DAVIS MALM & D'AGOSTINE P.C.
ATTORNEYS AT LAW

THE PENSION PROTECTION ACT OF 2006

BY: GEORGE L. CHIMENTO
AUGUST 17, 2006

THE NEW PENSION LAW

The Pension Protection Act of 2006 ("PPA"), signed on August 17, 2006, is headlined as a reform of the defined benefit system. However, nearly one-half of PPA's 991 pages deals with defined contribution plans, fiduciary concerns, and odds and ends related to IRA's and deferred compensation arrangements. This article addresses the matters which will be relevant for our clients who do not sponsor defined benefit plans. PPA requirements for our single employer and multiemployer defined benefit clients will be addressed separately.

1. Faster vesting for defined contribution plans (applies to contributions for plan years which start after 2006).

Employer contributions to defined contribution plans must vest more quickly. One permitted PPA schedule is three year cliff, meaning 100% vesting after three years of service. PPA also permits a six year graded schedule, with 20% vesting after two years and increasing at 20% increments, with 100% vesting after six years. Service prior to PPA's effective date must be counted.

This continues the trend of EGTRRA, which required these faster schedules for matching contributions in plan years starting after 2001. The new minimum vesting schedules in PPA are also similar to the schedules which have been required for years for "top-heavy" plans (i.e. plans where 60% or more of the benefits are accumulated by key employees).

A plan with a slower vesting schedule permitted by prior law, such as 100% five year cliff or 20% graded vesting between three and seven years, may still apply it to accounts related to plan years starting prior to January 1, 2007. However, many plans will probably opt to use the new rules for all contributions, rather than having one set of rules for 2006 and earlier years, and another set for 2007 and later years.

> **Example**: *Plan has a June 30 fiscal year. Contributions for the year ending June 30, 2007 will be made in September, 2007. The account based on these contributions may still be administered under the plan's prior law vesting schedule. Accounts for the Plan years starting on and after July 1, 2007 must be administered under a PPA schedule.*

The new vesting rules do not apply to most defined benefit plans. ESOP's with outstanding loans as of September 26, 2005 may delay the effective date until the plan year starting after the earlier of the ESOP loan's maturity date or repayment date. Collectively bargained defined contribution plans need not comply until the plan year starting after the earlier of the conclusion of the current bargaining cycle or December 31, 2008.

We advise an amendment and employee communication as soon as possible to simplify plan administration. However, as described later in Section 21 of this memorandum, PPA permits a much later date for plan amendments.

2. Hardship distributions based on beneficiary's needs (permitted after regulations, which Treasury is required to issue by February 16, 2007).

Current rules for 401(k), 403(b), 457(b) and 409A non-qualified plans only permit hardship distributions based on the circumstances of a participant, or the spouse or tax-dependents of the participant. PPA provides that a covered plan may be amended to take into account the circumstances of any person named as a beneficiary, even if he or she is not a spouse or tax-dependent.

This broader rule will facilitate distributions with respect to relatives who are not tax-dependents, and lifetime "partners" regardless of sex. The regulations will clarify whether the person must be named as a 100% beneficiary, and whether a prompt change of beneficiary before or after the distribution will disqualify it.

3. Reservists will not be penalized for early withdrawals (for individuals ordered or called to duty after September 11, 2001 and prior to December 31, 2007).

Payments before age 59½ from an IRA, qualified plan, or 403(b) contract are generally subject to a 10% early withdrawal penalty. The new law exempts reservists who have been called into active duty for an indefinite period, or for at least 180 days. A reservist who has already paid the 10% penalty should file an amended return within three years. August 17, 2007 is a special extension date for returns filed more than three years ago.

Note that the special treatment only applies to amounts which the reservist has deferred (i.e. 401(k) deferrals, 403(b) savings, and IRA's), and not to additional employer contributions.

Within two years of the end of active duty, the reservist may restore to an IRA some or all of the withdrawn amounts (from all sources, not just from the IRA) on a non-deductible basis.

4. In-service withdrawals after reaching age 62 now allowed from pension plans (distributions after 2006).

Under current law, in-service withdrawals on reaching age 59½ are permitted from 401(k) plans and traditional profit sharing plans. However, plans with fixed contributions, such as defined benefit and money purchase plans, may not pay benefits until actual retirement.

The new law permits in-service payments on or after age 62 from fixed contribution pension plans. Note that this is a permissive feature, and not a required part of plan design.

5. Quarterly benefit statements for self-directed plans/annual statements for other defined contribution plans (plan years starting after 2006).

Prior to PPA, benefit statements were only required if a participant requested them. PPA now mandates what has been an industry practice. Without request, plans which permit self-directed investments must supply quarterly statements; other defined contribution plans must supply annual statements. The Department of Labor is required to supply model notices by February 16, 2007.

Subject to DOL rules, notices may be distributed through E-Mail and company websites. The penalty for failing to provide these notices can be $110 / day per form, which is a clear message to small employers to hire competent third party administrators, or to discontinue sponsorship of retirement plans.

6. Waiver forms may be distributed up to 180 days in advance (plan years after 2006).

Payments over $5,000, and payments which require waivers of annuities, require signed waivers. The waiver forms may now be distributed up to 180 days before the proposed payment date. The prior law limit was 90 days.

7. Participant distribution notices must be revised (plan years after 2006).

We doubt many participants read the current, lengthy tax distribution notices before signing payment election forms. Congress wants more. Distribution notices will now have to contain more caveats about the evils of electing taxable cash distributions. The new notices will not be required until 90 days after IRS publishes its PPA guidance.

8. Easier 5500 reporting requirements and "blackout" reporting requirements for small plans (plan years after 2006).

Plans with 24 or fewer participants will get a less complicated Form 5500 to complete, provided that the employer is not part of a controlled group or affiliated group and does not use leased employees.

"One person" plans with less than $250,000 in assets will be exempted from all reporting, provided the employer is not part of a controlled group or affiliated group and does not use leased employees. "One person" actually means a plan that covers only an owner and spouse of a C corporation or proprietorship, or only partners and spouses of a partnership, or only 2% shareholders and spouses of an S-Corporation.

One person plans are also exempt from the "blackout" notice procedures when participant-directed account plans switch funding vendors. This "blackout" rule is effective retroactively to January 27, 2003

9. Rollovers allowed for non-spouse beneficiaries (distributions starting in 2007).

Until PPA, only spouses were allowed to roll over distributions from qualified plans to IRA's. This was a tax planning nightmare for non-spouse beneficiaries. Plan rules, geared to administrative efficiency, often do not allow beneficiaries an extended period to receive

payments. Non-spouse beneficiaries often were forced to receive taxable death benefits at a faster rate than desired.

Starting in 2007, non-spouse beneficiaries (including trusts) will be allowed to have IRA's for distributions from qualified plans, 403(b) plans, and governmental 457 arrangements. Distributions must be by means of direct rollover to the IRA, rather than a payment followed by a 60 day traditional rollover. Distributions may not be made to any type of qualified vehicle except a rollover IRA. The minimum distribution rules under 401(a)(9) of the Code would continue to apply after the transfer.

> **Example:** *Jack dies in 2006 and a trust for his three children, ages 12, 15 and 20, is his beneficiary. Jack's trustee may direct that the benefit be transferred in 2007 to an IRA in the trust's name. Payments may then be made from the trust over a period permitted by IRS minimum distribution rules. In this example, that would mean payments could be stretched over the life expectancy of the oldest child named in the trust. The trustee, subject to the terms of the trust, would have the ability to accelerate payments from the IRA.*

Note: Now that IRA's are available for all beneficiaries, plan sponsors may wish to eliminate installment payment options for death benefits.

10. EGTRRA changes made permanent.

All of the EGTRRA reforms, which permitted higher retirement savings benefits as of 2002, were scheduled to sunset in 2010. They have now been made "permanent," at least for this Congress. Some of the popular provisions are: catch-up deferrals for persons age 50 or more, increases to pension and IRA contribution and benefit limits, $500 small business credit for start-up of new retirement plans, optional addition of ROTH features to 401(k) plans, permission for Sub-S and unincorporated business owners to borrow from their qualified plan accounts, and expanded rollover choices. Section 529 plans are also given a permanent existence.

11. IRA distributions may be contributed directly to charities without tax (2006 and 2007 only).

PPA gives a tax break to older individuals who are charitably inclined. A taxable transfer to an "eligible charity" from a traditional or ROTH IRA will be excluded from income, up to a maximum of $100,000 in each year. The IRA owner must be at least age 70½, and the distribution must be a direct transfer which is not first paid to the IRA owner. Transfers from SEP IRA's and SIMPLE IRA's are not eligible.

The maximum permitted for an individual is $100,000 per year, without regard to the 50% of adjusted gross income limit which usually applies to charitable donations. Because the transfer is an income exclusion, rather than a deduction, it is helpful to those who do not itemize, and those whose tax deductions are being phased out because of high income. Unused portions of the $100,000 may not be carried forward from one year to the next. The non-taxable charitable transfer will be credited towards the IRA required minimum distribution requirement.

A charity is "eligible" only if it is the type of charity for which taxpayers can deduct contributions up to 50% of adjusted gross income (i.e. churches, tax-exempt schools, hospitals,

medical research organizations, 501(c)(3) charities, and some governmental units). Donations to donor-advised funds and private foundations, even if of a type eligible for the 50% of adjusted gross income deduction, are not eligible. There cannot be any benefit to the donor, such as use of a beach or facilities, or the entire transfer will be taxable.

If some of the IRA is attributable to "after-tax" contributions to a traditional IRA, there is good news. The transfer will first be considered a transfer of taxable amounts.

> **Example**: *A $100,000 IRA has a $40,000 after-tax basis. Joe directs that $60,000 be transferred to an eligible charity. The remaining $40,000 in the IRA will be considered as "after-tax" funds. Without this special rule, the $60,000 charitable transfer would have dragged out 60% of the after-tax basis in the IRA.*

Generally, it will not make sense to transfer from a ROTH IRA because it is a non-taxable account.

Finally, because this is an exclusion from gross income, rather than a tax deduction, it saves taxes in Massachusetts. A charitable donation is not deductible in Massachusetts, but because the charitable transfer is an exclusion from federal income, it will be excluded from Massachusetts income.

12. Huge increase in penalties for interfering with rights under an ERISA plan (effective for bad acts after August 16, 2006).

Use of fraud, force, or violence to interfere with ERISA rights is now punishable by a fine of up to $100,000 and/or ten years imprisonment. Enough said.

13. Defined contribution plan annuities do not have to be the "safest" possible annuities (effective August 17, 2006).

The Department of Labor standard for annuity purchases has been troublesome since it was first announced in 1995. Is only one insurance company permitted to issue annuities?

DOL is required to revise Regulation 2509.95-1 by August 16, 2007 to substitute the standard of "prudence." Note that the "safest" standard still apparently applies to defined benefit annuity purchases.

14. Default investment elections for individually directed plans (plan years starting after 2006).

ERISA 404(c) is the law that protects plan fiduciaries if participants lose money while self-directing their plan investments. There has been concern that ERISA 404(c) applies only if participants make direct selections, and that it cannot apply to default selections.

Unfortunately, "automatic enrollment" has created a new class of participants who sometimes just go along, and never really take action with respect to funds automatically deducted from their pay and contributed to default investments in their 401(k) plans. PPA provides ERISA 404(c) protection provided that participant-directed plans follow Department of Labor regulations on "default investment" procedures.

The default investment election provisions are effective immediately, and PPA requires DOL regulations within 180 days of enactment. ERISA 404(c) protection will not be available unless plans provide to participants an annual notice, prior to the start of each plan year, explaining that participants have the right to direct their investments, and describing the default investment which will be used if the participant takes no action.

The "default" investment may not be a simple money market fund or GIC, but must be a mix of assets. Because ERISA 404(c) only applies to fiduciary liability under ERISA, it does not apply to programs which are designed to be exempt from ERISA, such as 403(b) and 457(b) arrangements for which the employer has limited its role to wage withholding.

15. Fiduciary education (plan years starting after 2006).

Mutual funds, registered investment advisors, insurance companies, brokers, and banks often have multiple roles with retirement plans. They and their affiliates administer the plans, sell the investments, and provide literature and presentations to participants. All have been concerned that employee educational programs may cross the line and be deemed to be prohibited transactions. Employers have been concerned about liability if advisors provide the wrong advice.

PPA now permits the establishment of "eligible investment advice arrangements" ("EIAA's"). EIAA's must be authorized by a plan fiduciary that is unrelated to the vendor. The fee structure cannot vary based on the investment option selected. EIAA's will have to be independently audited each year for compliance with regulatory requirements. EIAA providers will have to retain records for audit purposes for at least six years.

The employer, or a fiduciary appointed by the employer, must select the EIAA advisor with prudence, and must periodically review the performance. Theoretically, there is no duty to review actual recommendations. In practice, there may be more liability to employers which authorize EIAA's than those who do not. We urge plan sponsors to be very careful before authorizing such arrangements.

16. Automatic enrollment plans and default investment elections (generally for plan years after 2007).

Automatic enrollment in 401(k) plans is considered by some to be a good way to increase participation by employees who would not normally save for retirement. PPA removes some of the legal obstacles. For most clients, we continue to believe that automatic enrollment is not a good idea, because of the extra costs and compliance burdens.

Note that most of these new rules will also apply to 403(b) plans and governmental 457(b) plans.

A. State minimum wage laws altered to facilitate automatic enrollment (effective August 17, 2006).

Automatic enrollment in 401(k) programs was an arguable violation of some state laws which prohibit reductions from pay without express employee consent. PPA overrides these state laws, provided that the automatic enrollment program and its default election procedures is administered according to PPA procedures, including annual

notice and default investment requirements that will be set out in Department of Labor regulations. PPA says no implication is to be drawn with respect to automatic enrollments prior to August 17, 2006.

B. Alternate Safe harbor design (plan years starting after 2007).

A safe harbor design makes it unnecessary to pass the special discrimination tests for 401(k) deferrals and matching contributions. The present law considers a matching contribution feature to be a safe harbor if the match is fully vested at all times and has the same in-service withdrawal restrictions as 401(k) deferrals. The match must be at least 100% of the first 3% of savings and 50% of the next 2% of savings (i.e. a total maximum match of 4% on the first 5% of 401(k) savings). A 3% across the board contribution, without regard to 401(k) deferrals, is also a safe harbor design.

Automatic enrollment plans may choose a less expensive safe harbor, with additional savings because immediate vesting will not be required. Employees do not have to vest until they have two years of service, and the total maximum match is 3½%, not 4%, calculated this way: 100% match on the first 1% of savings and 50% match on the next 4% of savings.

To qualify, the plan must provide for automatic enrollment of 3% of a participant's first year of compensation, and then increase the automatic enrollment percentage in following years to 4%, 5% and 6%, subject to the participant's right to decline or reduce the deferral rate. Annual notices according to regulations will be required also.

C. 90 day withdrawals after automatic enrollment (plan years starting after 2007).

This is optional for certain plans which require automatic enrollment for voluntary deferrals, meaning 401(k), 403(b), and governmental 457(b) plans. A plan may permit participants to withdraw their automatic withdrawals, but only if: (i) the withdrawal is elected within 90 days of the first automatic withholding, (ii) the election is for all of the withheld amounts, (iii) the withdrawal is included in income (no penalties) in the year of the withdrawal (not the payment), (iv) the plan provides an annual notice describing automatic withholding, withdrawal rights, and default investment procedures, (v) and the plan is amended to permit these withdrawals.

D. Expanded correction period for automatic enrollment plans (plan years starting after 2007).

Automatic enrollment plans which do not have a "safe harbor" design must still pass the ADP and ACP discrimination tests. Automatic enrollment plans get a small edge if correction is necessary. Under the general rules, a plan which fails its ADP or ACP test has a choice as to when to distribute the refund. If the refund occurs after a "designated period" the employer must pay a 10% excise tax on the refund. For refunds attributable to plan years starting after 2007, the designated period for an automatic enrollment plan is expanded to 6 months following the end of a plan year. For other plans, the refund period remains 2½ months.

See Section 22 for other relief for failed testing of 401(k) and 401(m) plans.

17. Fiduciary protection when changing vendors for self directed plans (plan years starting after 2007).

A. Blackout periods.

DOL is instructed to draft regulations dealing with "blackout periods", i.e. the period when participant investment choices are frozen during the change to a new vendor for plan investments. ERISA 404(c) protection for plan fiduciaries will only be available to plans which follow the regulations.

B. Investment mapping.

The DOL regulations will also address the "mapping" process which occurs during the transfer of a plan to new investment vendors. ERISA 404(c) protection will be available, even though the new vendor's "mapped" funds may be a bit different from the funds available from the prior vendor.

18. Increase in bonding requirements if plan holds employer securities (plan years starting after 2007).

The bond limit for fiduciaries must be at least 10% of assets handled, up to a maximum of $500,000. The maximum is increased to $1,000,000 if the Plan's assets include employer securities.

19. Joint and survivor annuity requirements (plan years starting after 2007).

Some defined contribution plans are required to provide joint and survivor annuities, either because of plan design or the type of plan (i.e. money purchase and target benefit plans). These plans will not be allowed to offer only one form of joint and survivor annuity. For plans where the normal form is joint and 50-74% survivor, a form of 75% survivor must be offered as an alternate. Similarly, if the normal form is joint and 75-100% survivor, a form of 50% survivor must be offered as an alternate. These alternate forms do not have to be subsidized.

20. ROTH IRA matters.

Persons considering conversion of qualified plan benefits to ROTH IRA's can do this in just one step starting in 2008. It will no longer be necessary to transfer plan money to a traditional IRA and then to convert it to a ROTH IRA. Direct transfer to a ROTH IRA will be allowed, subject to the requirement that "modified adjusted gross income" may not be more than $100,000.

And, starting in 2010, this type of one-step transaction, or a standard conversion of a traditional IRA to a ROTH IRA, will be allowed for persons with more than $100,000 of "modified adjusted gross income."

Finally, as noted in Section 10, PPA made permanent the EGTRAA change which allows 401(k) plans to include a ROTH feature.

21. The time to amend a plan.

Any amendments required or permitted by PPA will be deemed timely if the plan is amended before the end of the plan year starting in 2009, but only if the plan is administered according to the new law on a timely basis. There is an additional two years to amend government plans.

This late amendment procedure will create a lot of confusion. What does it mean to administer a plan in compliance with a new law? Is a contemporaneous employee notice required?

Is it prudent to wait until 2009 to make a plan amendment? At the very least, employers should provide timely employee notifications of the new rules which they are choosing for the plan. Arguably, a plan which does not provide timely notices of important changes is not being administered according to the new law, and could be vulnerable to suit of a participant or beneficiary who is unaware of an important retroactive change.

22. General relief for failed 401(k) and 401(m) testing (plan years after 2007)

If ADP or ACP testing is failed, there's good news about the refund procedure. Participants will now always be taxed in the year when they receive the refund. In addition, the refund will not have to be grossed up by "gap period" income from the end of the year to the date of the refund. As under prior law, refunds must occur within 12 months of the end of the failed plan year to preserve qualification. The employer remains responsible for a 10% excise tax if the refund occurs after a permitted period, which is generally 2½ months after the end of the failed plan year, with a new 6 month rule if there is a properly administered automatic enrollment feature. See Section 16(d) above.

23. Conclusion.

To keep this to a manageable length, we have omitted some very important PPA provisions. In particular, single employer and multiemployer defined benefit clients should be in touch with us directly for custom guidance.

PPA also is of great importance to the investment community. This article does not address the provisions which make it easier for plans to engage in sophisticated business, such as investment in non-public entities, and block trade and foreign currency exchange transactions.

We encourage all clients to discuss PPA with us in detail so that we may develop an appropriate action plan.

This article reflects the opinions of the author, George L. Chimento, and does not necessarily reflect the opinion of Davis, Malm & D'Agostine, P.C. It is provided as a courtesy by Mr. Chimento and may not be relied upon as legal advice, or to avoid taxes and penalties. Distribution to promote, market, or recommend any arrangement or investment to avoid or evade taxes, including penalties, is expressly forbidden. Any communication with the author as to its contents, does not, of itself, create a lawyer-client relationship. Under the ethical rules applicable to lawyers in some jurisdictions, this may be considered advertising.

One Boston Place, Boston, Massachusetts 02108 | phone 617.367.2500 | fax 617.523.6215 | info@davismalm.com.
© 2002-2010 Davis, Malm & D'Agostine, P.C. All Rights Reserved. Attorney Advertising: Prior results do not guarantee a similar outcome. Please read our Disclaimer.