account;
- an explanation of the importance of a well-balanced and diversified investment portfolio;
- a statement that holding more than 20% of assets in the securities of one entity, such as the employer, may not be adequate diversification; and

- directions to the DOL website for information on investing and diversification.

The Department of Labor has been directed to develop a model benefit statement by August 16, 2007. For non-collectively bargained plans, these rules are effective for the plan year beginning on or after January 1, 2007. Plans maintained pursuant to collective bargaining agreements have a delayed effective date. Calendar year plans may have to prepare a benefit statement for distribution in the first and second quarters of 2007 without the benefit of the DOL model.

MINIMUM VESTING SCHEDULE

The minimum required vesting schedule for employer contributions to a defined contribution plan, e.g. profit sharing contributions, is changed from a 5-year cliff or 7-year graded vesting schedule to a 3-year cliff or 6-year graded vesting schedule. The vesting schedule for employer contributions is now aligned with the minimum vesting schedules for matching contributions.

EXPANDED AVAILABILITY OF HARDSHIP DISTRIBUTIONS

Currently hardship distributions are available to meet the immediate financial needs of the participant, the participant's spouse or the participant's dependent. The Act expands this group of individuals significantly by allowing plans to make hardship distributions available to meet the immediate financial needs of the participant's designated beneficiary under the plan in addition to the participant, the participant's spouse or the participant's dependent.

The most common examples of individuals whom this provision might benefit are domestic partners, grandparents and grandchildren. The control of the designated beneficiary rests with the participant. However, in some circumstances, participants may be inclined to name a beneficiary solely to access the hardship distribution for that individual when the need arises. In the unfortunate event of the participant's death, that individual will be the beneficiary or one of the beneficiaries of the participant's account. Therefore, it will be even more important for participants to periodically review and update their beneficiary designations.

This provision is effective August 17, 2006. The IRS was directed to issue regulations interpreting this provision on or before mid-February, 2007, so most plan sponsors will delay implementation of expanded hardship distributions until after guidance is issued.

OTHER DISTRIBUTION PROVISIONS

Distributions During Working Retirement

The Act specifically allows money purchase plans, as well as defined benefit plans, to make in-service distributions to employees who are age 62 or older. This option is available for distributions in the first plan year beginning on or after January 1, 2007.

Active Duty Reservists

In an effort to relieve some of the financial hardship faced by families when active duty reservists are called-up for long tours of duty, the Act allows those participants to take withdrawals from their defined contribution plans, including a 401(k) plan or 403(b) plan, without incurring a 10-percent early withdrawal penalty. In

addition, reservists who take such distributions have some opportunity to recover financially by repaying the distribution within two years from the date their active duty period ends.

These "qualified reservist distributions" are available only if:

- the individual is called to active duty in excess of 179 days or for an indefinite period;
- the withdrawal is made between the date of the military orders and the end of the active duty period; and
- the individual is called to active duty after September 11, 2001 and before December 31, 2007.

Eligible reservists who took a distribution and who were subjected to the 10% penalty may file a claim for a refund or credit of such amounts.

Qualified Joint and Survivor Annuity

Money purchase plans must make benefits available in the form of a qualified joint and survivor annuity ("QJSA"), unless the participant and his or her spouse consent to another form of benefit payment. The Act requires plans to provide for payment in the form of a "qualified optional survivor annuity." If the survivor annuity provided by the QJSA is 50%, the survivor annuity under the qualified optional survivor annuity must be 75%. If the plan's mandatory QJSA is 75%, the qualified optional survivor annuities must include one at 50%.

Expanded Rollovers of Distributions to Roth IRAs

Currently, participants can roll money from a qualified plan, a tax-sheltered annuity, or a 457(b) plan into a traditional IRA. The individual may then pursue the rollover of the monies from the traditional IRA into a Roth IRA. However, the ability to convert to a Roth IRA is limited by the adjusted gross income caps on such conversions. For married individuals filing jointly, a rollover cannot be made to a Roth IRA if the couple's adjusted gross income exceeds \$100,000. However, on January 1, 2010, that adjusted gross income cap is being eliminated.

The PPA permits direct rollovers from a qualified plan, a 403(b) plan or a governmental 457(b) plan into Roth IRAs after December 31, 2007. However, those rollovers will be subject to the limitations that apply to rollovers from traditional to Roth IRAs until January 1, 2010. For example, a married individual cannot rollover the distribution into a Roth IRA if the couple's adjusted gross income exceeds \$100,000. On or after January 1, 2020, no adjusted gross income limitation will apply.

If the monies are directed into a Roth IRA, the distribution is taxable income to the participant and any 10% penalty tax for early withdrawal will not apply.

Rollovers By Nonspouse Beneficiaries

Currently, the spouse of a deceased beneficiary may roll over the plan distribution to an IRA. In that case, minimum distributions generally do not have to begin until the date the deceased participant would have attained age 70 ½.

Effective as of January 1, 2007, the Act allows a nonspouse beneficiary to roll over the distribution from an eligible retirement plan, including a 403(b) and 457(b) plan, to an IRA via a direct trustee-to-trustee transfer. However, the special rules which would not require minimum distributions to begin until the date the deceased participant would have attained age 70 ½ do not apply. Instead, where distributions have not begun as of the date of the participant's death, the monies rolled over to the transferee IRA must be

distributed to the nonspouse beneficiary within five years after the participant's death or distribution must begin within one year after the participant's death and be paid out over the beneficiary's life expectancy.

Rollover of After Tax Accounts

Currently, after-tax contributions can be rolled over to another a defined contribution plan which separately accounts for pre-tax and after-tax contributions or to an IRA. Defined benefit plans and 403(b) plans may not accept rollovers of after-tax contributions from qualified retirement plans.

Effective January 1, 2007, defined benefit plans and 403(b) plans will be able to accept a trustee-to-trustee rollover of after-tax contributions so long as they separately account for those contributions and the earnings on those contributions.

Selection of Annuity Providers

The DOL has been directed to develop and issue final regulations on the selection of annuity providers for plan distributions. The regulations must be issued on or before August 16, 2007. The Act clarifies that the plan fiduciary is (1) not required to select the safest possible annuity and (2) that the plan fiduciary must select the most prudent option with respect to its plan and its plan participants and beneficiaries.

Investments In Employer Securities

The Enron debacle, as well as failures of other publicly traded companies, focused attention on the risks to plan participants when substantial portions of plan assets are invested in employer securities. The PPA introduces new diversification requirements for defined contribution plans. The plan must provide three diversified investment options in addition to employer securities or employer real property.

Any participant must be allowed to move assets attributable to elective deferrals or employee contributions (e.g., after-tax employee contributions) out of employer securities and into other investment options at least once each calendar quarter. This requirement is effective for plan years beginning on or after January 1, 2007.

Where the employer securities are attributable to employer contributions (e.g., matching contributions), a participant who has at least three years of service must be allowed to diversify his or her account by divesting employer securities. For employer securities acquired in a plan year beginning before January 1, 2007, a three-year phase in applies. For pre-2007 employer contributions of employer securities, a participant with three years of service may elect to divest up to 33 percent in the first plan year, up to 66 percent in the second plan year, and 100 percent in subsequent plan years. A participant with three years of service may divest 100% of contributions of employer securities made after December 31, 2006.

The plan administrator must notify each participant and beneficiary of their right to divest their accounts of employer securities and invest in alternatives. This notice must be given no later than 30 days before the first day on which the individual is eligible to divest employer securities. The DOL has been instructed to develop a model notice on or before February 17, 2007. However, action may need to be taken before January 1, 2007, if your defined contribution plan holds employer securities.

Investment Advice

The PPA contains detailed requirements to permit "fiduciary advisors" to provide investment advice to participants and beneficiaries of participant-directed account plans and receive compensation for such advice within the parameters set forth in PPA. Under the permitted arrangements, fees cannot vary depending upon the investment option selected by the participant. In the alternative, the advice must be

based on a computer model that meets certain requirements and is certified by an outside expert. Plan fiduciaries will have a fiduciary responsibility for the selection and monitoring of advice providers, but they will not be obligated to monitor the specific advice that is given to an individual participant or beneficiary.

Blackout Periods

Plan fiduciaries may be exposed to fiduciary liability during periods in which the participant does not have control over the investment of funds. The PPA provides that plan fiduciaries may limit their exposure during blackout periods when a "qualified change in investment options" occurs. The DOL is to issue interim final regulations on these rules by August 17, 2007.