

UPDATE**PENSION PROTECTION ACT OF 2006
EFFECT ON DEFINED CONTRIBUTION PLANS
(INCLUDING 401(K) PLANS)**

September 2006

INTRODUCTION

This memorandum summarizes various provisions of the recently enacted Pension Protection Act of 2006 (the "Act") which affect defined contribution qualified retirement plans (including 401(k) plans). The following is intended to highlight those provisions with the greatest potential impact; other provisions of the Act may affect the administration of your plan(s). Generally speaking, plan amendments to reflect the changes made by the Act must be made on or before the last day of the first plan year beginning on or after January 1, 2009. Furthermore, subsequent guidance from the Internal Revenue Service and the Department of Labor will inform the manner in which these provisions must be implemented. However, many of the provisions described below are effective for plan years beginning on or after January 1, 2007. As a result, plan administrators should begin to familiarize themselves with the Act's requirements so that they can properly administer their plans in a timely fashion. If you would like further information or assistance, please feel free to call Jonathan McKeon, a partner of the firm specializing in Employee Benefits/Executive Compensation matters, at (212) 326-0245 (or call your contact at the firm who will put you in touch with Mr. McKeon).

NEW REQUIRED VESTING SCHEDULES FOR EMPLOYER NONELECTIVE CONTRIBUTIONS

Employer "nonelective" contributions (*e.g.*, profit sharing and money purchase plan contributions) made for plan years commencing on or after January 1, 2007 (and the earnings thereon) must either vest (i) commencing no later than after two (2) years of service at a rate of at least twenty percent (20%) per year or (ii) on a three (3) year "cliff vesting" schedule (*i.e.*, one hundred percent (100%) after three (3) years of service or less). The new faster vesting schedule requirements are the same requirements that currently apply to matching contributions. Plan sponsors can retain the currently applicable vesting schedule with respect to employer nonelective contributions made for plan years commencing prior to January 1, 2007 (and the earnings thereon). Plan sponsors who need to implement a new required vesting schedule should consider whether they wish to retain the old vesting schedule with respect to such grandfathered contributions, or to apply one of the new faster vesting schedules to all employer nonelective contributions held under the plan. A delayed effective date applies for certain ESOPs and to collectively bargained plans.

PLAN DISTRIBUTIONS

- **Nonspouse Beneficiary Rollovers:** Effective for distributions made after December 31, 2006, nonspouse beneficiaries may roll over death benefit distributions received from qualified plans, 403(b) arrangements or governmental Section 457 plans to a traditional IRA.
- **Rollovers of After-Tax Amounts:** Effective for distributions made after December 31, 2006, participants may directly roll over after-tax contributions to qualified plans or 403(b) arrangements.

- Direct Rollovers to Roth IRAs: Effective for distributions made after December 31, 2007, distributions from qualified plans, 403(b) arrangements and governmental 457 plans may be directly rolled over to a Roth IRA, subject to the Roth IRA conversion rules.
- In-Service Withdrawals from Pension Plans: Effective for plan years beginning on or after January 1, 2007, money purchase pension plans may permit active employees who have reached age sixty-two (62) to take distributions.
- Additional Qualified Joint and Survivor Annuity Option: Effective for plan years beginning on or after January 1, 2008, money purchase pension plans must offer both fifty percent (50%) QJSA and seventy-five percent (75%) QJSA forms of benefit. A delayed effective date applies to plans maintained pursuant to collective bargaining agreements.
- Distribution Notices: Effective for plan years beginning on or after January 1, 2007, the notice and consent time periods for distributions from qualified retirement plans (including cash outs) have been extended from no more than ninety (90) days to no more than one hundred eighty (180) days before the date distributions commence.
- Hardship Withdrawals: The Act directs the Treasury to issue rules that allow hardship withdrawals under a 401(k) plan for events that would constitute a hardship event with respect to any person who is a beneficiary under the 401(k) plan.
- Qualified Reservist Distributions: 401(k), 403(b) and 457 plan elective deferrals may be distributed to a participant who is performing qualifying reserve service during the individual's period of active duty if he or she is called to active duty after September 11, 2001 and before December 31, 2007 for a period exceeding one hundred seventy-nine (179) days. The ten percent (10%) early withdrawal penalty tax does not apply to these distributions, which may be recontributed to an IRA within two (2) years after the end of the active duty period.

AUTOMATIC ENROLLMENT UNDER ELECTIVE DEFERRAL PLANS

In recent years, plan sponsors have tried to encourage participation in their 401(k) and 403(b) plans by implementing "automatic enrollment" provisions, whereby a participant who does not make an initial elective deferral election is deemed to have elected to contribute a certain percentage of compensation to the 401(k) or 403(b) plan. Effective for plan years commencing on or after January 1, 2008, the Act attempts to make such automatic enrollment programs more attractive to plan sponsors by eliminating actual deferral percentage ("ADP") testing with respect to elective deferrals and "top-heavy" rule requirements for 401(k) and 403(b) plans that include automatic enrollment programs that meet certain requirements.

The default automatic enrollment deferral percentage amount is capped at ten percent (10%), but cannot be less than three percent (3%) in the first year of participation, with the minimum rate increasing by one percent (1%) each year thereafter until it reaches six percent (6%) for years four (4) and beyond. The plan sponsor must also satisfy either a nonelective or matching contribution requirement. The nonelective contribution requirement is met if at least three percent (3%) of compensation is contributed on behalf of each non-highly compensated employee who is eligible for the automatic enrollment feature. In the alternative, the plan sponsor can satisfy the employer contribution requirement by making a matching contribution on behalf of each non-highly compensated employee that is equal to one hundred percent (100%) of elective deferrals up to one percent (1%) of compensation and fifty percent (50%) of elective deferrals between one percent (1%) and six percent (6%), provided, further, that the rate of match with respect to elective deferrals for highly compensated employees is not greater than that for non-highly compensated employees. Participants must not be required to contribute more than six percent (6%) of

compensation in order to receive the full match, and any such nonelective contribution or matching contribution (and the earnings thereon) must be fully vested after two (2) years of service.

In order for a plan to be deemed to satisfy the actual contribution percentage (“ACP”) test with respect to matching contributions, the plan must satisfy certain additional rules, including a requirement that matching contributions may not be made with respect to elective deferrals in excess of six percent (6%) of compensation.

Finally, the plan sponsor must give each eligible employee: (i) notice of the employee’s right to elect not to participate in the 401(k) or 403(b) plan; (ii) notice of the right to change the individual’s elective deferral rate; and (iii) information on how contributions will be invested if the employee fails to make an investment election.

INVESTMENT INFORMATION AND ADVICE/ADDED PROTECTION UNDER SECTION 404(C)

- **Investment Education:** Effective for plan years beginning on or after January 1, 2007, plan administrators must annually provide participants who have the right to direct the investment of their account(s) with a model notice relating to basic investment practices.
- **Periodic Benefit Statements:** Effective for plan years beginning on or after January 1, 2007, plans must provide quarterly benefit statements to participants who have the right to direct the investment of their account(s). Otherwise, annual benefit statements must be provided.
- **Investment Advice:** Effective January 1, 2007, certain fiduciary advisers that were previously prohibited from providing investment advice to plan participants of plans with respect to which they have a conflict of interest may provide such investment advice (even if there is a potential conflict of interest), as long as fee disclosures are made up front and the advice is based on an independently certified computer model. The new law also authorizes certain flat fee arrangements for providing advice.
- **Default Investment Options/404(c) Protection:** Section 404(c) of ERISA protects plan fiduciaries from liability with respect to investment decisions where plan participants exercise control over the investment of their individual accounts. Questions have arisen as to what protection is available where a participant fails to make an investment election. Effective for plan years beginning on or after January 1, 2007, a participant will be treated as exercising control over his plan account(s) (and thus the plan fiduciary will be accorded a certain amount of protection) if the individual receives a notice explaining the participant’s investment rights and obligations, including the right to exercise control over investments, and how contributions will be invested if the employee fails to make an investment choice. Furthermore, the plan’s default investment option must comply with forthcoming Department of Labor regulations.
- **Replacement of Investment Options/“Blackout Periods”:** Effective for plan years beginning on or after January 1, 2008 (with a delayed effective date for collectively bargained plans), the Act makes ERISA Section 404(c) protection available when investment options under a participant-directed defined contribution plan are changed. In order to take advantage of this protection, the plan administrator must furnish a written notice to participants at least thirty (30) days but not more than sixty (60) days before the change in the investment options. The notice must include a comparison of the old and new investment options and explain how assets will be invested absent direction by the participant. Further, the characteristics of the new investment options chosen on the participant’s behalf must be reasonably similar to the investment options offered immediately before the change. Also, the investments chosen immediately before the change must have been the product of the exercise of the participant’s investment control.

DIVERSIFYING INVESTMENTS IN EMPLOYER STOCK

Effective for plan years beginning on or after January 1, 2007, plans that hold publicly-traded “employer securities” must permit participants to diversify such holdings. Immediate diversification is required for amounts attributable to elective deferrals and employee contributions. Diversification is required after three (3) years of service for amounts attributable to employer nonelective and matching contributions (provided that, except with respect to individuals aged fifty-five (55) or over with at least three (3) years of service, this requirement may be phased in over a three (3) year period).

The diversification requirements do not apply to an employee stock ownership plan (“ESOP”) if the ESOP (i) does not hold elective deferrals, after-tax contributions or matching contributions, or (ii) is a separate plan from any other qualified retirement plan of the employer.

A plan subject to the diversification requirements is required to provide a choice of at least three (3) diversified investment options (other than employer securities) with materially different risk and return characteristics.

A plan administrator must provide to participants (and beneficiaries, if applicable) notice regarding their right to diversify their employer securities holdings not later than thirty (30) days before the first date on which the individual is eligible to divest a particular type of contribution. A model notice will be provided by the IRS and the DOL. Failure to provide the required notice could result in a civil penalty against the plan administrator of up to \$100 per day, per violation.

BONDING

The Act modifies the existing rule concerning the maximum amount of the required ERISA bond by providing that, with respect to plans that hold employer securities, the maximum amount of the bond is increased from \$500,000 to \$1,000,000.

Please feel free to contact the following members of our Employee Benefits / Executive Compensation practice group if you have questions about this memorandum or wish to discuss any other related matters:

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