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Employee Benefits

A Littler Mendelson Newsletter

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Comprehensive Pension Reform Becomes Law: A Look At Changes Primarily Affecting Defined Contribution Plans

By J. René Toadvine and Kevin L. Wright

After years of political debate and negotiation, the Pension Protection Act of 2006 was signed into law by President Bush on August 17, 2006. This landmark legislation arguably is the most comprehensive pension reform legislation since the enactment of ERISA in 1974. This newsletter summarizes some of the major defined contribution plan components of this new and important legislation and conveys some basic observations regarding them. A separate newsletter will summarize the major components of the legislation that relate to pension plans (including multi-employer plans) and cash balance plans.

EGTRRA Permanence

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), among other things, made numerous changes relating to qualified retirement plans. However, under current law, the changes made by EGTRRA are scheduled to sunset on December 31, 2010. The new law makes permanent the changes made by EGTRRA.

Auto Enrollment Under 401(k) Plans

Safe Harbor

Under current law, 401(k) plans generally are subject to nondiscrimination testing requirements (*i.e.*, the actual deferral percentage test (the "ADP test") and the actual contribution percentage test (the "ACP test")) and the "top-heavy" rules that ensure that certain employees of a company do not benefit disproportionately under the plan. Current law provides for certain "safe harbor" status from the nondiscrimination testing rules if the plan sponsor makes either "safe harbor non-elective contributions" or "safe harbor matching contributions." Generally, such safe harbor contributions would satisfy the top-heavy rules. In addition, 401(k) plans are permitted to "automatically enroll" employees with respect to employee pre-tax salary deferrals, provided the employees are given advance notice of such automatic enrollment and the opportunity to change or opt out of the automatic enrollment at any time.

Generally effective for plan years beginning after 2007, the new law provides an additional safe harbor for plans that have an automatic enrollment feature. Significantly, this new safe harbor requires lower employee contributions than the current safe harbor. If the requirements of the safe harbor are satisfied, the plan will be deemed to have satisfied the ADP test, the ACP test and, in certain cases, the top-heavy rules. In order to satisfy this safe harbor, among other things, the plan must provide the following:

- Unless an employee elects otherwise, the employee will be deemed to have elected to defer a portion of his or her compensation which is set by the employer into the plan. The amount of this "automatic" deferral may not exceed 10% of compensation and may not be less than:
  - 3% of compensation for the first plan year in which the deemed election applies to the participant;
  - 4% of compensation for the second plan year;

- 5% of compensation for the third plan year; and
- 6% of compensation for the fourth and subsequent plan years.

- The plan sponsor generally must make either (i) a non-elective contribution on behalf of all non-highly compensated employees eligible to participate in the plan, without regard to whether such employees make a contribution under the plan, in an amount equal to at least 3% of compensation or (ii) a matching contribution on behalf of all non-highly compensated employees covered under the plan equal to (a) 100% of the elective contributions up to 1% of compensation, plus (b) 50% of the elective contributions from 1% to 6% of compensation.
- Participants must be 100% vested in employer matching or non-elective contributions upon the completion of 2 years of service.
- Notice must be given to employees (similar to requirements under current law).
- The new automatic enrollment rule generally applies only to new employees; however, current employees that have not made an affirmative election to participate (or not participate) may be covered.

The above rules also apply to 403(b) plans.

In addition, with respect to any eligible automatic enrollment arrangement (regardless of whether it satisfies the safe harbor rules discussed above), a plan may (but is not required to) permit employees to elect during the first 3 months after the start of automatic contributions to receive a corrective distribution (plus related earnings). Employer matching contributions are forfeited or subject to such other treatment as may be prescribed by the IRS. The corrective distributions are taxed in the year paid, are not subject to the ADP test, and are exempt from the 10% early distribution tax. In addition, the 401(k) plan is not treated as violating the rules relating to restrictions on distributions. This rule applies to 401(k) plans, 403(b) plans and governmental 457(b) plans.

Observation: The new law provides a planning opportunity for employers because the automatic enrollment safe harbor is less costly to employ than the traditional safe harbor. Not only can an employer offer a lesser match (i.e., 3½% of compensation as opposed to 4% of compensation under the traditional safe harbor), but a vesting schedule (up to a 2-year cliff) may be instituted (vesting is immediate under the traditional safe harbor).

ERISA Preemption

Under current law, there has been concern as to whether the automatic enrollment provisions under a 401(k) plan may violate certain state garnishment laws, as the employee's compensation is withheld without an employee's affirmative election. Generally effective August 17, 2006, the new law preempts any state law that prohibits or restricts automatic enrollment provisions under an ERISA-governed plan, provided the plan provides annual notice to affected employees within a reasonable period of time before each plan year that explains (i) an employee's right to opt out of the automatic enrollment feature and (ii) how automatic contributions will be invested.

Observation: Presumably, the annual notice must be provided to all participants affected each plan year, not just those participants who commence automatic contributions for the first time in any given plan year.

Rollovers

Under current law, distributions from qualified retirement plans, 403(b) plans and governmental 457(b) plans to a non-spouse beneficiary may not be rolled over or otherwise contributed to another qualified plan or to an IRA. Generally effective for distributions commencing after December 31, 2006, the new legislation provides that distributions under such plans to a non-spouse beneficiary may be directly transferred or rolled over to an IRA. The IRA will then be treated as an inherited IRA and the benefits within the IRA must be distributed in accordance with the minimum distribution rules applicable to inherited IRAs (*i.e.*, either (i) distribution of the entire interest must occur within 5 years after the participant's death or (ii) distribution must commence within one year after the participant's death and be paid out over the beneficiary's life expectancy).

Observation: This change in law presents an important estate planning opportunity. For example, under prior law, in many cases upon the death of a participant, a retirement plan required the non-spouse beneficiary to receive an entire distribution of the funds either immediately or within 5 years of the participant's death. Now, the non-spouse beneficiary may directly transfer the funds into an IRA (treated as an inherited IRA) and receive a distribution of the funds over the beneficiary's life expectancy.

Fiduciary Provisions

Default Investments

The investment of plan assets generally is a fiduciary act under ERISA. However, if the requirements of Section 404(c) of ERISA are satisfied, a plan fiduciary will be relieved from any liabilities arising with respect to a participant's exercise of investment control over his or her plan account. Nonetheless, the Department of Labor has long taken the position that 404(c) relief is unavailable where a participant fails to make an affirmative investment direction, including situations where a participant has been "deemed" to have made an investment direction to invest his or her account in a default investment option. Under the new law, generally effective in 2007, a plan fiduciary may receive 404(c) relief for "deemed" investments, provided the plan (i) complies with Department of Labor regulations (final regulations to be issued no later than February 17, 2007, which are to provide safe harbor guidance on default investments (proposed regulations were issued on September 27, 2006)) and (ii) provides notice to participants that explains the participant's right to direct the investment of his or her account and how the account will be invested in the event the participant fails to make an affirmative investment election. The notice must be provided annually and the participant must have a reasonable amount of time following the receipt of the notice to make an affirmative investment election.

Observation: This change in law provides much needed relief to plan fiduciaries from potential liability with respect to "deemed" investment elections into default investment options under a retirement plan.

Mapping

The Department of Labor currently takes the position that a plan fiduciary does not receive 404(c) relief (i) during a plan investment "blackout period" or (ii) when participant accounts are "mapped" to new investment options without the participant's affirmative investment direction. ERISA generally requires plan fiduciaries to provide at least 30 days advance notice of a blackout period (*i.e.*, a period of at least 3 consecutive days during which a participant cannot make direct trades, effect loans or receive distributions). Under the new law, plan fiduciaries receive 404(c) relief during a blackout period, provided they comply with general blackout notice rules. Also, plan fiduciaries receive 404(c) relief for "mapping," provided (i) the participant's account is reallocated among one or more investment options that have similar characteristics relating to risk and return as the investment options that existed immediately prior to the change; (ii) the participant receives notice of the change at least 30 days, but not more than 60 days, prior to the effective date of the change, which informs the participant how his or her account will be invested as of the change if the participant fails to provide affirmative investment directions and includes information comparing the current and new options; (iii) the participant has not provided contrary affirmative investment direction prior to the change; and (iv) the investment options within which the participant's account were invested immediately prior to the change were as a result of the participant's prior affirmative investment direction.

Observation: As with the "deemed" election change previously discussed, this change in law provides much needed relief to plan fiduciaries from potential liability with respect to "blackout periods" and "mapping of investments" under a retirement plan.

Investment Advice

Under current law, plan sponsors have a fiduciary duty to act prudently in the selection and monitoring of an investment advisor. In addition, a plan sponsor may be liable for the breach of a fiduciary duty by an investment advisor under certain circumstances. Further, unless certain requirements are satisfied, an investment advisor that provides advice to invest in specific securities or investment vehicles that pay additional fees to the advisor may result in a prohibited transaction. The new law, generally effective in 2007, provides a prohibited transaction exemption which, in certain circumstances, permits an investment advisor to provide investment advice to plan participants (as opposed to plan fiduciaries) and receive fees as a result of such advice. Additionally, plan sponsors are provided limited fiduciary liability protection from the specific advice given by the investment advisor, provided the requirements of the exemption are satisfied and the investment advisor acknowledges in writing that it is a plan fiduciary with respect to the provision of investment advice.

Miscellaneous

Employer Stock

Under current law generally, defined contribution plans may require that certain plan assets be invested in employer stock without giving participants the ability to switch to alternative plan investments. The new law, effective in 2007, requires that participants be permitted to immediately diversify their investment in employer stock that is attributable to pre-tax salary deferrals or after-tax employee contributions. With respect to employer stock investments attributable to employer matching and employer non-elective contributions, participants must be permitted to diversify such investment after the participant completes three years of service. Plans with employer stock must provide at least three diversified investment options other than employer securities or employer real property. Exceptions to this new law are provided for certain privately held companies and certain ESOPs. Even though the new law generally is effective in 2007, companies may employ a three-year transition rule which allows the diversification rights to be spread over three years.

The new law also requires plan administrators to provide notice at least 30 days in advance of the participants becoming eligible to diversify investments in employer stock. Failure to provide the required notice may result in a penalty of up to $100 per day per participant. The Secretary of Treasury is directed to issue a model notice within 180 days of the date of enactment.

Observation: As with the changes under the deferred compensation rules, this change in law is another step by Congress, post-Sarbanes Oxley Act of 2002 ("SOX"), to effect corporate governance reform.

Benefit Statements

Under current law, plan administrators are required to provide benefit statements to participants upon request, but no more than once per year. The benefit statement must include the participant's total accrued benefits and the vested accrued benefit (or the earliest date upon which such benefit will be vested). Generally effective in 2007, the new law requires defined contribution plans to provide a benefit statement (i) at least once each calendar quarter to any participant or beneficiary who has the right to direct investments, (ii) at least once each calendar year to any participant or beneficiary that does not have the right to direct investments and (iii) upon request to any other plan beneficiary. In addition to the information already required to be provided under current law, the new law requires that a benefit statement include, among other things, the value of the participant's investments, an explanation regarding the importance of diversification of investments and information directing the participant to the Department of Labor's website for investment and diversification information. Failure to provide the required benefit statement may result in a penalty of up to $100 per day per participant. The Department of Labor is directed to issue model benefit statements within one year of the date of enactment (*i.e.*, by August 17, 2007).

Observation: The new law will result in participants being better equipped to make investment decisions under the retirement plan and, as a result, should provide greater fiduciary liability protection.

Faster Vesting of Employer Non-elective Contributions

Current law requires that employer non-elective contributions made to a defined contribution plan vest under either a five-year cliff vesting schedule or a seven-year graded vesting schedule. As a result of EGTRRA, employer matching contributions must vest under either a three-year cliff vesting schedule or a 6-year graded vesting schedule. The new law, generally effective in 2007, provides that employer non-elective contributions must vest according to the rules applicable to matching contributions, *i.e.*, under a three-year cliff or six-year graded vesting schedule.

Observation: This law change applies only to employer non-elective contributions made for plan years beginning in 2007. Consistent with numerous changes made by EGTRRA, this law change promotes retirement savings and portability of retirement savings by plan participants. However, faster vesting may increase an employer's plan costs, as forfeitures that may otherwise be used to pay plan expenses or reduce future employer contributions may decrease.

Deferred Compensation Plans

Under current law, sponsors of single-employer defined benefit pension plans may also sponsor non-qualified deferred compensation plans and may set aside amounts to fund obligations that may accrue under such deferred compensation plans without regard to the funded status of the defined benefit pension plan. The new legislation provides for the immediate taxation of any assets that are reserved or set aside in a trust (including a rabbi trust or other technically "unfunded" arrangement) to pay nonqualified deferred compensation benefits to a "covered employee" of a public corporation at any time (1) while the sponsor is in a bankruptcy reorganization, (2) during the 12-month period beginning on the date which is 6 months before the termination of an underfunded single-employer defined benefit pension plan or (3) in other situations where the government deems the single-employer defined benefit pension plan to be "at-risk" under the new law. In addition, a 20% penalty tax will be imposed on the amount that is subject to this immediate income tax and any "gross-up" payment made to cover the income tax and 20% penalty tax will also be immediately taxed and subject to the 20% penalty tax. Generally, "covered employees" are current and former employees who are or have been (a) one of the "top 5" officers for compensation reporting purposes on a company's proxy statement and (b) Rule 16 officers under the Securities and Exchange Act of 1934. The new law applies to any "transfers" made after the date of enactment, August 17, 2006.

Observation: The new law is another step by Congress, post-SOX, to effect corporate governance reform.

Plan Amendments

Generally, plan amendments that are made as a result of the Pension Protection Act of 2006 (or as a result of regulations promulgated thereunder) may be given retroactive effect, provided they are made on or before the last day of the first plan year that begins on or after January 1, 2009.

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