

Management Alert

Pension Protection Act of 2006 Affects Public and Private Company Employee Stock Ownership Plans

The Pension Protection Act of 2006 (Act), which was signed into law by President Bush on August 17, 2006, significantly impacts all defined contribution plans, including employee stock ownership plans (ESOPs). This Alert highlights the provisions of the Act that apply to ESOPs. For information highlighting the changes applicable to defined contribution plans generally, see the previously released [Alert](#) on this topic.

EGTRRA Changes Made Permanent

The Act makes permanent the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which were scheduled to lapse, or “sunset”, in 2010. EGTRRA, among other things, increased the deduction limits on contributions to non-leveraged ESOPs and stock bonus plans from 15% to 25% of the compensation paid to plan participants. Employees’ elective contributions to 401(k) plans are included as compensation but are not applied against the 25% deduction limit. For both leveraged and non-leveraged ESOPs, the maximum benefits that may be allocated to employees’ accounts each year was increased to \$40,000 (subsequently increased to \$44,000) or 100% of compensation, whichever is less.

Automatic Enrollment

The Act provides much needed relief for combined ESOPs and 401(k) plans that use automatic enrollment, and creates a new nondiscrimination safe harbor for automatic enrollment plans that also provide for minimum employer contributions.

Faster Vesting for Non-Matching Employer Contributions

The Act requires all defined contribution plans, including ESOPs, to vest all employer contributions no later than

- after three years of service, or
- after six years with at least 20% vesting per year after the second year.

This vesting schedule is currently required for matching contributions. The Act expands this requirement to cover all employer contributions made to defined contribution plans. However, employers may elect to limit the new vesting schedule to contributions made beginning in 2007.

The faster vesting has limited application to an ESOP which had an outstanding employer stock acquisition loan on September 26, 2005. For these ESOPs, the faster vesting requirement does not apply to any plan year beginning before the earlier of (a) the date on which the loan is fully repaid, or (b) the date on which the loan was, as of September 26, 2005, scheduled to be fully repaid.

Faster Diversification for Public Company ESOPs

Public companies with ESOPs or employer stock funds under their 401(k) plans, must allow participants to diversify out of the employer stock investment. For employer nonelective or matching contributions, the diversification requirements apply after the participant has completed at least three years of service. For elective deferrals and after-tax contributions, the diversification requirements apply immediately. At least three diversified investment options must be provided (other than an employer stock fund). Notice must be provided to participants at least 30 days before they are eligible to exercise their diversification rights (with a \$100-per-day penalty for noncompliance).

The new diversification rules are generally effective for plan years beginning after December 31, 2006. Existing plans, with employer stock acquired in a plan year beginning prior to 2007 and which is attributable to employer contributions, may phase-in the new rule ratably over three years. However, the phase-in option may not be applied to any participants who are age 55 or older and who have at least three years of service. A delayed effective date applies to collectively bargained plans.

Stand-alone ESOPs without elective employee or matching contributions are not subject to the new diversification rule. Although the rule generally applies only to employer stock that is readily tradable on an established securities market, it may also apply to non-publicly traded employer stock

held by a plan if any member of the employer's controlled group (using a 50% ownership threshold) has issued a class of stock which is publicly traded.

Diversification Notice

The Act adds a new diversification notice requirement. A notice must be provided no later than 30 days before the first date on which an individual could exercise his or her election to divest out of employer stock. The notice must include:

- a description of the diversification right, and
- a description of the importance of diversifying the investment of retirement account assets.

The Secretary of the Treasury is required to provide a model notice within 180 days of the date of enactment of the Act. The notice requirement is generally effective for plan years beginning after 2006, but no earlier than 90 days after enactment of the Act. As a result, many companies will be required to provide the diversification notice before the end of 2006.

Increased Bond limit for Plans holding Employer Securities

Fiduciaries of plans and others who handle plan assets must be bonded for at least \$500,000. The Act increases the fiduciary bond requirement to \$1 million for plans that hold employer securities. The proposal is effective for plan years beginning after 2007.

Limited Relief From Prohibited Transaction Excise Tax

The Act may provide limited relief from excise tax for non-controlling shareholders who sell stock to an ESOP in a transaction that fails to satisfy the current prohibited transaction exemption. The Act contains a new prohibited

transaction exemption that applies to the acquisition, holding or disposition of any security or commodity if the transaction is corrected within a certain period, generally within 14 days after the disqualified person knows or reasonably should have known that the transaction is a prohibited transaction absent this new exemption. This exemption does not apply if, at the time of the transaction, the disqualified person knew or reasonably should have known that the transaction would constitute a prohibited transaction. In addition, the exemption does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of employer securities.

The extent to which the new exemption will apply to individuals who sell employer securities to an ESOP will depend on how broadly the Department of Labor construes who is an affiliate of a plan sponsor. The Act does not contain

a definition of the term “affiliate,” nor is the term defined generally in ERISA. The definition of “fiduciary” under ERISA, however, does provide that an affiliate of a fiduciary includes any person who has effective control over the fiduciary. Likewise, the term “affiliate” is defined for securities law purposes to include any individual who is a director or a large shareholder having the power to direct the management and policies of the company. If the DOL follows the securities law concept, the new exemption may be available to minority shareholders who sell stock to an ESOP (or who buy stock from an ESOP) in a transaction that fails to satisfy the existing prohibited transaction exemption, so long as the person did not know or reasonably should have known that the transaction would constitute a prohibited transaction and the transaction is corrected within fourteen days after the person learns that the transaction failed to satisfy the exemption.

If you have any questions about the Act and its impact on ESOPs, please contact the Seyfarth Shaw Employee Benefits Department attorney with whom you work or any [Employee Benefits](#) attorney listed on the website at www.seyfarth.com.

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E.
Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

World Trade Center East
Two Seaport Lane
Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

131 South Dearborn Street
Suite 2400
Chicago, Illinois 60603-5577
312-460-5000
312-460-7000 fax

HOUSTON

700 Louisiana Street
Suite 3700
Houston, Texas 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza, Suite 3300
2029 Century Park East
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas
Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall
Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street
31st Floor
San Francisco, California 94105-2930
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W.
Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2) 647 60 25
(32)(2) 640 70 71 fax



Breadth. Depth. Results.

This newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.

Copyright © 2006 Seyfarth Shaw LLP. All Rights Reserved.