ALERT

CONGRESS CHANGES THE PENSION LAWS AGAIN (BUT MOST OF THE CHANGES ARE GOOD)

September 14, 2006

In what is becoming almost an annual tradition, Congress has once again changed the laws governing the nation's "qualified" retirement plans. In some years, the changes are fairly limited and fairly "technical." Such changes may affect only a small number of plans or may affect only certain types of "qualified" plans, such as defined benefit plans. In other years, the changes are far-reaching and may affect all types of "qualified" plans. This is one of those years.

The Pension Protection Act of 2006 (the "PPA") is the most significant pension law since EGTRRA was enacted in 2001. In some ways, particularly when it comes to defined benefit plans, it may be the most significant pension law since ERISA was enacted in 1974. The PPA makes a number of significant changes to key rules in both the Internal Revenue Code and ERISA. In fact, by our count, it makes more than 80 significant changes. These changes will affect any employer that has a "qualified" retirement plan, including 401(k) plans, profit sharing plans, and defined benefit plans.

Although we do have clients with defined benefit plans, 401(k) plans and other types of defined contribution plans are far more common. This is true nationally as well. Government statistics suggest that defined contribution plans outnumber defined benefit plans by a ratio of at least ten-to-one and that the gap is growing larger. For this reason, we are focusing this Alert on the provisions in the PPA that affect 401(k) plans, profit sharing plans, and other types of defined contribution plans. These provisions include the following:

- ***EGTRRA Permanency.*** The many different changes made by EGTRRA have now been made permanent. These changes include higher deduction limits, higher contribution limits, 401(k) "catch-up" contributions, simplified rollover rules, Roth 401(k) plans, and much more. Without the PPA, these EGTRRA provisions would have expired at the end of 2010.

- ***Automatic Enrollment for 401(k) Plans.*** The PPA expressly authorizes employers to add an "automatic enrollment" feature to their 401(k) plans and provides rules for doing so. In fact, the PPA encourages employers to add an "automatic enrollment" feature by providing that, if certain requirements are met, plans with "automatic enrollment" will automatically "pass" the "nondiscrimination" testing that would otherwise apply to a 401(k) plan.

- ***Investment Advice for Plan Participants.*** The PPA makes it possible for employers to make investment advice (as opposed to investment education) available to participants in their plans without having to worry about being held liable if that advice is later second-guessed.

- ***Employer Securities.*** The PPA adds a number of special rules for plans that allow (or require) participants to invest in employer securities (that is, in publicly traded shares or securities issued by the plan sponsor).

More information about the PPA may be found in the accompanying client memorandum. If you have any further questions regarding this matter or if we can be of assistance to you in reviewing and updating your "qualified" retirement plans, please feel free to contact Eric Namee or Steven Smith at (316) 267-2000.

HINKLE ELKOURI LAW FIRM L.L.C.

Downtown Office 2000 Epic Center • 301 North Main Street, Wichita, KS 67202
East Office 8621 East 21st Street North, Suite 200, Wichita, KS 67206
(316) 267-2000 • www.hinklaw.com

HINKLE ELKOURI LAW FIRM L.L.C.

PENSION PROTECTION ACT OF 2006
CLIENT MEMORANDUM

To: Hinkle Elkouri Law Firm L.L.C. Employee Benefit Plan Clients

Date: September 14, 2006

Re: Important Provisions Affecting 401(k) and Other Defined Contribution Plans

Last month, Congress enacted, and the President has now signed, the Pension Protection Act of 2006 (PPA). The PPA is a lengthy and complicated Act. It is more than 900 pages long in bill form and, by our count, makes more than 80 changes to the laws governing the nation's retirement plans.

Many of these changes affect the rules that apply to defined benefit plans, such as the rules that govern the "funding" of defined benefit plans. These changes have been the subject of a number of different articles in the popular press and in various financial publications. This is appropriate. As far as defined benefit plans are concern, the PPA is probably the most significant pension law enacted by Congress since the Employee Retirement Income Security Act of 1974 (ERISA) was enacted more than 30 years ago.

The PPA also makes significant changes to the rules governing defined contribution plans, such as 401(k) plans and profit sharing plans. These changes affect many more employers – defined contribution plans outnumber defined benefit plans by more than ten-to-one – but have not received as much attention in the popular press. The remainder of this memo will focus on these changes in more detail.

I. EGTRRA Changes Are Made Permanent

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made many significant changes to the laws governing employer-sponsored retirement plans. These changes, which are summarized in more detail below, were scheduled to expire at the end of 2010. The PPA makes these EGTRRA changes a permanent part of the law (although other parts of EGTRRA, such as the EGTRRA changes to the estate tax, are still scheduled to expired at the end of 2010).

A *partial list* of the EGTRRA changes affecting "qualified" retirement plans that have now been made permanent includes the following:

(1) ***Increased Contribution Limits.*** EGTRRA significantly increased the dollar limits that apply to participant 401(k) deferrals and the overall dollar limits that apply to defined contribution plans.

(2) ***401(k) Catch-up Contributions.*** EGTRRA introduced the concept of "catch-up contributions" for participants who are age 50 and older. Prior to EGTRRA, the same dollar limits applied to participants regardless of their age. But as a result of EGTRRA, participants who are age 50 and older are allowed to contribute an additional amount to a 401(k) plan or to an IRA.

(3) ***Increased Deduction Limits.*** EGTRRA made two significant changes to the deduction limits that apply to employers who are sponsoring defined contribution plans. First, it increased the deduction limit from 15% of compensation to 25% of compensation. Second, and perhaps more significantly, it provided that 401(k) deferrals made by employees no longer count against this limit.

(4) ***Tax Credit for Low Income Savers.*** EGTRRA introduced a federal income tax credit for certain low income taxpayers who contribute to a 401(k) plan or other type of retirement plan.

(5) ***Simplified Rollover Rules.*** EGTRRA greatly simplified the rules that apply when money from one type of retirement plan is rolled over into an IRA or is rolled over to another type of retirement plan.

(6) ***Automatic Rollovers to an IRA.*** To reduce "leakage" from the retirement plan system, EGTRRA introduced a requirement that involuntary distributions from a qualified plan - that is, distributions that are made because the participant is no longer employed and has a vested account balance of $5,000 or less - must be rolled over to an IRA that has been established for the participant if the amount of the distribution is $1,000 or more.

(7) ***Faster Vesting on 401(k) Matching Contributions.*** EGTRRA required employers to vest matching contributions in a 401(k) plan more quickly. If a plan uses a graded vesting schedule – that is, a vesting schedule in which participants gradually become vested over a period of years – EGTRRA provided that the longest vesting schedule that may be used is a 6-year graded vesting schedule (instead of the 7-year graded vesting schedule that was previously permitted for plans that were not "top-heavy"). If "cliff" vesting is used – that is, a vesting schedule in which participants become vested "overnight" – the longest vesting schedule that may be used is a 3-year cliff vesting (instead of the 5-year cliff vesting that was previously permitted for non-top-heavy plans).

(8) ***Roth 401(k) Deferrrals.*** EGTRRA expanded the idea of Roth IRAs into the world of 401(k) plans. Under EGTRRA, a participant may contribute to a 401(k) plan on an after-tax, Roth basis. If the participant does this, the tax treatment is essentially the same as that for contributions made to a Roth IRA. The contribution is taxed before it is put in, but when a distribution is made from the Roth 401(k) account, both the original after-tax contribution and the earnings thereon will be tax free. This change was particularly significant because, unlike Roth IRAs, there are no income limits that would prevent higher income taxpayers from contributing on a Roth basis. Additionally, the dollar amount that may be contributed on a Roth basis is significantly higher than the dollar amount that could be contributed to a Roth IRA.

These are some of the more significant changes that were made by EGTRRA. These changes came with a catch, however. Because of the budget rules that Congress follows when it makes changes to the nation's tax laws, EGTRRA was drafted so that all of these changes would expire after December 31, 2010. In other words, as EGTRRA was drafted and enacted into law, at the stroke of midnight on December 31, 2010, all of these changes would go away and the law would revert back to whatever it was before EGTRRA was enacted.

It was widely expected at the time EGTRRA was passed that Congress would come back later and make these changes permanent. Concern began to grow, however, as the years went by and Congress took no such action. Fortunately, Congress has now acted in the PPA to make these changes permanent. As a result, Roth 401(k)s, the higher contribution limits, and the higher deduction limits that EGTRRA introduced are now a permanent part of the Internal Revenue Code. This alone would cause the PPA to be a significant Act from the point of view of most employers with defined contribution plans.

II. Automatic Enrollment for 401(k) Plans

The PPA authorizes and encourages employees to "automatically enroll" their eligible employees in a 401(k) plan. *This is widely considered to be one of the most significant changes made by the PPA.* Although employers are not required to offer "automatic enrollment,"these new provisions will cause many employers to give it serious consideration.

The concept of "automatically enrolling" employees is fairly simple; the "automatic enrollment" provisions of the PPA are not. The PPA contains three different sets of provisions relating to "automatic enrollment":

(1) The "automatic contribution arrangement" provisions of the PPA authorize the use of "automatic enrollment";

(2) The "eligible automatic contribution arrangement" provisions build on these provisions by providing a handful of optional provisions that employers with "automatic contribution arrangements" may take advantage of if they wish;

(3) The "qualified automatic contribution arrangement" provisions are also optional. Employers that choose to take advantage of these provisions will basically receive a "free pass" on their "nondiscrimination testing" and on their "top heavy" testing in return for providing either a minimum matching contribution or a minimum employer contribution.

Having briefly summarized the three different sets of "automatic enrollment" provisions in the PPA, we also need to say that, at a detail level, they are actually fairly complicated. For that reason, we are summarizing each of these three provisions separately below.

A. Automatic Contribution Arrangements

The most basic form of "automatic enrollment" is known as an "automatic contribution arrangement."

(1) *Types of Plans.* Employers offering 401(k) plans, 403(b) plans, and/or 457(b) plans may offer an "automatic contribution arrangement."

(2) *Applies Only If a Participant Has Not Made a Different Election.* Automatic enrollment will apply *only* to participants who have *not* affirmatively elected to defer some other amount (or no amount at all). In other words, it will apply only to those participants who have not done anything. Instead of deferring nothing, as in the past, they will end up deferring the default percentage of their compensation.

(3) *Optional as to Existing Plan Participants.* Automatic enrollment must be applied to all employees who become participants in the plan *after* the automatic enrollment provision takes effect. It may be applied to employees who are already participants, but this is not required.

(4) *Annual Notice Requirement.* An employer is required to provide an annual notice to employees who are subject to automatic enrollment. The notice must explain the following:

(a) An employee's right to "override" the default deferral percentage by electing a different contribution percentage (including a percentage of zero);

(b) The deadline for making a different election; and

(c) How contributions will be invested (if the participant does not affirmatively choose different investment options).

(5) *Default Investment Rules.* Amounts that have been contributed pursuant to an automatic contribution arrangement must be invested in accordance with "default investment" regulations that the Department of Labor is required to issue (unless the participant has affirmatively elected a different investment option).

(6) *Fiduciary Liability.* Because these amounts will be invested as required by Department of Labor regulations, the fiduciaries for the plan will be relieved from their normal responsibility to ensure that such amounts are invested prudently.

(7) *Preemption of State Law.* State laws that would "directly or indirectly" prohibit deductions from an employee's pay without the employee's express consent are preempted to the extent that a deduction is being made pursuant to an "automatic contribution arrangement."

B. Eligible Automatic Contribution Arrangements

An "eligible automatic contribution arrangement" is generally subject to the same rules as an "automatic contribution arrangement" but with the following differences:

(1) *Not Available for 457(b) Plans Offered by Tax-Exempt Employers.* Any employer that is eligible to offer an "automatic contribution arrangement" may offer an "eligible contribution arrangement" with one exception: A tax-exempt employer that is offering a 457(b) plan is not permitted to offer an "eligible automatic contribution arrangement."

(2) *"90 Day Return Privilege."* If money is contributed as a result of "automatic enrollment," an employer with an "eligible automatic contribution arrangement" may permit an employee to withdraw the money if the employee requests the withdrawal within 90 days after the first contribution. If money is withdrawn, any matching contributions will be forfeited and the amount withdrawn will be included in the employee's taxable income for the year in which

the distribution is made. The employee will not, however, be liable for the 10% penalty tax that would normally apply to premature distributions.

(3) *Returning Contributions Following a Testing "Failure."* If a "qualified" plan fails its required "nondiscrimination" testing, it may be required to return contributions to its "highly compensated" employees in order to correct the failure.

(a) *Normal Rules.* Ordinarily, these contributions must be returned with 2½ months after the end of the plan year and they are reported as taxable income to the participant for the year in which they were originally contributed to the plan. Because of the complexity of nondiscrimination testing, it can be difficult to meet this deadline. Additionally, employees who have already filed their personal income tax returns may find that they have to file an amended return in order to report the additional income that will result from the contributions that have been returned to them.

(b) *Special Rules for Eligible Automatic Contribution Arrangements.* If an employer is offering an "eligible automatic contribution arrangement," the employer will have six months (rather than only 2½ months) to return contributions *and* amounts that are returned will be reported as income for the year in which they were returned (rather than the year in which they were originally contributed to the plan).

It is our expectation that most employers with an "automatic contribution arrangement" will also want to take the handful of additional steps that are required to have an "eligible automatic contribution arrangement."

C. Qualified Automatic Contribution Arrangements

Like an "eligible automatic contribution arrangement," a "qualified automatic contribution arrangement" is generally subject to the same rules as an "automatic contribution arrangement." The differences may be summarized as follows:

(1) *Applies to 401(k) Plans Only.* A "qualified automatic contribution arrangement" is available for 401(k) plans only.

(2) *Initial Deferral Percentage.* The initial deferral percentage for employees who are automatically enrolled must be at least 3% of their compensation. An employer can choose a higher default percentage if it wishes, but the default percentage cannot be more than 10% of compensation.

(3) *Annual Increases in the Default Deferral Percentage.* The minimum deferral percentage increases each year by one percent until it reaches 6% of compensation. If a plan's default percentage is not already equal to the legal minimum, and if an employee has not affirmatively elected a different deferral percentage, the employee's deferral percentage will need to be increased each year until it reaches 6% of compensation.

(4) *Required Employer Contributions.* The employer must provide *either* a minimum matching contribution or a 3% employer contribution. The matching contribution must be equal to 100% of the first 1% of compensation that is deferred and must be at least 50% of the next 5% of compensation that is deferred (that is, 50% of deferrals between 1% and 6% of compensation).

(5) *Vesting.* The required employer contribution – that is, the minimum matching contribution or the 3% employer contribution – must be fully vested after two years.

(6) *Nondiscrimination Testing.* A "qualified automatic contribution arrangement" will automatically pass the "nondiscrimination" tests – that is, the ADP test and the ACP test – that apply to most 401(k) plans.

(7) *Top-Heavy Testing.* Additionally, a "qualified automatic contribution arrangement" will automatically pass "top-heavy" testing.

It is our expectation that many employers with 401(k) plans will be interested in learning more about "qualified automatic contribution arrangements." In some ways, *a "qualified automatic contribution arrangement" may turn out to be a "poor man's safe harbor 401(k) plan."* It will offer most of the advantages of a "safe harbor" plan at what could be, for some employers, a lower total cost.

D. Effective Dates

The preemption of state laws for "automatic contribution arrangements" is effective immediately (although regulations providing detailed guidance on the notices that must be provided have not yet been issued). The remaining "automatic enrollment" provisions will take effect for plan years beginning after 2007. For employers with calendar year plans, this means that they will take effect on January 1, 2008.

III. Default Investment Elections

If a plan permits participant direction of investment but the participant fails to make an investment election – a situation that is likely to occur if a plan offers automatic enrollment – the participant will still be treated as exercising control over the assets in his/her account if those assets are invested in accordance with regulations that will be issued by the Department of Labor. This provision applies to plan years beginning after 2006 and the Department of Labor is required to issue regulations within six months after the enactment of the PPA – that is, by mid-February 2007. As drafted, this provision applies only to plans that qualify for "ERISA § 404(c) relief"; however, there is some indication that the Department of Labor may issue similar regulations that would apply to all plans that permit participant direction of investment.

IV. Investment Advice

Under current law, an employer is potentially liable for any investment advice that is provided to its employees. As a result, many employers were willing to provide "investment education" to participants but were not willing to take the next step by providing specific investment advice. The PPA changes this by protecting employers from liability for investment advice if the investment advice is provided in one of two different ways:

(1) ***Fee-Based Fiduciary Adviser.*** First, a "fiduciary adviser" may provide investment advice to participants if the fees received by the fiduciary adviser do not vary based on the investment options that are chosen. The employer is still responsible, however, for the decision to choose a particular "fiduciary adviser" and for the ongoing monitoring of the performance of that "fiduciary adviser."

(2) ***Computer Model.*** Second, advice may be given using a computer model if the computer model meets certain conditions, if the model is approved by an independent fiduciary, and if various disclosures are made.

This provision is effective for advice provided after 2006, although the Treasury and Department of Labor have been given until December 31, 2007, to determine if there are any computer model investment advice programs that meet the requirements of this provision.

We would note that this is only a brief summary of the PPA's provisions relating to investment advice and that, in the interest of space, a number of important details have been omitted. If you are interested in learning more about this provision, please do not hesitate to contact our office.

V. Faster Vesting for Profit Sharing Contributions

The PPA requires employer "profit sharing" contributions to be vested more quickly. The longest vesting schedule that may be used is either a 6-year graded vesting schedule or a 3-year cliff vesting schedule. This provision is generally effective for employer contributions made in plan years beginning on or after January 1, 2007. As a result of this change, the maximum vesting schedule that may be used for "profit sharing" will be the same as the maximum vesting schedule that is currently permitted for matching contributions.

VI. Participant Statements and Other Communications

The PPA requires increased disclosures to plan participants. New or changed requirements include, but are not limited to, the following:

(1) ***Benefit Statements.*** Defined contribution plans will be required to provide benefit statements at least annually. If the plan permits participant direction of investment, benefit statements must be provided at least quarterly. The Department of Labor is required to provide model notices for this purpose.

(2) ***"Intranet" Postings.*** If an employer maintains an Intranet website for its employees, it will be required to post information from its Form 5500 "Annual Report" on that website in accordance with regulations to be issued by the Department of Labor.

These requirements are in addition to the notices that are required if a plan uses "automatic enrollment" or provides for default investments for those participants who fail to make an investment election.

VII. Hardship Distributions

Under current law, a qualified plan may permit a participant to receive a hardship distribution in the event of a "heavy and immediate financial need" involving the participant, the participant's spouse, or the participant's dependents. The PPA requires the Internal Revenue Service to issue additional regulations that would permit hardship withdrawals if the participant's beneficiary experiences a hardship or unforeseeable emergency, even if the beneficiary is not the participant's spouse or dependent. The IRS is required to issue these regulations within 180 days after the date the PPA was enacted – that is, by sometime in mid-February 2007.

VIII. Distributions for "Qualified Reservists"

If a participant who is a "qualified reservist" is called up to active duty before December 31, 2007, for more than 179 days, a qualified plan may make a distribution to the participant. The participant would not be subject to the 10% penalty for a premature distribution. This provision is retroactive to distributions that were made to "qualified reservists" who were called to active duty after September 11, 2001. If such an individual was required to pay the 10% premature distribution tax on a distribution, he/she may claim a refund or credit if this is done within the one-year period after the PPA was enacted – that is, within one year after August 18, 2006. There is also a special provision that permits "qualified reservists" to "pay back" such distributions to an IRA (but not to the plan from which the distribution was received).

IX. Non-Spouse Rollovers

Under current law, the only persons who may rollover a distribution from a qualified plan into an IRA are the participant and, in the event of the participant's death, the participant's surviving spouse. The PPA modifies this rule so that a beneficiary who is not the participant's surviving spouse will also be able to rollover a distribution to an IRA. If this is done, however, the rollover will still remain subject to the "required minimum distribution" rules, which require amounts to be paid out within a specified period of time. This provision applies to distributions received after 2006.

X. "Missing Participants"

When a defined contribution plan is terminated, the remaining assets must be distributed to the participants. But many times a plan will have at least one participant it cannot find. In this situation, a plan could try to locate a missing participant using a letter-forwarding program run by the IRS and a separate letter-forwarding program run by the Social Security Administration. Although these programs are useful, they do not provide a solution if a "missing participant" fails to respond.

The PPA has addressed the problem by allowing defined contribution plans to use the "missing participant" program that is administered by the Pension Benefit Guaranty Corporation ("PBGC"). The PBGC program has been available for many years, but only for defined benefit plans that are required to be insured with the PBGC. Under the PPA, defined contribution plans that are being terminated may also choose to use the PBGC program. If they are not able to find a participant, the plan may deposit the participant's account balance with the PBGC, which will hold the account balance until the participant is located. This provision will take effect after implementing regulations have been issued.

XI. Employer Securities

Plans that hold “employer securities” will be subject to a number of new requirements. If the employer securities are publicly traded, participants with three years of service would have “diversification rights” (unless the plan is an ESOP that meets certain conditions). Participants would also have the right to receive a 30-day advance notice of their diversification rights. The IRS is directed to issue a model notice for this purpose. This provision is generally effective for plan years beginning after 2006. Additionally, for plan years beginning after 2007, the maximum fidelity bond that is required under ERISA will be increased from $500,000 to $1,000,000 if the plan holds employer securities.

XII. DB(k) Plans

Finally, the PPA authorizes a new type of plan design known as a “DB(k) plan.” The “(k)” comes from the fact that employees will be permitted to “defer” part of their compensation into the plan in the same way that they can defer compensation into a 401(k) plan today. Instead of providing a matching contribution and/or a “profit sharing” contribution that would have to be invested and which would be subject to market risks, however, the employer would provide a guaranteed benefit. This benefit could be calculated using either a traditional benefit formula, such as a percentage of “final average pay” multiplied by “years of service,” or a “cash balance” formula.

DB(k) plans will be subject to higher contribution limits than defined contribution plans. For this reason, it seems likely that the primary appeal of DB(k) plans will be to employers who want to put more money into their retirement plans than they are allowed to contribute to a defined contribution plan. DB(k) plans will be permitted for plan years beginning after 2009.

Please note that the above represents only a *partial summary* of the changes in the PPA affecting 401(k) and other defined contribution plans. We have tried to identify the changes that are most likely to affect our clients and to summarize those provisions as concisely as possible using “plain English.” Having said that, details are important in this area of the law, and some changes that we have not summarized may be significant for some clients.

Finally, it is our expectation that the IRS will be requiring plans to adopt amendments reflecting the changes made by the PPA. The IRS has not yet announced a deadline for adopting any such amendments nor has it said whether or not it will be providing “model amendments” that employers will be able to adopt. We will be keeping an eye on the IRS and will communicate with our clients when there is more to report.

If you have any questions regarding the provisions of the PPA and how those provisions might affect you and your qualified plans, please do not hesitate to contact our office.