Management Alert

Faster Vesting, Automatic Enrollment Highlight Defined Contribution Provisions of New Pension Act

Just before its summer recess, on August 3, 2006, Congress passed the Pension Protection Act of 2006, a comprehensive pension reform law, which President Bush is expected to sign. Although much of the press coverage has dealt with the impact of the new law on defined benefit plan funding, the Act also contains a number of provisions dealing with 401(k) and other defined contribution plans, new and revised notice and disclosure requirements for all plans, plan investment and fiduciary issues and restrictions on funding nonqualified deferred compensation arrangements. This Alert, one of a series of alerts summarizing the Act, highlights the Act provisions dealing with 401(k) and other defined contribution plans.

On August 17, 2006, the Seyfarth Shaw Employee Benefits Practice Group will host a teleconference client briefing on the new Act. In order to register, please visit www.seyfarth.com/events, or contact Craig Maas at 312-460-6422 or cmaas@seyfarth.com.

Faster Vesting for Non-Matching Employer Contributions

Beginning in 2007, all employer contributions must vest completely after three years of service, or must vest at the rate of 20% per year beginning not later than the second year. This is the same vesting schedule that currently applies to matching contributions. Employers can decide whether to apply the faster vesting only to contributions made beginning in 2007, or to participants' entire accounts. For collectively bargained plans, the effective date is postponed until the current bargaining agreement expires, but not later than 2009.

EGTRRA Changes Made Permanent

The Act makes permanent the provisions of the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which were scheduled to lapse, or "sunset," in 2010. EGTRRA, among other things, created catch-up contributions for those participants age 50 and older, enhanced participant vesting of employer matching contributions, increased pension and individual retirement account limits, and created Roth 401(k) plans. The Act also makes permanent Section 529 college

tuition programs and the saver's tax credit for contributions to 401(k) plans.

Automatic Enrollment

The Act provides much needed relief for 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.

Current law allows automatic enrollment (where the employer withholds contributions out of the participant's pay unless the participant opts out of the program), but some employers have been hesitant to implement automatic enrollment because of concerns over whether automatic enrollment violates state wage payment laws and whether they may have fiduciary liability for the investments of participants who do not make an affirmative investment election. The Act provides the following relief for all automatic enrollment plans that meet minimum disclosure requirements:

• Plan fiduciaries will be protected from liability for accounts of participants who do not make an investment election, if the accounts are invested in safe harbor investment options to be specified by the Labor Department (see below);

• Automatic enrollment is exempted from state wage payment laws, provided that the plan makes use of the safe harbor investment options;

• Participants who wish to opt out will have a 90-day window to withdraw automatic enrollment contributions without being subject to the 10% penalty tax on premature withdrawals; and

• Plans will have six months, rather than the current 2½ months, to distribute excess contributions resulting from automatic enrollment without the employer being subject to a 6% penalty tax.

Protection from state wage payment laws will take effect immediately, and rules governing safe harbor investment options will take effect January 1, 2007. The remaining provisions dealing with automatic enrollment will take effect beginning January 1, 2008.

In addition to these rules - which will apply to all automatic election plans that meet the notice and default investment requirements - beginning in 2008, a special matching safe harbor for nondiscrimination testing will be available to qualified automatic contribution arrangements that meet the following:

• Any participant who has not made a written election in the past to participate or to decline participation must be automatically enrolled in the arrangement. The required entry-level contribution is 3%, increasing in annual 1% increments to 6% of pay. Plans may provide for automatic increases in contributions up to 10% of pay. The plan must provide notice of the ability to opt out of contributions or automatic increases.

• The employer must match 100% of the first 1% of pay contributed by the participant, plus 50% of the next 5% of pay, for a maximum match of 3½% of compensation to each employee. Alternatively, employers may make non-elective contributions of 3% of pay for all eligible employees.

• The employer non-elective and matching contributions safe harbor contributions must be 100% vested after two years of service.

The new safe harbor is quite similar to the existing 401(k) safe harbor, under which plans that provide minimum levels of employer contributions are exempt from discrimination testing. The principal differences are that the existing safe harbor requires a higher level of matching (100% of the first 3% of pay and 50% of the next 2%), and the existing safe harbor requires that all employer contributions be fully vested. Thus, plans that currently use the existing safe harbor may wish to

consider switching to the new automatic enrollment safe harbor in 2008.

Safe Harbor for Default Investment Elections

Section 404(c) of ERISA provides that plan fiduciaries are not responsible for the results of investment decisions made by participants, provided that the requirements of the Labor Department regulations are met. However one drawback to §404(c) is that it requires an affirmative investment election by the participant; there is no protection if the participant fails to make any investment decision. This has been become a particular concern with the growth in popularity of 401(k) plans with automatic enrollment.

The Act provides §404(c) protection effective January 1, 2007, for plans that utilize a safe harbor default fund for participants who fail to make an investment election, and also directs the Department of Labor to issue regulations defining the safe harbor fund within 180 days. In fact, the Labor Department was already working on this project. Early indications are that the safe harbor will not allow investments to default to a fixed income fund, but will require a more balanced blend of debt and equity funds. This is likely to result in increased usage of so-called "lifecycle" funds.

The Act also eliminates §404(c) protection during blackout periods unless the plan has complied with the blackout notice requirements enacted by the Sarbanes-Oxley Act. However, on the positive side, the Act extends §404(c) protection for the first time to situations in which participant accounts are "mapped" to new investments in connection with a change in investment options. These changes are effective for plan years after 2007 (with a delay for collectively bargained plans until the current bargaining agreement expires, but not later than 2010).

Quarterly Benefit Statements Required

At present, ERISA only requires benefit statements to be furnished to participants once a year, and only if requested, although most plans provide benefits statements automatically and at more frequent intervals. The Act in effect codifies existing practice by making quarterly benefit statements mandatory for defined contribution plans with investment discretion, which will include virtually all 401(k) plans (defined contribution plans without investment discretion will have to provide the statements annually). The statements will need to include a number of disclosures that are not typically included in current statements; however, much of the new disclosure language will be in the form of a "boilerplate" about the importance of a well-diversified retirement portfolio, and the Department of Labor is required to provide model notices within 180 days of enactment. The notice provision generally applies to plan years beginning after 2006; there is a delay for collectively bargained plans that could delay the effective date until 2009.

Hardship Withdrawals and Rollovers for Non-Spouse Beneficiaries

Under current IRS safe harbor regulations, a hardship distribution from a 401(k) plan can be taken for payment of medical expenses or college tuition only if the person for whom the expense is incurred is the participant, or the participant's spouse or tax dependent. The Act directs the IRS to issue regulations within 180 days expanding the list of permissible hardship withdrawals to include any person who is the participant's beneficiary, even if not a dependent for tax purposes. As under current law, a plan is not required to use the IRS safe harbor hardship definition, although most do.

Also under current law, the only beneficiary who can roll over a distribution to an IRA after the participant's death is the participant's spouse. The right to roll over distributions will be expanded to all beneficiaries, including trusts, beginning in 2007. However, the rollover will have to be to a special type of "inherited" IRA that will be subject to the same minimum distribution rules that would have applied to the participant.

Both of these changes will be particularly helpful to participants who designate domestic partners or other non-traditional family members as their beneficiaries.

Diversification Out of Employer Stock

The Act requires plans that provide for employer contributions to be made in publicly-traded employer stock, or to be automatically invested in such stock, to allow participants with three years of vesting service to diversify out of the employer stock. 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). Standalone ESOPs without elective employee or matching contributions and one-participant plans are not subject to this new rule.

This new rule generally applies beginning in 2007. There is a delayed effective date for collectively bargained plans, and the employer may choose to phase-in the new rule for stock acquired by the plan before 2007 over three years (1/3 each year) for participants who have not attained age 55 with at - least three years of service before the 2006 plan year.

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 a publicly traded security.

Other Provisions

• ERISA prohibits financial providers from providing investment recommendation to participants in 401(k) plans which include investment options affiliated with their own institutions. The Act creates an exemption allowing qualified fiduciary advisors to offer personal investment advice to employer-sponsored retirement plans through objective computer models certified by the Departments of Labor and Treasury or fixed fee programs, subject to annual audit. These provisions could be effective as soon as 2007.

• Fiduciaries of plans and others who handle plan money 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 after 2007.

• The Act increases penalties for coercive interference with ERISA rights from a $10,000 fine and one year in prison to a $100,000 fine and three years in prison.

• The Act creates a new exception from the premature distribution tax for distributions to a reservist (called up between September 11, 2001, and before December 31, 2007, for more than 179 days). The Act applies to distributions after September 11, 2001, and allows for the money to be paid back in within two years after the latter of the end of active service or enactment of the Act.

• Beginning in 2010, employers with no more than 500 participants can create combined cash balance/401(k) plans with simplified discrimination testing and reporting requirements.

• The PBGC's missing participant program will be available to terminated defined contribution plans. This provision will become effective for distributions made after final regulations are issued.

If you have any questions about the Act or its impact on defined contribution plans, please contact the Seyfarth Shaw Employee Benefits Group attorney with whom you work or any employee benefits attorney listed on our website at www.seyfarth.com.

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