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# Pension Protection Act of 2006: Implementation and Aftermath

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## Special Report

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*Well over a year has passed since the Pension Protection Act of 2006 (PPA) became law on Aug. 17, 2006. As summer turned to winter and 2006 transitioned into 2007 – and then 2008, regulatory agencies have worked furiously to turn out regulations and guidance mandated by the PPA. In this five-section special report, we provide the insights of benefit experts on retirement plan administration in this post-PPA world as well as a look at how the PPA affects critical aspects of this important topic as the dust continues to settle.*



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# Pension Protection Act of 2006: Implementation and Aftermath

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## One Year After the Pension Protection Act

It's now been over a year since the Pension Protection Act (PPA) was signed into law. Since then, the focus of Congress, the Departments of Labor (DOL) and Treasury, the Securities and Exchange Commission (SEC) and the public has been much more on the issues of 401(k) fees than on implementation of the 401(k) plan changes required by the PPA.

To some degree other 401(k) plan issues have eclipsed the PPA because most of the PPA was driven by concern about the solvency of defined benefit pension plans. Changes to 401(k) plans were secondary and focused on issues such as the appropriate procedures to encourage automatic enrollment in 401(k) plans while protecting the rights of both the employee and the plan sponsor, standards for default options and investment education.

Unquestionably the most significant "change" in 2007 was the release of various notices, proposed rules and other advisories from the IRS and DOL providing plan sponsors with preliminary guidance needed to implement the PPA. Ironically, one of the PPA's most important features is receiving the least attention. The PPA repealed the Dec. 31, 2010 sunset date for the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), thus encouraging plan sponsors to use 2007 to take advantage of EGTRRA's many features that will now be permanent.

Of course, Congress can always change the laws again, but the elimination of the sunset rule is enormously important.

For example, the sunset repeal makes it possible to adopt the Roth 401(k) after-tax contribution feature and has led to final IRS rules for Roth 401(k) distributions being issued, meeting another important milestone in the adoption of Roth 401(k) account features.

### PPA's Permanence Boosts Roth 401(k) Plans

The initial Roth 401(k) regulations issued in 2006, before the PPA's enactment, were met with little enthusiasm because of questions about the long-term viability of Roth 401(k) arrangements. Also before the PPA, the holding rules for a Roth 401(k) account required that it be held in the 401(k) plan for at least five years to qualify for tax-free earnings. But under EGTRRA as originally drafted, Roth 401(k) features would never have qualified for the tax deferral on earnings because the authorizing law would have expired before any Roth account completed the required five-year holding period. Like the rest of the changes EGTRRA made, the Roth 401(k) provisions of Section 402A were scheduled to sunset after Dec. 31, 2010.

With the PPA's elimination of the sunset, employers now appear more inclined to consider a Roth 401(k) option. Vanguard reported that 14 percent of Vanguard retirement savings plans adopted the Roth 401(k) in 2006 and smaller plans adopted the Roth feature at a faster rate than larger plans (16 percent

versus 8 percent). Five percent of all participants eligible to adopt the Roth 401(k) feature did so in 2006.

According to the Profit Sharing Council of America's (PSCA) Roth 401(k) Survey 2007, 69 percent of companies that do not currently offer a Roth 401(k) plan said they were more likely to do so now that EGTRRA's provisions are permanent. And the latest round of regulatory guidance should help, too. Approximately one-fourth of participants in the PSCA survey, which was conducted before the IRS issued these final Roth 401(k) regulations, cited "insufficient regulatory clarification" as a reason for not implementing a Roth 401(k).

## Mid-year Changes

In late May 2007, the IRS officially blessed the addition of a Roth 401(k) feature or hardship withdrawals in mid-year with Announcement 2007-59, "Guidance for Employers Concerned About Certain Mid-Year Changes to a §401(k) Safe Harbor Plan," specifically holding that such mid-year adoptions will not jeopardize a 401(k) plan's status as a safe harbor plan.

## Roth Distribution Final Rule

As noted earlier, Roth contributions must be held for at least five years, distribution rules were not a high priority before the PPA. Nevertheless, the IRS moved quickly. The final rules on Roth (k) distributions effective for 2007 provide that only "qualified distributions" from Roth 401(k) accounts are eligible for tax preferred treatment. See Box 1 for details on qualified distributions.

Under the final regulations, distributions to an alternate payee or beneficiary, will receive favorable tax treatment based on the participant's age, disability status or death, not the recipient's status.

## Investment Advice Guidance

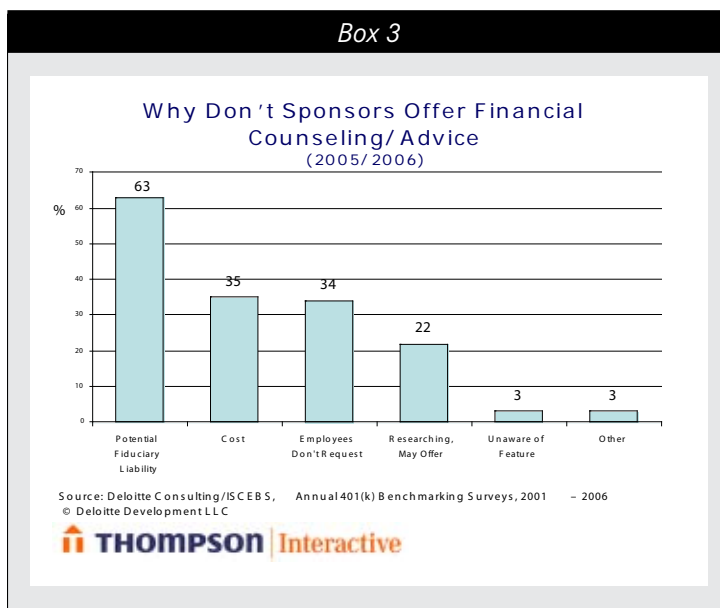
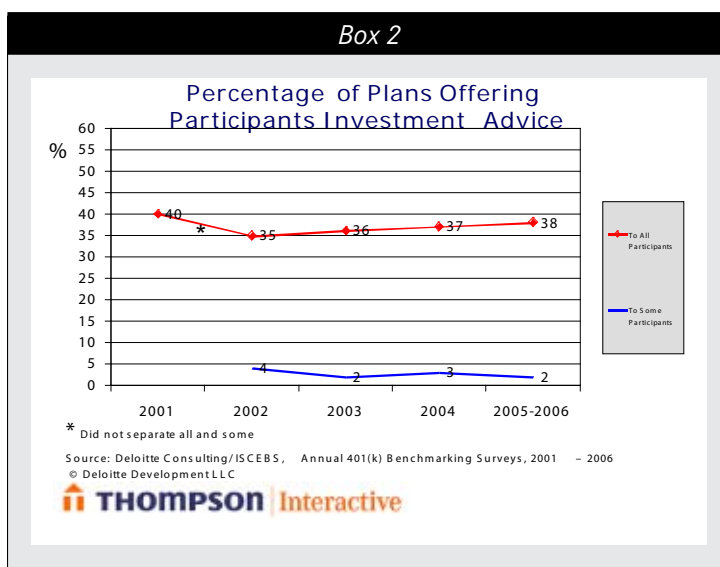
With plan participants increasingly responsible for the investment of their 401(k)

*Box 1*

### Qualified Distributions

A qualified distribution is available only after a five-year period of participation in the plan and must be either:

- 1) made on or after the date the employee attains age 59½;
- 2) made after the employee's death; or
- 3) attributable to the employee being disabled.



#### Box 4

### What Is a QDIA?

Generally QDIAs fall under four basic categories:

- life-cycle or targeted retirement-date funds with mixed investments, usually taking into account the individual's age or expected retirement date;
- an investment service that allocates the individual's contributions among existing plan options, designed to result in an asset mix that takes into account the individual's age or retirement date (this could include a professionally managed account);
- an option that uses a mix of investments taking into account the characteristics of the group of employees as a whole, rather than each individual (such as a balanced fund); and
- a capital preservation product, but only for the first 120 days of participation.

plan assets, investment advice and information have become important to the participant's ability to manage the 401(k) account. Historically, fewer than 40 percent of plan sponsors offered participants investment guidance. Most of those say "fear of liability for the advice" is their primary reason for not offering such advice. (See Boxes 2 and 3 on p. 3).

Rules that protect 401(k) plan sponsors that automatically enroll employees in a 401(k) plan, but do not receive specific investment direction from the enrolled employee were issued Oct. 24, 2007 by DOL's Employee Benefits Security Administration (EBSA). The PPA added provisions that form the basis for these new qualified default investment alternative (QDIA) rules (see Box 4), designed to protect fiduciaries that followed regulatory guidelines when selecting default investments for participants enrolled automatically in 401(k) and similar plans. In the absence of the employee's 401(k) investment choice, the plan sponsor may invest the employee's deferrals in a QDIA without incurring liability for that automatically enrolled participant's 401(k) plan losses. This QDIA rule became available effective Dec. 24, 2007.

This guidance should ease concerns of 401(k) plan administrators and sponsors about fiduciary duties for both the default investments selections that currently hold automatic enrollees' contributions and future investment options. Of course the fiduciary prudence and diligence rules still apply for all investments, so fiduciaries are not entirely carefree in selecting the QDIA alternatives.

These plan sponsor protections were specifically designed to encourage more plans to adopt automatic enrollment and to adopt default investments that could provide more assets at retirement. While DOL has fulfilled its portion of PPA automatic contribution requirements, the Treasury Department and IRS have released their own set of proposed rules (see Box 5).

### Auto Enrollment

As it became clear that automatic enrollment was popular and effective when adopted, employers and investment companies sought regulatory guidance and protection to move plan participants into more appropriate,

#### Box 5

### IRS Proposes Rules on Safe Harbor For Qualified Auto Enrollment Plans

The IRS and Treasury released proposed rules on Nov. 8, 2007, regarding cash or deferred arrangements (CODAs) in 401(k) plans. The PPA created a new safe harbor for 401(k) plans, a qualified automatic contribution arrangement (QACA). If adopted, a QACA will satisfy nondiscrimination testing and, in some cases, exempt plans from top-heavy rules.

The proposed rules establish permissible withdrawal provisions for eligible automatic contribution arrangements (EACA). In order to be considered an EACA, an arrangement must meet the following requirements:

- 1) A participant must be permitted to elect to have the employer make a contribution on his or her account.
- 2) If the above election is not made by the participant, the employer may make an automatic contribution on the participant's behalf equal to a uniform percentage of compensation.
- 3) The plan must satisfy ERISA Section 404(c)(5) requirements for default investments.
- 4) The plan must provide specific information to participants in a notice.

but still relatively conservative investments. The investment industry created and promoted new investment alternatives, such as life-cycle funds that rebalance holdings to less volatile investments as retirement nears, thus providing alternatives for 401(k) plan automatic deferral investments. To further protect both plan sponsors and participants, the PPA authorized plan sponsors to use a variety of QDIAs for automatic enrollees in the plans, rather than simply a money fund or other very conservative default options that had been common for the pioneering automatic enrollment plans.

## Final Automatic Investment Rule Highlights

In the final regulations, DOL replied to a frequently asked question on whether the rule provides fiduciary protection for a plan sponsor's initial selection of the category of QDIA options permitted by the rule, in addition to the protection for the specific QDIA investment product ultimately selected by the plan sponsor. Because any of the alternatives among the defined QDIAs investments satisfies fiduciary requirements, DOL has assured the public that as long as the

### Box 6

#### Qualifying for Relief

Under these new regulations generated by the PPA's statutory requirements, plan sponsors seeking safe harbor relief from fiduciary liability for investment outcomes must satisfy the following requirements:

- The plan must offer a "broad range of investment alternatives" as defined in the DOL's regulation under ERISA 404(c).
- 401(k) plan assets must be invested in a QDIA as defined in the regulation.
- Participants and beneficiaries must have been given an opportunity to provide investment direction, if they have not done so.
- A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. To date, DOL has not indicated it will provide a model notice. (In fact, given the nuances involved in automatic enrollment and in the QDIA rules, a model notice appropriate for most automatic enrollment plans may be all but impossible to create.) However, the regulation requires the notice to include information on:
  - the circumstances that will trigger automatic enrollment, the percentage of salary of such withholdings and the right of the participant to opt out of the plan or to change the contribution percentage and the right to opt out of such withholdings;
  - the right to direct investments;
  - a description of the QDIA, including investment objectives, fees and expenses and risk and return characteristics;
  - a description of the participant's right to direct the investment of the account in other alternative investments; and
  - an explanation of how to obtain information about other investment alternatives.
- Material, such as investment prospectuses for the QDIA, provided to the plan also must be furnished to participants and beneficiaries.
- Participants and beneficiaries must have the opportunity to move investments out of a QDIA as frequently as from other plan investments, but no less frequently than quarterly.
- The rule limits the fees that can be imposed on a participant who opts out of participation in the plan or who decides to direct his or her investments.

fiduciary selects any of the QDIAs classes of investments and complies with the other requirements of the QDIA rule, the rule will protect the fiduciary.

In statutory drafting that will surely trip up a number of employee benefits writers, plan sponsors, lawyers and perhaps even courts, the Congressional drafters placed these new QDIA protections for automatic investments in ERISA Section 404(c).

Section 404(c) was designed to protect plan sponsors from bearing responsibility for losses caused by a plan participant's own actions in managing his or her 401(k) account, but only if the plan offers participants specific rights in such management. Section 404(c) outlines the plan design requirements a plan must meet, if the plan fiduciaries are to have the affirmative defense that the participant, not the fiduciary, controlled the his or her account. In fact, DOL comments in releasing the QDIA specifically note the protection offered to QDIAs is not limited to plans that meet all Section 404(c) requirements. The QDIA regulation also states that a plan does not have to meet Section 404(c) requirements that are not specifically in the QDIA rule. (See Box 6 on p. 5; also see 29 C.F.R. 2550.404c-5(a) (1).)

The final regulations do not absolve fiduciaries of the duty to prudently select and monitor QDIAs, nor do they exempt fiduciaries or the plan from any liabilities arising from prohibited transactions, such as self-dealing.

## **Reaction to the Final Rules**

The final QDIA rules generally have received a favorable reception from most quarters, with one notable exception. The final rules do not include "stable value funds" as a QDIA. Stable value funds typically invest in short and intermediate term bonds, and also are protected by insurance, if bond returns fall below the yield stipulated by the fund. The insurance industry has vigorously protested the failure to include stable value funds as QDIAs.

Apparently, DOL agreed with some stable value fund critics, who argue that the returns from these funds are too low to enable plan participants to achieve sufficient assets for retirement. Some longtime observers of 401(k) plans argue that stable value funds are essential because they guarantee a fixed rate of return. This guarantee is critical for many participants who do not want to manage their 401(k) plan account and are most likely to be those who also have been automatically enrolled in the 401(k) plan.

Supporters of stable value funds also argue that these funds are useful for those nearing retirement, which should not be faced with market fluctuations just as the participant may be ready to cash out of the plan. No doubt the exclusion of stable value funds from QDIA status will be a matter of controversy for some time. However, supporters of the ban on classifying stable value funds as a QDIA will argue that plans are not restricted in offering such funds and plan participants are free to affirmatively enroll in the stable value funds offered by the plan. Hence, the participant can avoid any perceived harm from not having stable value funds used as a QDIA by affirmatively selecting the fund as an investment.

## **Preemption of State-law Limits on Auto 401(k) Enrollment Deductions**

The recent rule package also provides another gift that is not limited to QDIA plans. The rule also includes the PPA provision preempting state laws that would restrict or prohibit automatic

enrollment or contribution arrangements for any 401(k) plan, regardless of whether that plan qualifies for the QDIA rules.

## Fee Disclosure

A proposed rule that will enhance disclosure from service providers to 401(k) and other employee benefit plan fiduciaries was announced by EBSA in late 2007. The proposed rule will help fiduciaries ensure they pay only “reasonable” fees and should help determine what “reasonable” is. The rule stems from the complexity increase in the financial services marketplace surrounding fee relationships and compensation arrangements.

The DOL amendment prohibits plans from entering into transactions with a party in interest and specifies that for a contract to be valid under the regulations, it must fit within Section 408(b)(2).

The regulation applies to the specific service providers (see Box 7) because “there is more likely to be a conflict” with all employee benefit plans, not just 401(k)s.

## Disclosure Requirements

All disclosures between designated service providers (see Box 7) and employee benefit plans must be outlined in writing and provided before a contract is in place. The contract need not be limited to one document; if necessary, detailed descriptions of all services, fees and direct and indirect compensation may be outlined in multiple contracts.

The regulation requires fees be documented in the disclosure and may be expressed as a dollar amount, formula or other value. The proposed rule also defines “compensation or fees” as “money and any other thing of monetary value received by the service provider or its affiliate in connection with the services provided to the plan or the financial products in which plan assets are invested.”

All relationships that may lead to a conflict of interest must be disclosed to the plan. Service providers must disclose the following:

- 1) If they are acting as a fiduciary.
- 2) Any financial or other interest in transaction in which the plan will partake in connection with the contract or arrangement.
- 3) Any material financial, referral or other relationship it has with various parties that may create a conflict of interest for the service provider.

### Box 7

#### How Does the DOL Proposed Disclosure Rule Apply to Me?

The DOL said during a press briefing that the proposed rule applies to those that provide the following services:

- banking
- consulting
- custodial
- insurance
- investment advice (plan or participants)
- investment management
- recordkeeping
- securities or other investment brokerage
- third-party administration, and
- providers that receive any indirect compensation in connection with:
  - accounting
  - actuarial
  - appraisal
  - auditing
  - legal, or
  - valuation services

- 4) If the service provider can affect its own compensation without prior approval from an independent plan fiduciary.
- 5) If any conflicts of interest exist, the service provider must disclose any policies or procedures developed to mitigate the conflict of interest.

Any material changes – that is, if the relationship between the service provider and a third party is one that a reasonable plan fiduciary would consider to be significant – must be provided to plan sponsors within 30 days.

The proposed rule also would impose civil penalties for failure to disclose information to participants and beneficiaries (see Box 8).

#### *Box 8*

### **DOL Proposes Civil Penalty Rule**

The rule would bring civil penalties against plan administrators that fail to disclose certain documents to participants and beneficiaries. The PPA granted DOL authority to assess civil monetary penalties of up to \$1,000 per day against plan administrators for violating the PPA's new disclosure provisions.

While the proposed regulation does not address substantive provisions of the new disclosure requirements, it establishes administrative procedures for assessing and contesting penalties.

### **Proposed Class Exemption**

The DOL also proposed a class exemption for plan sponsors to provide them relief when a contract fails to remain “reasonable” based on the service providers failure to follow disclosure guidelines.

### **401(k) Plan Benefit Statements**

Unlike defined benefit plan pension sponsors, 401(k) plan sponsors generally have little trouble with providing benefit statements to 401(k) plan participants. For many participants, benefit statements are available at any time electronically or are mailed on a quarterly or even monthly basis from the plan record-keeper. A DOL Field Assistance Bulletin (FAB 2006-03) provides guidance on the required new rules of disclosure.

Under the PPA, administrators of defined contribution (DC) plans must furnish statements to participants or beneficiaries who cannot direct investments in their accounts at least once each calendar year. Those participants or beneficiaries who can direct investments in their accounts must be given a statement at least once each calendar quarter. A DC plan administrator must give a statement to any other beneficiary only upon written request.

Considerably more information is required for DC participants or beneficiaries who can direct investments in their accounts, including:

- An explanation of any limitations or restrictions on the participant’s or beneficiary’s rights under the plan to direct investments.

- An explanation of the importance of a well-balanced and diversified investment portfolio for long-term retirement security, and a statement that a portfolio may not be adequately diversified if more than 20 percent of its value is allocated to any one entity's stock (including the employer's stock).
- A notice directing the participant or beneficiary to the DOL's Web site for information about individual investing and diversification.

Statements can be furnished in written, electronic or other appropriate form that is "reasonably accessible to the participant or beneficiary."

## Stock Diversification

The PPA's employer stock diversification rules were implemented by an IRS proposed regulation (73 Fed. Reg. 136701-07 Jan. 3, 2008) that incorporated much of the guidance proposed under Notice 2006-107 (see Box 9).

### *Box 9*

#### **IRS Extends Relief for Employer Stock Diversification**

In Notice 2006-107, the IRS provided transitional relief and guidance for diversification requirements under Code Section 401(a)(35). Recently released Notice 2008-7 extends this relief until the proposed effective date of impending regulations under Section 401(a)(35). With the Jan. 3, 2008, release of IRS' employer stock diversification rules, the proposed effective date will be for plan years beginning on or after Jan. 1, 2009. Plans must continue to comply with Notice 2006-107 until the effective date.

### *Background*

PPA Section 901 created tax code Section 401(a)(35), which provides diversification rights for employees who hold publically traded employer securities in a defined contribution plan. PPA Section 507 created ERISA Section 101(m), which requires each plan to send a participant notice to describe their diversification rights and the importance of diversifying investments.

### *Diversification Requirements*

The diversification rights under the proposed regulation must be provided to each participant, each alternate payee with a plan account and each beneficiary of a deceased participant in an applicable DC plan (see Box 10).

### *Box 10*

#### **What Is an Applicable Defined Contribution Plan?**

A plan subject to Code Section 401(a)(35) under the proposed regulation is a DC plan, which holds publicly traded employer securities. Employee stock option plans (ESOPs) and one-participant retirement plans are exempt from the diversification requirements.

- The plan must provide that individuals with employee deferrals – including rollover contributions – invested in company stock are given the opportunity to sell the company stock and reinvest the assets in another investment.
- If a participant’s account maintains employer-funded company stock – based on an employer contribution – a divestment right must be provided to each participant with at least three years of service, each alternate payee who maintains a plan account regarding a participant who has at least three years of service and each beneficiary of a deceased participant (regardless of years of service). The proposed regulation states that a participant has completed three years of service on the last day of the plan’s vesting period that constitutes the completion of the third year of service or – for a plan that uses the elapsed time method or grants immediate vesting – the employee’s third anniversary.
- If a plan offers company stock as an investment option, participants must be able to sell the company stock and reinvest in a minimum of three investment options. The alternate investment options must be diversified with different risk and return characteristics. The investment options defined in DOL Reg. §2550.404c-1(b)(3) fit the stated requirements.

### **What’s the Hurry? ... PPA’s Effective Dates**

While the IRS and DOL have issued a remarkable amount of guidance and advice in a short time, deadlines are looming for which more agency advice and guidance would be helpful – or are critical. The following table outlines the effective dates for various 401(k) plan provisions, suggesting that much remains to be done by the regulators before plan sponsors can confidently satisfy their many required plan changes. And while working on the “must dos,” plan sponsors will also want to consider changes that would enhance their plans, while reducing their fiduciary risks.

## Pension Protection Act Guidance

Topic	IRC/ERISA § Changes	PPA § No.	Description	Published Guidance	Other Information Available
Annual financial and actuarial information reporting		303	Explains how the PPA provisions relating to PBGC's required interest rate for determining variable-rate premiums apply to certain PBGC requirements (in particular, reporting and disclosure requirements).	Technical-Update 064: Use of Corporate Bond Rate for Certain PBGC Purposes	
Benefit accrual for cash balance and other hybrid defined benefit plans	411	701	Benefit accrual standards	Notice 2007-6, 2007-3 I.R.B. 272	
				REG-104946-07, 72 Fed. Reg. 73680 (Dec. 28, 2007)	
Benefit limitations	436	113	Benefit limitations for single-employer defined benefit pension plans	Proposed §436 regulations on benefit limits	Employee Plans News Flash Aug. 29, 2007
Default investment	401	902	Increasing participation through automatic contribution arrangement	REG-133300-07, 72 Fed. Reg. 63144 (Nov. 8, 2007)	Sample Automatic Enrollment and Default Investment Notice
	411				Employee Plans News Special Edition Nov. 14, 2007
	4979				Employee Plans News Special Edition Nov. 7, 2007
	ERISA §404(c)(5)	624	Treatment of investment of assets by plan where participant fails to exercise investment election.	Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule	Fact sheet on final rule

[Continued on Page 12.]

Topic	IRC/ERISA § Changes	PPA § No.	Description	Published Guidance	Other Information Available	
Distributions	72			IRC Section 415 Final Regs	Form 5329 Instructions updated	
	415	303	Interest rate assumption for applying benefit limitations to lump sum distributions.		Publication 575 updated	
			828	Waiver of 10-percent early withdrawal penalty tax on certain distributions of pension plans for public-safety employees.	Notice 2007-7, 2007-5 I.R.B. 395	Publication 571 updated
			401	845		
	402				Form 1040 Instructions modified	
	403		Distributions from governmental retirement plans for health and long-term insurance for public safety officers	Notice 2007-99, 2007 52 I.R.B. 1243	Form 1040A Instructions modified	
	457				Form 1040NR Instructions modified	
	408	1201(a)	Tax-free distributions from individual retirement plans for charitable purposes		Form 5329 Instructions modified	
	417	302	Interest rate assumption for determination of lump sum distributions	Notice 2007-81, 200744 I.R.B. 899 Rev. Rul. 2007-67, 2007-48 I.R.B. 1047	Form 8606 Instructions modified	
	Diversification	409 ERISA §502(c)(7)	901	Defined contribution plans required to provide employees with freedom to invest their plan assets.	Final Rule-Amendment to Civil Penalties Under ERISA §502 (c)(7)	Employee Plans News Flash Nov. 6, 2007
401		Notice 2006-107, 2006-51 I.R.B. 1114				
		REG-136701-07, 73 Fed. Reg. 421 (Jan. 3, 2008)				
409		Notice 2008-7, 2008-3 I.R.B.				
Domestic relations orders	ERISA 206(d)(3)	1001	Regulations on time and order of issuance of domestic relations orders	Time and Order of Issuance of Domestic Relations Orders		

[Continued on Page 13.]

Topic	IRC/ERISA § Changes	PPA § No.	Description	Published Guidance	Other Information Available
Fiduciary	ERISA §404(a)(1)	625	Clarification of fiduciary rules	Interim Final Rule on Amendment to Interpretive Bulletin 95-1	
				Proposed rule on the Selection of Annuity Providers for Individual Account Plans	
Funding	430	112	Funding rules for single-employer defined benefit pension plans	Proposed §430(f) regulations on treatment of employer contributions	Employee Plans News Flash Aug. 29, 2007
				Proposed regulations on certain mortality tables under PPA	
				Rev. Proc. 2007-37, 2007-25 I.R.B. 1433	
				REG-139236-07, 72 Fed. Reg. 74215 (Dec. 31, 2007)	
409A	116	Restrictions on funding of nonqualified deferred compensation plans by employers maintaining underfunded or terminated single-employer plans		Form 5500 Instructions modified	
Hardships	401	826	Modifications of rules governing hardships and unforeseen financial emergencies	Announcement 2007-59, 2007-25 I.R.B. 1448	Publication 571 updated
	403			Field Assistance Bulletin 2007-2 pertaining to §403(b)	
	409			IRC Section 403(b) Final Regulations	
				Notice 2007-7, 2007-5 I.R.B. 395	Publication 560 updated
Multiemployer plan election procedures	ERISA §3(37)(G)	1106, as modified by amendment in Pub L. 110-028	This notice establishes implementing procedures for certain single-employer plans to elect to be multiemployer plans.	Notice: Election of Multi-employer Plan Status	
Notice	ERISA §502(c)(7)	507	Notice of freedom to divest employer securities	Final DOL regulations on civil penalties under ERISA §502(c)(7)	
	401			Notice 2006-107, 2006-51 I.R.B. 1114	
	417	1102	Notice and consent period regarding distributions	Notice 2007-7, 2007-5 I.R.B. 395	

[Continued on Page 14.]

Topic	IRC/ERISA § Changes	PPA § No.	Description	Published Guidance	Other Information Available
Participant notice of plan underfunding	ERISA §4011	501	Section 4011 of ERISA requires certain underfunded plans to notify participants of plan funding status and the limits on the PBGC's guarantee. PPA repealed section 4011 for plan years beginning after 2006 and replaced the disclosure requirement under that section with a disclosure requirement under Title I of ERISA. This rule amends PBGC's regulation on Disclosure to Participants to reflect that statutory change.	Final Regulation on Disclosure to Participants	
		303	Explains, among other things, how PPA interest rate changes can effect the requirement to issue a 2006 Participant Notice.	Technical Update 063: 2006 Participant Notice	
Phased retirement	401	905	Distributions during working retirement	Final Regulations on Distributions From a Pension Plan Upon Attainment of Normal Retirement Age	
				Notice 2007-69, 2007-35 I.R.B. 468	
				Notice 2007-8, 2007-3 I.R.B. 278	
Premiums	ERISA §4006 4007	401 402 405	This is a proposed rule to amend PBGC's regulations on Premium Rates and Payment of Premiums to implement certain provisions of the Deficit Reduction Act of 2005 (Pub. L. 109-171) and the PPA that are effective beginning in 2006 or 2007. The provisions that would be implemented by this rule change the flat premium rate, cap the variable-rate premium in some cases, and create a new "termination premium" that is payable in connection with certain distress and involuntary plan terminations.	Proposed Rule on Premium Rates; Payment of Premiums; Flat Premium Rates, Variable-Rate Premium Cap, and Termination Premium	

[Continued on Page 15.]

Topic	IRC/ERISA § Changes	PPA § No.	Description	Published Guidance	Other Information Available
Rollover	402	822	Allow rollover of after-tax amounts in annuity contracts	Amendments to Safe Harbor for Distributions From Terminated Individual Account Plans and Termination of Abandoned Individual Account Plans to Require Inherited Individual Retirement Plans for Missing Nonspouse Beneficiaries	Employee Plans News Special Edition
	ERISA §404			Field Assistance Bulletin 2007-2 pertaining to §403(b) plans	
	403	824	Allow direct rollovers from retirement plans to Roth IRAs	IRC Section 403(b) Final Regulations	Publication 560 updated
	408, 408A	829	Allow rollovers by non-spouse beneficiaries of certain retirement plan distributions	Notice 2007-7, 2007-5 I.R.B. 395	Publication 571 updated
	457				Publication 590 updated
	ERISA §404			Publication 575 updated	
	Statements	ERISA § 105	508	Periodic pension benefit statements	Field Assistance Bulletin No. 2006-03
Field Assistance Bulletin No. 2007-03					
Tax-Sheltered Annuities	403(b)	821	Model Amendments for creating or amending 403(b) plans	Rev. Proc. 2007-71, 2007-51 IRB 1184	
Vesting	411	904	Faster vesting of employer nonelective contributions	Notice 2007-7, 2007-5 I.R.B. 395	
Withdrawals	72	827	Penalty-free withdrawals from retirement plans for individuals called to active duty for at least 179 days		News Release IR-2006-152
	401				Publication 590 updated
					Publication 560 updated
					Publication 571 updated
6511	Publication 575 updated				
					Form 5329 Instructions updated

## Editors Discuss Major 401(k) Issues One Year After PPA Enactment

*Lindsey Mullen, editor of The 401(k) Handbook, and Contributing Editor Martha Priddy Patterson looked at current issues affecting 401(k) plans at mid-year 2007. Here's what they discussed...*

### **With regard to the ever-popular debate on fee disclosure – do you think this is an over-hyped issue?**

Fees and disclosures issues concerning 401(k)s have not been “over-hyped” – but it is getting close. The real problem with fees is that too many plan fiduciaries simply do not know all the fees the plan is paying and how much remuneration plan service providers and investment products, in fact, cost. And not knowing is prima facie a violation of two basic ERISA fiduciary duties: the fiduciary requirement to exercise diligence in managing the plan and to use the plan assets solely to pay for the “reasonable” expenses of a plan administration and benefits from the plan.

With more and more retirement plan participants having only 401(k) plans which those employees primarily are funding, plan participants are entitled to know the costs of the fees. Over a career the difference of even 1 to 2 percentage points paid in fees can mean literally thousands of dollars lost – or kept – by the 401(k) account holder. A fiduciary who answers “don’t know” to questions regarding the expenses of the 401(k) plan (and a number of surveys show a significant percentage of “don’t know” responses) has confessed to a violation of fiduciary duty, regardless of whether the actual fees could be considered reasonable.

### **Fee transparency – how much is too much information for plan participants?**

Plan participant information, whether concerning plan fees or any other information about the plan and investment options, is less a question of “too much” or “too little” than of “when and how.” Every plan participant should have easy access to as much information as possible. But the when, how and especially the language used to convey that information is critical. And not all the required information necessarily needs to be delivered in one document.

Fee information should include at a minimum:

- a list of the types of fees charged to the plan and/or the participant;
- a description of the method of calculating fees (flat fee or percentage, etc), the fee amounts and purpose of fees paid by the plan sponsor and/or the plan;
- a similar description of the fees paid by the participant; and
- a few simple examples of the effect fees can have on a 401(k) plan account over a period of years.

Clearly, part of the reason for the difficulty in communications about fees and most other aspects of 401(k) plan operation may be too much focus on disclaimers and “fine print” warnings to protect the plan sponsor and not enough on trying to convey plan information in a concise, direct way. Of course, it is the role of lawyers to protect their clients – the plan or the plan sponsor – against liability. I plead guilty to this from time to time.

Another part of the problem is the laws and regulation of 401(k) plans and other retirement plans are complex and Congress changes them frequently. Drafting 401(k) communications – especially when the applicable law is itself so complex and filled with so many options, exceptions and nuances – is incredibly difficult.

One solution could be a series of “basic information” in bold type literally with “the fine print” placed directly below the basic information. (One of the advantages of conveying such information electronically is the ability offer the option of “click here to see the exceptions and details of ...” the basic statement.) Another helpful feature is a brief list of “Important Basic Terms Used in This [Notice, Booklet, Pamphlet, etc.] at the front of the communication and a “Dictionary of Terms Used ...” at the end of the document.

# PPA Impact on the Form 5500

## PPA Requires Changes to 2007 Form 5500

The Form 5500 did not escape the PPA's reach – further enhancing the law's effect on plans and administrators. And its effect on the Form 5500 has already shown up in the version to be used in 2008 for reporting about 2007.

For eligible plans with fewer than 25 participants, a simplified reporting option is available as stipulated by the PPA requirement that there be a voluntary alternative reporting option for certain plans with fewer than 25 participants.

Instructions on Schedule B (actuarial information) reflect updated mortality tables and valuation codes.

The 2007 filing instructions also included a word of caution advising defined benefit pension plan filers that they must use the 2007 Schedule R as an attachment to satisfy 2008 filing requirements.

## PPA Prompts DOL to Postpone Electronic Filing Mandate

A DOL official announced to a private group in that the agency would give employers another year to comply with the requirement to file their 5500 forms electronically. To blame: the PPA and the DOL's need to be judicious in its use of resources to apply it.

Joe Canary, deputy director at the DOL's Office of Regulations and Interpretations (part of the Employee Benefits Security Administration, EBSA), addressed attendees of a conference the DOL co-sponsored with the American Society of Pension Professionals and Actuaries (ASPPA) in Washington, DC, May 25, 2007. The electronic filing requirement would apply to plan years beginning on or after Jan. 1, 2009, said Canary according to ASPPA. In July 2006, DOL issued a rule making electronic filing mandatory for plan years beginning in 2008, meaning that employers and plan administrators will have to file electronically in 2009.

Canary reportedly said that DOL is giving the extension because some PPA provisions are using the same DOL resources that the electronic filing mandate use.

The DOL later confirmed the one-year delay in an official news release.

## How the PPA Treats Cash Balance Plans

Under the PPA, all defined benefit plans (including cash balance, pension equity (PEP) and other hybrid plans) are not inherently age discriminatory. Effective Aug. 17, 2006 (the new law's enactment date), all such plans can pass a test that clears them of age discrimination so long as each participant's accrued benefit is not less than that of any similarly situated younger employee.

The new law also requires cash balance plans – beginning with the 2008 plan year – to fully vest benefits after three years of service and keep interest credits from exceeding a market rate of return.

The PPA adds new requirements for converting a traditional to a cash balance plan, which will protect older workers' early retirement incentives from being eroded. It prohibits wear away of pre-conversion accrued benefits if the conversion occurs after June 29, 2005.

The PPA eliminates the “whipsaw” problem by allowing the lump sum distribution from a hybrid plan to be equal to the hypothetical account balance of a cash balance plan or the accumulated percentage of final average pay in a PEP plan. This is effective for distributions made after the date of enactment.


Consequently, the PPA describes how any employer considering adoption of a new cash balance plan can establish one that avoids age discrimination claims. However, the new law says that courts should draw no inference from the new conversion and whipsaw standards about questions of age bias in earlier conversions or existing plans. Therefore, litigation on these issues is likely to continue.

With fears of age bias litigation dispelled for new hybrid plans, there are great opportunities for creative plan design, says Tom Veal, a director in Deloitte's National Employee Benefits Tax Group. Veal argues that hybrids in cash balance or pension equity designs can surpass defined contribution (DC) plans in a number of areas.

- 1) They can provide pensions closely related to pre-retirement compensation. A pension equity plan accomplishes that objective automatically by expressing benefits as lump sums derived from length of service and average compensation during a period preceding retirement, typically three to five years.
- 2) They can readily add early retirement incentives in the form of additional cash balance pay credits or enhanced pension equity multiples. Disability benefits are also relatively easy to implement.
- 3) They can pay annuities from plan assets; while a DC plan can purchase an annuity from an insurance company, this is almost always an expensive alternative.
- 4) They can adjust annuitants' benefits for cost-of-living increases.
- 5) In a DC plan, all the investment risk and reward rest with employees, who are not all able to manage it well. Under a hybrid plan, the employer faces risk and reward – which generally leaves everyone better off.

However, he acknowledges that a few DC plan features cannot be replicated by hybrid plans – most notably elective deferrals, hardship distributions and loans. Those are the forte of Section 401(k) plans, which doubtless will continue to flourish.

The elimination of the whipsaw problem will foster a greater range of interest crediting rates in cash balance plans, Veal predicts. The prudent course used to be adopting one of the “safe harbor” rates in IRS Notice 96-8. Now, any interest crediting rate may be used, so long as it does not exceed a “reasonable interest rate” (to be defined by IRS regulations) and is not less than zero on a cumulative basis. If the IRS’ definition of “reasonable” is sufficiently broad, plans may begin pegging interest credits to returns on stock market indexes or even on specific investments. A handful of plans already do that, but their designs have generally been considered ultra-aggressive. They could become the mainstream, particularly for upper-income managers and professionals.

We may see a greater tendency to offer different benefit structures to groups of employees with different levels of sophistication and different retirement needs, Veal concludes. For example, a large employer might have a 401(k) plan for its entire work force, a cash balance plan with hypothetical investment options for upper-level managers, a standard cash balance plan for the middle and lower management ranks and a pension equity plan for the rank-and-file. 

## Domestic Partners' Rights Expand Under PPA Distribution Provisions

The PPA includes two provisions beneficial to employees who are currently in a domestic partnership or similar relationship. They are:

- 1) Section 826 regarding hardship withdrawals; and
- 2) Section 829 regarding account balance rollovers for non-spouse beneficiaries.

### Hardship Distributions

Employee benefit plans may allow a participant to receive a distribution from his or her plan account balance due to certain financial hardship events (for example, medical, tuition and funeral expenses). Before the PPA's enactment, an employee benefit plan could only allow a participant to receive a hardship withdrawal due to a financial hardship affecting the participant or his or her spouse or dependant.

PPA Section 826 adds to the list of persons that may be taken into account in determining whether a participant may receive a hardship withdrawal. As of Aug. 17, 2006 (the day the PPA was enacted), an employee benefit plan can permit hardship distributions for expenses related to medical, tuition (educational) and funerals for a "primary beneficiary" under the plan (see Box 1).

#### Box 1

#### Who Is a Primary Beneficiary?

A primary beneficiary under the plan is an individual who is named as a plan beneficiary and has a right to all, or a fraction of, the participant's account balance following the participant's death.

The employee benefit plan must follow all other relevant provisions regarding hardship withdrawals. PPA Section 826 applies to employee benefit plans under Code Sections 401(k), 403(b), 457(b) and 409A.

In effect, this provision enables a participant to withdraw funds from his or her account balance to pay for certain expenses of his or her domestic partner, but only if the domestic partner is the primary beneficiary under the plan. This change is significant because many, if not most, domestic partners do not meet the tax code's definition of "dependent" and same-sex spouses do not qualify as "spouses" under federal law due to the Defense of Marriage Act.

### Non-spouse IRA Rollovers

Before the PPA's enactment, only a surviving spouse could roll over the account balance of a deceased participant into his or her own individual retirement account (IRA). All other beneficiaries (including dependents, siblings and all other non-spouse beneficiaries) were generally required to withdraw the



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account balance in a lump sum or during a five-year period following the year of the date of the participant's death. The PPA's enactment now enables non-spouse beneficiaries to roll over the deceased participant's account balance to an inherited IRA.

An inherited IRA must be established for the purpose of receiving the deceased participant's account balance in a manner that identifies it as an IRA regarding a deceased individual (for example, Jane Doe as beneficiary of John Doe). What complicates this new rollover provision are the minimum required distribution rules under Code Section 401(a)(9). In short, once a participant reaches a certain age (the minimum required distribution beginning date), he or she must to receive a minimum distribution from his or her account balance. Under Section 401(a)(9), generally, two rules affect beneficiaries who inherit an account balance from a deceased participant (see Box 2).

#### Box 2

### Rules Affecting Beneficiaries

#### **The Five-year Rule**

The five-year rule requires the beneficiary receiving an account balance from a deceased participant to receive the entire amount by the fifth calendar year following the year of the participant's death.

#### **The Life-expectancy Rule**

The life expectancy rule states that a minimum required distribution occurs each year based upon the life expectancy of the non-spouse beneficiary.

Before the IRS released guidance, many viewed the PPA provision allowing non-spouse beneficiary rollovers as extremely favorable in solving an inequity in employee benefit plan tax rules. However, in Notice 2007-7, the IRS attempted to clarify the provision and it became apparent that the IRS was going to interpret the provision more conservatively than many first thought. Moreover, Notice 2007-7 took more than one such conservative position.

The provision seemed to grant the ability to stretch out distributions throughout the beneficiary's life expectancy to certain non-spouse beneficiaries who inherited an account balance for a death that occurred before Jan. 1, 2006 as well as after that date. However, Notice 2007-7 effectively limited this relief to only those non-spouse beneficiaries who inherited an account balance based upon the death of a participant that occurred after Jan. 1, 2006.

The IRS interpreted this provision as optional. However, in the list of 2007 interim and discretionary amendments the IRS said, "pursuant to an impending technical correction, non-spouse beneficiary rollovers will be required for plan years beginning on or after Jan. 1, 2008."

More transition guidance is expected from the IRS regarding these issues; however, it is not known whether it will grant the broad relief that may have been originally intended.

In addition, there was some confusion on the application of the Section 401(a)(9) minimum required distribution rules to non-spouse beneficiaries if the participant dies before his or her “required beginning date” as defined in that section. The confusion arose as a result of potential conflicts between Q&As 17 and 19 of IRS Notice 2007-7.

Q&A 19 has the general rule for determining minimum required distributions in the case of a non-spouse beneficiary rollover. It provides that the rules for determining minimum required distributions applicable to a non-spouse beneficiary under the plan also apply to the IRA. Therefore, if the plan document uses the five-year rule, the IRA should as well.

*Box 3*

**What Factors Can Affect Rollover Scenarios?**

The following chart summarizes the minimum required distribution rules based upon the potential rollover scenarios (taking into account rules provided under Notice 2007-7 and the interpretation in *Employee Plans News*):

	<b>Completes Rollover in Year of Death of Participant</b>	<b>Completes Rollover in Calendar Year Following Year of Participant's Death</b>	<b>Completes Rollover After end of Calendar Year Following Year of Participant's Death but Before Fifth Year Following Date of Participant's Death</b>
<b>Non-Spouse Beneficiary Inherits Account Balance Before Required Beginning Date</b>	Entire account balance may be rolled over and life expectancy rule may be used (unless participant elects to use five-year rule). Participant may elect to use life expectancy rule even if the plan uses five-year rule.	Minimum distribution for calendar year following year of participant's death may not be rolled over, and remaining portion of account balance may be rolled over. Life expectancy rule may be used (unless participant elects to use five-year rule). Participant may elect to use life expectancy rule even if the plan uses five-year rule.	A rollover may occur; however, non-spouse beneficiary is required to take minimum distributions from the IRA and full balance must be distributed by end of fifth calendar year following date of death.*
<b>Non-Spouse Beneficiary Inherits Account Balance After Required Beginning Date</b>	Minimum required distribution during year of death is not eligible for rollover; remaining portion of account balance is eligible for rollover.	Minimum required distribution for calendar year following date of death and prior year are not eligible for rollover; remaining portion of account balance is eligible for rollover.	Minimum required distribution for year the death occurred and all subsequent years before the fifth year following the date of the participant's death are not eligible for rollover; remaining portion of account balance is eligible for rollover.

*\*A rollover may not occur if the rollover is not completed by the end of the fifth calendar year following the year of the date of participant's death.*

However, Q&A 17 has a special exception to the general rule whereby a non-spouse beneficiary can treat the plan as using the life expectancy rule so long as the rollover is made before the end of the year following the year of the participant's death. In a special Feb. 13, 2007 edition of *Employee Plans News* the IRS clarified that the special rule of Q&A 17 trumps the general rule of Q&A 19.

Therefore, as long as the rollover is made before the end of the year following the year of the participant's death, a non-spouse beneficiary can elect to use the life expectancy rule for minimum required distributions from an IRA even if the distributing benefit plan had a provision using the five-year rule. Consequently, several different scenarios could unfold depending when the rollover is made, whether the death occurred before or after the required beginning date and a plan's provision on using the life expectancy or the five-year rule (see Box 3, p. 23).

Because of PPA Sections 826 and 829, domestic partnership law has taken great strides forward. Despite the interpretation that those sections are optional for employers, several companies have already implemented the rules under these sections in order to stay competitive for purposes of recruiting and retaining quality employees.



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