

AdvantEdge

A LEGISLATIVE & TECHNICAL UPDATE FOR OUR CLIENTS

Pension Protection Act Delivers Broader Savings Opportunities and New Regulations for Defined Contribution Plans

As the name implies, the Pension Protection Act of 2006 (the "Act") introduced new rules designed to stabilize the nation's pension system. However, its more than 900 pages of provisions also contain provisions to increase savings through defined contribution plans such as 401(k) plans. The Act permanently extends important retirement savings and IRA provisions that were scheduled to expire in 2010, encourages automatic enrollment and establishes guidelines for providing investment advice for defined contribution plans. Plan sponsors will also face new mandates — including faster vesting of employer non-matching contributions and more stringent diversification rules for employer securities. The last edition of Retirement Advantedge (Summer 2006) detailed the changes to defined benefit plans under the Act. This edition of Retirement Advantedge provides an overview of the key provisions of the Act on defined contribution plans and the steps employers must take to ensure compliance with these new rules.

New Vesting Requirements for Non-Matching Contributions

Beginning in 2007, the Act requires faster vesting schedules for employer non-matching contributions, such as profit sharing or discretionary contributions. Under the old law, these contributions were subject to five-year cliff vesting or a graded vesting schedule that partially vests in the third year and fully vests after seven years. With the passage of the Act, these contributions must vest according to the same requirements that apply to employer matching contributions (100% vesting after three years or 20% vesting per year beginning in the second year with 100% vesting after six years). While the vesting schedules for employer contribution types may continue to be different, they must conform to the new rules.

The new vesting rules apply to contributions made in plan years beginning after December 31, 2006. Contributions made prior to that date may continue to vest according to their existing schedule. **If your plan permits employer non-matching contributions, your vesting schedule may need to be amended to reflect this change. Please contact your Plan Consultant immediately if your plan has an employer non-matching contribution. We will work with you to amend your plan as necessary.**

New Diversification Requirements for Employer Securities

Beginning in January of 2007, new diversification requirements generally apply to defined contribution plans holding publicly traded employer securities (i.e., securities issued by the employer or a member of the employer's controlled group of corporations that are readily tradable on an established securities market). Employers must allow diversification immediately of amounts attributable to elective deferrals and employee after-tax contributions that are invested in employer securities, and they must allow diversification of amounts attributable to employer matching and non-matching contributions that are invested in employer securities after three years of service, except in stand-alone Employee Stock Ownership Plans (ESOPs).

Under a special transition rule, employers must allow amounts invested in employer securities attributable to employer contributions made before the provision's effective date generally to be diversified over three years—with one exception. Participants age 55 or older with three or more years of service before the first plan year beginning after December 31, 2005 will be allowed to diversify immediately.

Employers must offer at least three investment options other than employer stock, and may not single out employer stock for special treatment. For example, employers may not offer larger matching contributions to employees who invest in employer stock. **Employers must inform employees of their right to diversify their investments at least 30 days before they become eligible to exercise their right. The notice must describe the importance of diversification. The Secretary of the Treasury has until February 13, 2007 (180 days after August 17, 2006,) to issue a model diversification notice. Since many plan participants will be permitted to begin diversification on January 1, 2007, the notice must be provided by December 2, 2006. Pentegra will be prepared to provide a notice to you to distribute to your affected participants by late November and will modify that notice to conform to any model notice issued after that date.**

In addition, the maximum bond amount for plans that hold employer securities will increase from \$500,000 to \$1 million beginning in 2008.

EGTRRA Benefits Made Permanent

The Act permanently extends the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") which were due to expire in 2011. EGTRRA increased contribution and compensation limits, allowed employees to save more through defined contribution plans, permitted those over age 50 to make extra "catch-up" contributions, authorized Roth 401(k) plans and provided a tax credit for lower-income individuals who save for retirement. The following are the limits that apply to defined contribution plans for the 2007 plan year.

	<u>2006</u> <u>Limitations</u>	<u>2007</u> <u>Limitations</u>
Annual Addition Dollar Maximum	\$44,000	\$45,000
Employee 401(k) Contributions	15,000	15,500
Catch-up Contributions (Age 50 or older)	5,000	5,000
Annual Compensation	220,000	225,000

Military Personnel and the 10% Excise Tax

Military personnel (reservists and National Guardsmen) called up to active duty for at least 180 days after September 11, 2001 will be able to withdraw funds from their retirement savings while on active duty without incurring the 10% early withdrawal penalty. An individual who receives a qualified reservist distribution may repay (in one or more contributions) the amount of the distribution at any time during the two-year period after the end of the active duty.

Participant Benefit Statements

Beginning in 2007, defined contribution plans must provide periodic statements that detail plan benefits and account investment holdings. Participants who have the right to direct their investments must receive quarterly statements; other participants must receive annual statements. Statements must provide the dollar value of the accrued benefit as of the statement date along with the vested amount or the earliest vesting date. The statement must also detail the value of each investment held along with the amount invested in employer stock or real property. Quarterly statements must explain any limitations on the participant's right to diversify employer stock. If the value of any single investment option exceeds 20 percent of the market value of the entire portfolio, the statement must also include language that alerts the participant that the account may not be diversified. Pentegra plans to update our quarterly participant statements to comply with these new rules.

Default Investment Elections and Changes in Investment Options

The Act requires the Secretary of Labor to issue final regulations governing default investments by February of 2007. If a plan complies with the regulations and the default investment choice is considered prudent, the plan sponsor will avoid fiduciary liability because the participant will be considered to be exercising control over his or her assets. Proposed regulations recently issued by the DOL indicate that the types of investments that could be chosen for a qualified default investment alternative are life cycle or retirement date funds, balanced funds, and managed account funds. The employer must notify participants within a reasonable period before the plan year begins of their rights and responsibilities, including their right to control account investments. The notice must explain default investments. The regulations should be helpful to employers that offer automatic enrollment and those that make non-matching contributions.

In addition, the Act provides clarification on ERISA section 404(c) requirements being met in the event an employer changes investment options, as long as the following criteria are satisfied:

- The new investment options must be reasonably similar to the old options
- The employer must meet notice requirements
- The participant may not have made investment elections contrary to the proposed reinvestment of his or her account
- The participant must have directed the investment of the account before the change

The Secretary of Labor will also issue final regulations that provide guidance describing how plan sponsors and fiduciaries can satisfy fiduciary responsibility during a blackout period.

Automatic Enrollment

The Act removes the major legal obstacles to automatic enrollment. Under the Act, ERISA preempts state laws that conflict with automatic enrollment. To qualify for the preemption, the employer must notify employees of their rights and obligations, including the rights to opt out and to change the contribution amount. Employers must give employees a reasonable amount of time to make their elections. The notice

must also describe how the automatic contributions will be invested if the employee does not make an investment election. Default investments must conform to regulations that will be issued by the Secretary of Labor. As noted above, recently issued proposed regulations indicate that the types of investments that could be chosen for a qualified default investment alternative are life cycle or retirement date funds, balanced funds, and managed account funds.

Also beginning after 2007, automatic enrollment plans that fail nondiscrimination tests but comply with notice and default investment requirements will gain extra time to distribute excess contributions. Excess contributions normally must be distributed within 2½ months after the end of the plan year, but sponsors with automatic enrollment arrangements that comply with the Act will have six months.

The Act also creates a Safe Harbor design for automatic enrollment, based on enrolling new employees with a salary deferral of 3% of compensation (unless the employee elects not to participate by opting out in writing) and increasing the minimum contribution percentage by 1% per year for the following three years, providing a match of 100% of the first 1% of contributions and 50% of the next 5% of contributions (or a 3% non-matching contribution), and vesting the employer contributions after two years of service. The voluntary safe harbor design offers plan sponsors exemption from the top-heavy and nondiscrimination (ADP and ACP) rules.

Pentegra anticipates being able to offer an automatic enrollment feature in 2007. We are reviewing administrative and procedural issues surrounding implementation and will keep you informed as we get closer to implementing this service.

New Portability Rules

New portability provisions provide for non-spouse rollovers and allow direct rollovers from retirement plans to Roth IRAs as well as from one Roth IRA to another. Beginning in 2008, contribution limits for IRAs will be indexed annually, and tax refunds may be deposited directly into IRAs (subject to the usual IRA contribution and income limits).

Conclusion

While some of the provisions of the Act impose new regulations for plan sponsors—such as faster vesting of employer non-matching contributions and stock diversification rules—for many plan sponsors, the most important components of the Act are those that create new plan design options, such as automatic enrollment and automatic deferral increases. Pentegra will continue to analyze the provisions of the Act and will keep you updated as to how the Act will affect your program. Should you have any questions regarding the Act, please contact your Plan Consultant or Richard Rausser, Vice President, Consulting Services, at rrausser@pentegra.com, or 800-872-3473.

Our difference is your advantage



Pentegra Retirement Services
108 Corporate Park Drive
White Plains, NY 10604
800.872.3473

www.pentegra.com