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Pension Protection Act Rules for Defined Contribution Plans

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On Thursday, August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The PPA addresses numerous funding issues for single and multiemployer plans, new disclosure rules, and interest rate assumptions, which we have covered in previous LawFlashes. This LawFlash addresses a few additional discrete areas including investment advice, defined contribution plan changes, pension portability, and diversification.

EGTRRA Limits Made Permanent

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially increased pension and individual retirement account (IRA) contribution limits through 2010, and made other improvements in pensions and retirement savings through enhanced vesting, portability, and reduced regulatory burdens. The PPA makes a number of these improvements permanent (i.e., they no longer expire in 2010), including:

- maximum amounts employees may contribute to tax-favored retirement plans and IRAs (including providing for "catch-up contributions" for those age 50 and older);
- the dollar limit on maximum allocations for an individual under a defined contribution plan (including employer, employee pre-tax, and employee after-tax contributions);
- the maximum annual benefit an individual may receive from a defined benefit plan;
- the maximum amount of compensation that may be considered by the plan in calculating benefits and satisfying various regulatory requirements; and
- the availability of Roth 401(k) accounts under 401(k) plans

Investment Advice

The PPA amends both ERISA and the Internal Revenue Code to provide relief from fiduciary liability and prohibited transaction restrictions to plan sponsors and fiduciaries that appoint qualified fiduciary advisers for individual account plans with participant-directed investments. If statutory requirements are met, sponsors and fiduciaries are not liable for advice given by fiduciary advisers or for investment performance based on that advice. Fiduciary advisers include banks, insurance companies, broker dealers, registered investment advisers, and their employees and representatives. Advice must be given pursuant to an "eligible investment advice arrangement," which is an arrangement under which either

(i) any fees received by the adviser do not vary on the basis of investment options selected, or (ii) the adviser uses a computer model that is certified by an eligible investment expert (i.e., someone without a material affiliation or contractual relationship with the adviser who also satisfies any additional requirements the Department of Labor [DOL] may specify from time to time). The computer model must apply generally accepted investment theories that use relevant individualized participant information (retirement age, life expectancy, risk tolerance), must not be biased in favor of investments offered by the adviser or its affiliates, and must take into account all investment options available under the plan. An independent auditor (i.e., unrelated to the adviser or any provider of investment options under the plan) must certify annually that the model is appropriate, the only advice given must be pursuant to the computer model, and all transactions must result solely from participant decisions. In addition:

- Before investment advice is given, the adviser must provide notice to participants that discloses, among other things:
    - the role of all parties involved in developing the program or selecting investments options under the plan;
    - that the financial adviser is a fiduciary;
    - past performance of the investment options;
    - any fees or other compensation received by the fiduciary adviser;
    - how any participant information will be used; and
    - that participants may arrange for their own advice from another adviser.
- Presentation of the information must be written clearly and in a manner that is easily understood by participants and beneficiaries. The DOL will issue a model form of disclosures.
- Compensation received by the fiduciary adviser or its affiliates in connection with an investment transaction must be reasonable, and the terms of the transaction must be at least as favorable as an arms-length transaction.
- The relief is effective for advice given after December 31, 2006.

While the relief available to plan sponsors and other plan fiduciaries is both welcome and significant, it is not complete. The sponsor or plan fiduciary will still be responsible for the prudent selection and periodic monitoring of the investment adviser but will not be responsible to monitor the specific investment advice given by the fiduciary adviser.

Other Defined Contribution Plan Changes

Safe Harbor Default Investment Option: Within six months, the DOL must issue final regulations that provide a safe harbor for default investments. This relief will be particularly welcome for 401(k) plans that provide automatic enrollment. Although the DOL regulations will not identify specific safe harbor investment vehicles, the legislative history of the PPA suggests strongly that any safe harbor should be consistent with long-term capital appreciation, long-term capital preservation, or both. Participants will be required to receive an annual notice explaining how their accounts will be invested absent affirmative investment direction, and must be given a reasonable period to make investment elections after the notice is received and before the beginning of the plan year. These new rules will be effective for plan years beginning after December 31, 2006.

Fiduciary safe harbors for mapping investments and blackout periods: The first of these new fiduciary safe harbors applies to a "qualified change in investment options" in which an account is

reallocated to new investment options with characteristics, including risk and rate of return, that are similar to the characteristics of the corresponding investment options that were available before the reallocation. The safe harbor requires notice to participants between 30 and 60 days before the change, comparing the old and new investment options and explaining that, absent a participant investment direction to the contrary, the participant's account will be invested in new options with characteristics reasonably similar to the old options. The safe harbor applies if the prior investment was a result of participant direction.

The second new fiduciary safe harbor relieves plan fiduciaries of liability for losses during blackout periods if the ERISA notice requirements for blackouts are followed.

These new rules generally apply to plan years beginning after December 31, 2007.

Automatic enrollment: The PPA provides a new safe harbor under which a 401(k) plan with a "qualified automatic contribution arrangement" automatically meets the actual deferral percentage (ADP) test, actual contribution percentage (ACP) test, and top-heavy rules.

Requirements for the safe harbor:

- The default/automatic deferral percentage for the first year must be at least 3% of compensation;
- The default percentage must increase from 3%–6% of compensation over four years with a maximum of 10% of compensation;
- Either (1) 100% match on deferrals up to 1% of compensation and 50% match on deferrals between 1% and 6% of compensation, or (2) nonelective contribution equal to 3% of compensation;
- Employer contributions must vest within two years;
- Automatic enrollment may be limited to newly eligible employees; and
- Participant must receive initial and annual notices.

Employers now have three options for meeting the 401(k)/(m) nondiscrimination tests:

1. Perform regular discrimination testing, taking corrective action if the plan fails;
2. Institute automatic enrollment and comply with the new safe harbor; or
3. Comply with the old safe harbor ((i) matching contributions of 100% of deferrals up to 3% of compensation and 50% of deferrals between 3% and 5% of compensation or (ii) non-elective contributions of 3% of compensation).

Additional rules for plans that adopt automatic enrollment, whether or not they also use the safe harbor:

- Plans may allow participants to opt out during the first 90 days and receive a distribution of automatic deferrals already made;
- Corrective distributions for failure to satisfy ADP or ACP tests may be made within 6 months (extended from 2.5 months) after the close of the plan year without liability for 10% excise tax, and such amounts are included in income in the year of distribution;
- ERISA preempts state laws that directly or indirectly prohibit automatic enrollment provisions, effective August 17, 2006; and

- Except for the preemption rule, rules are generally effective for plan years beginning after December 31, 2007.

Miscellaneous defined contribution plan changes:

- Corrective distributions for failure to satisfy ADP or ACP tests are taxable in the year of distribution and need not include gap period income if distributed within the period prescribed to avoid the 10% excise tax. These rules generally apply for plan years beginning after December 31, 2007.
- Employer nonelective contributions made for plan years beginning after December 31, 2006 must vest under a three-year cliff vesting schedule or a six-year graded vesting schedule, as currently required for matching contributions.

Portability

For distributions after December 31, 2006, PPA enhances the portability of retirement benefits by expanding rollover options to permit:

- direct rollovers to Roth IRAs from qualified plans, tax sheltered annuities, or governmental 457 plans;
- rollovers to an IRA by non-spouse beneficiaries from qualified plans, tax-sheltered annuities, or governmental 457 plans; and
- rollovers of after tax contributions from a qualified plan to a tax sheltered annuity.

Plans with Employer Securities

For plan years beginning after December 3, 2006, defined contribution plans must allow participants to diversify amounts invested in publicly traded employer securities. These new requirements do not apply to ESOPs that have no elective deferrals or matching contributions and do not form part of another plan. Under the new rules:

- Employees have an immediate right to diversify employee contributions and elective deferrals, and a right after three years of vesting service to diversify employer nonelective contributions and company match;
- Plans must provide at least three diversified investment options other than employer securities or employer real property;
- Participants must be given notice no later than 30 days prior to effective date of any new diversification rights; and
- Diversification for employer non-elective and matching contributions under existing plans is subject to a three-year phase-in period.

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