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The Pension Protection Act of 2006: Essential Insights

Special Report

Highlights:

- *Fundamental changes to the philosophy underlying minimum funding standards*
- *Deficit reduction as the basis for a new funding methodology*
- *Higher limits for what an employer can deduct for contributions to its pension plan*
- *New protections for automatic enrollment*
- *Permanence for the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 affecting 401(k) and other retirement plans*
- *New opportunities for creative plan design*
- *A new nondiscrimination safe harbor*



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Introduction

With the stroke of a pen on Aug. 17, 2006, President George W. Bush signed into law the most significant piece of pension funding legislation in more than 30 years. At first blush, the Pension Protection Act of 2006 (PPA) appears to be an effort to shore up the defined benefit pension system. And it is — but it's also so much more.

The law also makes significant changes for investment advisers and 401(k) plan sponsors. These include new protections for automatic enrollment, participant financial advisory services, an added nondiscrimination safe harbor and a new plan design letting small employers combine a 401(k) with a defined benefit plan.

The PPA also provides for faster vesting for some employer contributions, imposes new restrictions on employer stock in plans and requires increased reporting to employees.

In addition, one of the most important provisions of the PPA makes permanent many of the 401(k) and other retirement plan improvements of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Absent the PPA, they would have expired after Dec. 31, 2010. The PPA also makes permanent the Saver's Credit, whose demise had loomed.

The ripple effects of a far-reaching measure like the PPA will be washing many shores for a long time. What are employers and plan administrators to make of this law that affects so many plans and ways in which benefits programs are run?

The Pension Protection Act of 2006: Essential Insights offers the perspectives of three nationally known experts regarding how the new law will affect employers and plan administrators. It serves as a quick and handy resource that will not only inform its readers, but alert them as to what they can expect in years to come now that the PPA has entered the scene.

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The Pension Protection Act and 401(k) Plans: Employers, Individuals and the U.S. Economy

By *Martha Priddy Patterson*

A significant part of the Pension Protection Act of 2006 (the PPA, Pub. L. 109-280) involves 401(k) plan changes and improvements, although the primary driver of that law was the need to shore up defined benefit (DB) pension plans through enhanced funding rules to secure employees' and retirees' pension guarantees.

EGTRRA's Effects on Retirement Plans

Among its many features, EGTRRA:

- raised dollar limits for most retirement plan purposes;
- reduced vesting schedules for 401(k) matching contributions;
- provided for "catch-up" contributions to 401(k)s and IRAs; and
- initiated the new Roth 401(k).

One of the most important PPA features, which may be overlooked or taken for granted, is the elimination of the Dec. 31, 2010 expiration date that would have terminated many of the 401(k) and other retirement plan improvements the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, see box) made. The PPA also makes the Saver's Credit permanent, so it will not expire at the end of 2006. This extension alone is an important boost to the retirement security of employees.

The 2006 PPA — and the continued shift to 401(k) plans and other defined contribution (DC) plans — will affect at least four constituencies, some profoundly.

- **Employers** who maintain and, in most cases fund the plans, at least partially, will be subject to new rules affecting both 401(k) plans and pensions. Fortunately, most of the changes affecting 401(k) plans are positive.
- **Employees** will be more responsible for funding and managing their own retirement savings and will see several changes to retirement benefit plans. Increasingly, these individuals will need education and support in investing their own retirement savings both as individual savers and as participants in DC plans.
- **Regulators**, including the IRS and Department of Labor (DOL), must craft new plan rules in response to the 1,100 page law — almost always playing "catch up" with Congress. Securities law regulators at the federal and state levels charged with protecting investors, including retirement plan participants, will have new challenges as individuals retire with lump sum payments to be invested. In most cases these lump sum distributions will be more money than the individual has ever managed — money that needs to last a lifetime.
- **Capital markets and the national economy** will also experience the effects of the shift from employer-operated pension plans to employee invested and managed DC plans. The capital markets may see fewer institutional buyers for

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their securities as DB plans are terminated, liquidate their holdings or freeze their plans, and stop adding money that must be invested to their plans. Recent studies, including one by the U.S. Government Accountability Office, do not indicate that retirees will “dump” their shares causing a market down turn. But what has not been studied is the effect on the overall national economy if the big-spending baby boomers and gen-X’ers, who will retire without DB pensions, stop spending because they fear outliving their DC account balances.

Employers and the PPA

U.S. employers are competing in a global economy in which in many countries either the government provides rich retirement benefits or there is no expectation or concept of retirement. Clearly, to be competitive, all U.S. labor costs must be efficient — including retirement benefits. While there is significant debate about whether the defined benefit pension funding rules and other changes will preserve pensions or only hasten their demise, employers are increasingly looking to 401(k) plans and other variations of DC plans to supply the bulk of their retirement benefit obligations.

Looking for New Products (Efficient and Cost-controlled)

Employers’ recognition that they must control retirement benefit costs does not mean they want to drop all retirement benefits. But it does mean that employers are looking for innovative plans and investments that provide efficient retirement plan benefits while controlling the costs and the funding volatility of plans. Numerous entities are seeking new ways to increase retirement security through basic changes such as 401(k) automatic enrollment and “step up” plans that automatically increase 401(k) deferrals over time or as the employee’s salary increases. Many of the changes in the PPA encourage these innovations.

Finding a Safer Way to Annuitize 401(k) Account Payouts

This quest for controlling the expense of retirement benefits is already leading to new products. For example, recognizing the inefficiencies of the DC plan as a payout mechanism in which the retiree bears all the risk of investment, various entities are designing annuity products that would be offered only to groups of employer plans. Participants would be offered the option of buying an annuity based on their 401(k) plan balance that would guarantee lifetime benefits and survivor benefits. By collecting large pools of individuals from known employee populations, the annuity provider could not only spread the risk, but also increase the investment power and keep administrative costs to a minimum.

Seeing Opportunity to Embrace Simplicity

The shift to 401(k) plans as the major retirement plan also may be an opportunity to reduce the complexity of the 401(k) plan’s operations and investments. For the last decade or more, 401(k) plan sponsors have been urged to offer more investment choices, more options for matching contributions, loans, hardship distributions, etc.

It is now time to reflect on whether these features actually encourage individuals to enter the plan, stay in the plan, and pay attention to their plan investments. By now,

most plan sponsors are familiar with the “jam studies” showing that when individuals are facing a few options they will “test” the options and make a decision, but when faced with dozens of options, they give up, refuse to choose, and refuse to buy. Maybe it’s time for employers to step back and simplify plan options rather than continuing to increase options and complexity.

401(k) Plan Automatic Enrollment

Automatic enrollment can easily overcome the employee inertia factor, and the PPA contains a number of new advantages for 401(k) plans that use automatic enrollment. Among the most important is the PPA’s specific preemption of state laws that restrict the percentage of wages an employer can withhold from an employee’s pay without the employee’s specific consent. These so-called “wage payment” laws were primarily designed to protect employees from creditors’ demands for repayment of debts directly from the employee’s wages. Under these laws, creditors generally must obtain a court order — usually a garnishment — before employers have to abide by such a diversion of pay absent the employee’s consent.

The 401(k) plan rules require virtually universal coverage if automatic enrollment is used. Consequently, if an employer received a garnishment notice for an automatically enrolled employee, that garnishment amount, when added to the 401(k) automatic enrollment deduction, could exceed the state law’s imposed withholding limit. In that situation the employer could face the dilemma of violating a state court order, a state law or the federal 401(k) rules. Not surprisingly, many plan sponsors believed the advantages of automatic enrollment did not outweigh the conflict of legal issues automatic enrollment could generate. But the PPA sweeps away those legal uncertainties.

The PPA also removes other disincentives to adopting automatic enrollment. First, the law explicitly includes automatic enrollment plans in the ERISA Section 404(c) protections that shield 401(k) plan sponsors from liability for a participant’s poor investment decisions. This 404(c) protection will apply so long as the plan sponsor:

- 1) gives the employee the legally required notice of the right to opt out of automatic enrollment; and
- 2) invests the automatically deferred amounts under the DOL’s published guidance for appropriate automatic enrollment investments.

The PPA directs the DOL to issue regulations implementing this provision by Feb. 14, 2007, but the agencies have been known to miss such deadlines.

Second, the PPA removes another disincentive by enabling plan sponsors to stop (or “unwind”) automatic deferrals and distribute them as cash to the employee if the employee affirmatively opts out of automatic enrollment within 90 days of the first automatic deferral. Some employers refused to adopt automatic enrollment — and most plan record keepers did not encourage it — because they feared a substantial number of employees would act belatedly to disenroll from the 401(k). Those automatic deferrals, like most 401(k) deferrals, could not be distributed except in very limited circumstances (e.g., after age 59½). Consequently, the plan quickly could acquire a number of very small accounts and these frequently could be forgotten or abandoned as employees leave without taking their small 401(k) balances. (For an

extended time to correct excess deferrals that accommodates this 90-day “unwinding” period, see box.)

These abandoned small accounts have the potential to generate significant costs, especially in high-turnover industries. Ultimately the cost of managing these accounts could become an expense issue for any kind of employer. Yet most observers dismiss the possibility of massive opt outs after a short time in the 401(k) plan. They believe the same inertia that kept employees from affirmatively enrolling in the 401(k) plan will also keep those employees from acting affirmatively to stop the withdrawals, except in instances in which the individual is facing true hardship.

How the PPA Extends Time for Correcting Excess Contributions under Automatic Enrollment

Employers may adopt automatic enrollment arrangements that comply with the Pension Protection Act’s notice and opt-out standards but not the safe harbor contribution amounts. For those employers, it still will be necessary to perform annual nondiscrimination testing. However, the Pension Protection Act lets employers take six months to correct excess contributions instead of the usual 2½ months to avoid a 10-percent excise tax. This extra time can be especially important when plan contributions fluctuate due to the withdrawals made by employees that opt out of the plan within 90 days after initially becoming participants under the automatic enrollment mechanism.

New Automatic Enrollment Safe Harbor

Automatic enrollment has an important side effect of making it easier for the plan to pass the 401(k) nondiscrimination tests and also enables highly compensated employees to contribute a higher percentage of their compensation to their 401(k) accounts. The new law includes other substantial improvements that should encourage the adoption of automatic enrollment features.

First, a new safe harbor allows automatic enrollment plans another way to avoid nondiscrimination testing (see box) for both elective deferrals and matching contributions. To qualify for the “qualified automatic enrollment feature” the deferrals must be at least 3 percent of compensation in the participant’s first year of participation, increasing by 1 percentage point each year up to 6 percent in the fourth year and remaining at least at 6 percent thereafter. The automatic deduction cannot exceed 10 percent and the percentages must be applied uniformly to all automatically enrolled employees.

For non-highly compensated employees (NHCEs), the employer also must provide either:

- 1) a nonelective contribution equal to at least 3 percent of the employee’s compensation; or
- 2) a matching contribution of 100 percent of at least 1 percent of the participant’s compensation and 50 percent of the employee’s deferrals between 2 and 6 percent of compensation.

The matching rate for highly compensated employees (HCEs) cannot exceed that for NHCEs. Plans using this approach must vest employer contributions 100 percent within two years. This grants the employer more time to vest such contributions than is the case with the existing nondiscrimination safe harbor (in which an employer

Three Nondiscrimination Testing Alternatives for Automatic Enrollment Plans

With the Pension Protection Act's new safe harbor for nondiscrimination testing, employers now have three different methods for testing 401(k) plans with automatic enrollment features:

- 1) the traditional numerical tests examining each eligible participant's deferrals;
- 2) the existing safe harbors requiring the employer's contribution of limited nonelective contributions or matching contributions; or
- 3) the new approach that could range from 3 to 10 percent of the participant's compensation.

may use automatic enrollment or it may not). The employer's contributions under the existing safe harbor must become vested immediately.

Other Barriers to Automatic Enrollment Removed

"Step-Up" Programs

With these changes, automatic enrollment should become much more common; hence, more effective in fostering growth in employees' accounts and in helping the plan satisfy the nondiscrimination rules if the plan sponsor prefers not to use the safe harbor method of complying with those rules. But automatic enrollment is not a panacea for an employee's ability to create significant retirement savings. Recognizing this, some plan sponsors are also using "step-up" programs that automatically increase participants' deferrals each year.

According to Deloitte's 2005 survey data, 16 percent of plans offer step-up features on a stand-alone basis, and another 2 percent offer it as part of an automatic enrollment feature. Among those plans currently using the step-up feature, 91 percent are satisfied with the step-up program, although only about 8 percent of participants have enrolled in the step-up feature. Plans that do not use a step-up feature will need a good campaign to urge employees to look beyond automatic enrollment and increase their savings whenever possible.

Roth 401(k) Finally Viable

The elimination of the scheduled 2010 sunset for Roth 401(k) plans should provide a significant boost for those plans. Roth 401(k) plans, which are funded with after-tax dollars, permit retirees to withdraw all amounts — their original investment and all the earnings — on a tax-free basis at retirement, to the extent the amounts have been held in an account that has existed for at least five years.

Before the elimination of the 2010 sunset of the Roth (k) provision, no Roth (k) plan account holdings would have qualified because the Roth accounts would not have met the five-year qualification period. Deloitte Consulting's survey data indicate that only 12 percent of 401(k) plan sponsors have adopted the Roth approach and another 18 percent were considering a Roth feature. The Deloitte data also showed almost one-third of those 401(k) plan sponsors that were not offering Roth 401(k) plans cited the sunset or other potential legislative changes as their reason for avoiding those plans.

Now with the permanence of the Roth 401(k) provisions, these data suggest the Roth 401(k) plans are likely to become more popular. Roth 401(k) plans could be especially attractive to low-income and younger workers. These employees generally pay relatively low tax rates and do not receive as much immediate benefit from the tax advantages of traditional pre-tax 401(k) deferrals as those employees in higher tax brackets. The fact that no earnings on the Roth 401(k) plan will be taxable in retire-

ment could be especially attractive to younger employees because they will have decades in which to accrue tax-free earnings. In addition, when these employees retire, they could well find themselves subject to higher tax rates in retirement than apply today. The distribution of the tax-free Roth 401(k) amounts would generate additional tax savings from use of those 401(k) plans. Plan sponsors offering the Roth feature may want to give special attention to publicizing these features to those employees.

New Auto-K+Pension Option for Employers of 500 or Less

Small employers traditionally have had a difficult time maintaining a DB pension plan. The considerable administrative costs of such plans and the extreme volatility of pension funding requirements are simply too much expense and uncertainty for many small employers. The PPA offers an intriguing new option that may entice employers with 500 or fewer employees to reconsider pensions. This new option combines an automatic enrollment 401(k) plan and a DB pension plan. Known as the “auto-K+Pension” plan, it will have one combined plan document and one trust and file one Form 5500, thereby reducing administrative costs considerably. Otherwise the 401(k) plan and the DB plan will operate independently, with both plans required to satisfy all tax and ERISA rules applicable to their specific plan designs.

What makes the “auto-K+Pension” intriguing is the opportunity to fund a relatively modest pension benefit; yet, when coupled with proceeds from the 401(k) plan, the combined plans could yield plan participants a significant retirement income. The modest pension benefit would enable the employer to share some of the risk of investment and longevity with employees, but would still require each employee to contribute substantially to his or her own retirement savings.

Additional Prohibited Transaction Exceptions

The PPA also includes a number of new prohibited transaction exemptions, which recognize the complexities of an increasingly international economy and investment markets with various money management and transfer techniques that make it difficult to detect prohibited entities or transactions. These include relaxed prohibited transaction exemptions for arm’s length transactions regarding:

- block trading, involving significant numbers of shares by a fiduciary holding unrelated client accounts;
- trades between a plan and party-in-interest of the plan through communication, when the parties are unknown and the fiduciary is aware such transactions may occur;
- exemptions for service providers (who are not fiduciaries); and
- certain foreign exchange transactions.

Employees and the PPA

As for employers, perhaps the most important change in the law for employees is the fact that the PPA makes permanent the increased annual contribution and benefit limits for IRAs, 401(k) and other plans, both individual and employer-sponsored.

Without the PPA, the significant increases in permitted retirement plan funding, including catch-up contributions for those age 50 and older, were scheduled to expire at the end of 2010. The PPA also extends the important “Saver’s Credit” that enables low-income individuals to deduct contributions to 401(k) plans, 403(b) plans and IRAs. The Saver’s Credit is especially helpful because the very act of deferring income to the 401(k) plan may make the individual eligible for the credit. This point should also be a valuable selling tool for 401(k) plan enrollment.

Shifting the Risks of Retirement Plan Investment

These changes increasing employees’ limits on individual saving vehicles in IRAs, 401(k) and other plans are essential, because more and more employees will have to bear the overall responsibility for their retirement saving, even when the employer is providing the plan. The substantial changes in funding and maintaining defined benefit plans will not stem the closing of defined benefit plans. In fact, many pension experts argue the PPA changes will increase the termination of these traditional pension plans.

The loss of DB plans means saving for retirement will become less efficient. The irony here is that virtually no employer would manage the enterprise’s pension plan investments. Pension plan sponsors hire legions of professional managers to choose and monitor plan investments for their DB plans. Plan sponsors also typically look to financial experts for help in choosing the investment options their 401(k) plans offer.

Yet in most 401(k) plans and many other DC plans, the plan sponsor leaves the selection among the plans’ investment options entirely to the individual. The employee bears all the risk of investment, and may have a relatively limited range of investment choices. By contrast, DB plans have huge assets, making diversification and hedging available in a magnitude simply not available to any individual’s account. In addition, the 401(k) account as a true retirement vehicle is inherently inefficient. Unlike DB plans, whose benefits last a lifetime and cease at death (or, in some cases, the survivor beneficiary’s death), there is no guarantee 401(k) accounts will last a lifetime. Consequently, underfunding the 401(k) plan during working years or overspending in retirement means running out of money. But funding heavily and spending sparingly in retirement means the individual may needlessly deny a more comfortable working life and retirement only to leave a large estate.

Only if employees are aware of their responsibilities can 401(k) plans be adequate to the task of funding retirement — in fact, more than adequate to build a secure retirement. The employee must start to save when young, continue that saving consistently and have access to reasonable investment options. In addition, the 401(k) participant must have the knowledge, interest and time to actually make relatively reasonable investment decisions. And the employee must do all this while diligently focused on and working towards the employer’s business purposes and goals. New products such as life cycle funds, auto enrollment and automatic increases in the amounts deferred into the 401(k) plan help the employee with that quest.

Investment Advice

Many 401(k) plans offer numerous investment options, including “managed” and “lifestyle” funds, but ultimately 401(k) plans and other DC plans put the burden of financial management and the risk of investment on busy employees who may lack the time and information to successfully handle this responsibility. While all parties recognize the need for financial advice for 401(k) participants, fears about fiduciary liability for poor financial advice have restrained employers from offering access to financial advisors. Deloitte Consulting LLP’s latest 401(k) survey found more than half of all respondents did not provide any financial or investment advice and 63 percent of those who did not provide advice cited fiduciary liability as the reason.

At the same time, an employee’s personal financial adviser may have difficulty understanding or even obtaining the specific rules of each client’s employer-provided plans. Consequently, it becomes challenging for even the most thorough personal adviser to provide individual clients with detailed advice on the client’s employer plans. Additionally, while most individual financial advisers may not be aware of the fact, any entity that offers financial advice about an ERISA plan for a fee becomes a fiduciary with respect to the plan. Consequently, personal financial planners take on a considerable risk when they begin to advise an individual on his or her employer plan.

The DOL recently confirmed that position in Advisory Opinion 2005-23A (Dec. 7, 2005). That opinion addressed a situation in which a plan sponsor asked whether an investment advisor who had been hired by a plan participant to manage the participant’s account in a plan meeting the requirements of ERISA Section 404(c) was a fiduciary under ERISA. The DOL’s response was:

In a participant-directed account meeting the regulatory requirements of section 404(c) set out at ERISA Reg. sec. 2550.404c-1, a participant-selected adviser, “such as a financial planner or investment manager or adviser” who receives compensation is a fiduciary and would be liable to the participant for imprudent investments, even though the participant selected the individual.

At long last, the PPA recognizes these issues and provides some encouragement for employers who want to provide access to professional advice. First, the PPA offers a prohibited transaction exemption allowing plan fiduciaries to receive compensation for giving participants investment advice on investments in self-directed plans. The PPA offers protection to the employers and the advisers who advise employees through an “eligible investment advice arrangement.”

The PPA and Investment Advice

The PPA removes a number of barriers to employer-provided investment advice, but before an individual can maximize such investment advice — and retirement saving and ultimately managing plan withdrawals once retirement begins — he or she needs basic financial advice.

Study after study shows that most Americans do not understand basic financial concepts such as the time value of money and the differences between stocks, bonds and mutual funds. This lack of individual basic financial education is not due to the absence of education sources. Numerous independent financial literacy and education programs and tools are available for free; many others are available for a nominal fee.

Delivering this required basic financial education should not necessarily become the duty of the employer. Yet, to maximize and protect the value of employer-provided retirement benefits, employers, educators and public interest groups should be joining together to encourage individuals to seek out and use these financial literacy and education programs.

Under an eligible investment advice arrangement, the adviser must be one who is subject to regulation by the SEC or other entity regulating financial advice. The adviser must acknowledge that he or she is a fiduciary to the plan with respect to the advice offered. These investment advice arrangements must provide that fees will not vary based on any investment option selected.

Alternatively, the advice can be a computer-generated plan that:

- 1) uses generally accepted investment theories based on historic returns;
- 2) takes into account the participant's age, retirement age and risk tolerance;
- 3) uses objective criteria to create investment portfolios;
- 4) is not biased in favor of the adviser or its affiliates; and
- 5) appropriately weights investment options.

The employer or other fiduciary will not be responsible for the individual advice given to employees. However, in selecting the advisers and ensuring that the advisers meet the requirements outlined in the PPA for professional advice, employers and plan fiduciaries still will be subject to the same ERISA fiduciary standards of skill, prudence and diligence that apply to their other plan responsibilities.

As noted, the investment advice provisions contain a number of required notices. The DOL is responsible for issuing models of these notices, but the law does not appear to have a deadline for DOL's release of these notices.

Existing Regulatory Guidance Status

Some observers believe the requirements under the PPA are more stringent than the DOL's existing guidance on financial advice provided in a 2001 DOL advisory opinion.

That opinion authorized SunAmerica to engage independent financial experts to create asset allocation portfolios for individual plan participants in plans administered by SunAmerica. SunAmerica had no influence or control over either the development of the programs or their communication to the plan participant. The independent experts' compensation from SunAmerica was not related in any way to fees or other income SunAmerica received from investments made as result of the expert's portfolio construction or recommendations.

In light of PPA's statutory guidance for investment advice, it remains to be seen whether the DOL will withdraw the SunAmerica advisory opinion. However, the PPA specifically states that its provisions will not affect existing prohibited transaction exemptions.

Quarterly 401(k) Plan Statements

While many employers' plans currently offer 401(k) participants access to their 401(k) accounts on a daily basis, using the internet, the PPA now requires plans to provide 401(k) statements at least quarterly to each plan participant. Such statements must include the value of account assets and inform participants of their rights to diversify and of the importance of maintaining a diversified portfolio. The PPA does not specify whether these statements can be provided through electronic means

or at a website. However, given the strong U.S.-government-wide trend toward all electronic communication, it is reasonable to believe that electronic delivery of statements would be permitted so long as the plan sponsor can be reasonably certain that respondents have access to electronic communication and paper notifications are sent if the participant elects to receive paper notices.

Regulators — More Work and New Challenges for the IRS, PBGC, DOL and the SEC

Any change in ERISA's retirement provisions usually imposes heavy burdens on the IRS, the Pension Benefit Guaranty Corporation (PBGC) and DOL's Employee Benefits Security Administration (EBSA). The PPA is no different. And a number of provisions affecting 401(k) plans have an effective date of Jan. 1, 2007, which only increases the burden to produce guidance in the form of regulations, notices, etc. Fortunately, EBSA, the IRS and the PBGC have monitored the legislative provisions closely and been consulted by Congress, so those agencies' regulatory tasks are somewhat eased. And the agencies appear to be attempting to issue needed guidance as rapidly as possible. For example, within days PPA's enactment, the IRS released important guidance on interest rates for pension funding calculations.

Employers, plan sponsors and plan administrators can be expected to pose a number of questions that the agencies may not be prepared to answer definitively for months. As with almost any complicated new law, retirement plan advisers are discovering a number of ambiguities. Organizations such as the ERISA Industry Committee, the American Benefits Council and other retirement plan associations are currently drawing up lists of questions to pose to the agencies in hopes of having some ambiguities cleared up before the effective dates in the law. In some cases, to achieve the law's true intent, Congress may have to enact "technical corrections" in the law to resolve contradictions and errors in the drafting.

New Urgency for Securities Regulators Focusing on Retirement Savings

The growing importance of 401(k) plans means that they serve as an increasingly important source of capital for the national economy. At the same time the risk of 401(k) investments continues to be borne by individual 401(k) plan participants.

Undoubtedly, the ranks of financial advisers will grow to meet — and help create — the need and availability of financial advice about building and investing retirement saving during working years and management of that money at retirement. Most of these advisers will be skillful and diligent, but inevitably some will be incompetent and others will be frauds. The DOL will continue to have the authority and responsibility to regulate plan sponsors and provide new responsibilities for those offering advice to ERISA plan participants. And they will need to redouble their efforts in this area.

Those nearing or beginning retirement will be even more vulnerable. With the beginning of retirements among baby boomers, who will need to reinvest the proceeds from their 401(k) plans, a great deal of money will be coming into the hands of individuals who may have limited ability, training and time to manage those assets efficiently. Following the motto of the famous 1930s thief, Willie Sutton, "I rob banks because that's where the money is," unscrupulous or merely incompetent "financial

advisers” will increase in numbers and prey on retirees with large accounts, because “... that’s where the money is.” (A mere eight days after the enactment of the PPA, one of the authors of this publication (who has never studied or provided personal financial planning) received an e-mail from a totally unknown source offering extensive lists of prospective clients for fee-only financial advice.)

Once the retirement money is out of the employer accounts, the DOL and the IRS will have no regulatory role in preserving these retirement assets. The Securities and Exchange Commission (SEC), as well as state government securities regulators, will need to increase their regulatory oversight of investment advisers, to cope with and deter such fraud. Avoiding massive fraud on the newly enriched former 401(k) account holders will require prompt action by the SEC and its state counterparts to protect retirees from unscrupulous or incompetent financial advisers.

Fortunately, the SEC already has begun a plan of action aimed at fraud against senior citizens. The agency began with a July summit organized by Chairman Christopher Cox that focused on how regulators and others can better coordinate efforts to protect older Americans from investment fraud and abusive sales practices. Chairman Cox recognized that older Americans are investing more through 401(k) plans and other investments and are ripe targets for fraud. “Those who would rob older Americans of their retirement nest eggs steal more than hopes and dreams — they erode the trust on which our entire financial system and economy depend,” Cox acknowledged.

Public Policy, Economy and Capital Markets in Shift from DB to DC

Concern about protecting retirees’ 401(k) plan and other assets is not paternalism towards older individuals. It is a matter of national economic security. Retirement plans of various types now represent trillions of dollars in the U.S. economy. Among DB plans, that money is almost always managed by entities regulated by the SEC and the investments in the plans are regulated by the DOL and the PBGC. While fraud in pension plans is not unknown, it is relatively rare and usually quickly discovered and prosecuted.

But 401(k) plans’ individual accounts — giving employees liberal investment choices and options for trading in those choices — are more subject to manipulation as recent cases have shown. When those cases have occurred while the investments were in the 401(k) plan, employers and plan administrators could act to protect the individual and the plan from unscrupulous advisers generating these trades. But once the individual has retired, the employer’s responsibility — and capability — to protect assets distributed from the 401(k) ceases. At that point, securities regulators must step in.

When a retiree loses his or her retirement assets to fraud, it is tragedy. But those losses also affect capital markets by reducing the pool of funds available from legitimate investors. For all of these reasons, securities regulators at every level, as well as professional societies representing legitimate, competent financial advisers, should act now to inform investors, especially those investing their retirement plan benefits — and potential fraudulent “advisers” — that authorities are alert to fraudulent schemes and will be ready to prosecute the perpetrators.

Next Steps

The effective dates of these provisions vary greatly and many of the provisions will require further guidance from the IRS or the DOL in the form of notices, rulings, advisory opinions, and, ultimately, regulations. The good news is that most of these provisions are focused on increasing retirement saving and the security of those savings.

Effective Dates of Pension Protection Act (Pub. L. 109-280)

Defined Benefit Plans

Generally the effective date for single employer defined benefit plan funding changes is plan years beginning after Dec. 31, 2007. This date is delayed for collectively bargained plans. The major exceptions to these effective dates are noted below.

- A special transition rule applies for plans that were not paying a deficit reduction contribution in 2006. This rule permits plans to avoid funding based on the new generally applicable amortization schedule, if the plan's assets equaled or exceeded the funding target. In these cases, the otherwise required funding targets will be phased in over four years, beginning with the 2008 plan year.
- The new segmented yield curve, which can be used to determine interest rates for minimum required contributions to defined benefit plans, will be phased in over three years, at the rate of one-third in 2008, two-thirds in 2009, and 100 percent in 2010. Alternatively, plans may elect to use a full yield curve.

Following is a chart outlining the dates various provisions are effective.

Defined Contribution Plans

Effective Dates of Pension Protection Act

Provision	Effective Date
Protections for fiduciary advice under an eligible investment advice arrangement	Advice provided after Dec. 31, 2006
401(k) benefit statements to participants and beneficiaries; quarterly for participant-directed plans; annually for nonparticipant-directed	Plan years beginning after Dec. 31, 2006
Faster vesting (3 year cliff or 2 to 6 years) for employer contributions to a defined contribution plan	Plan years beginning after Dec. 31, 2006 (special transition periods apply for leveraged ESOPs and collectively bargained plans)
Automatic 401(k) enrollment safe-harbor limit on application of state garnishment laws	Effective Aug. 17, 2006
401(k) automatic enrollment 404(c) fiduciary protections applied (DOL regulations required by February 2007)	PYs beginning after Dec. 31, 2006
A plan participant may qualify to take a hardship distribution based on a hardship need of any of any of his or her beneficiaries	Hardship distributions provided after Aug. 17, 2006; regulations to be published within 60 days of Aug. 17, 2006.
Direct trustee to trustee transfers to IRAs for nonspouse beneficiary of deceased employee	Distributions after Jan. 1, 2006
Combined Pension+401(k) Plan for small employers	PYs beginning after Dec. 31, 2009
Notice to participants of right to divest of employer securities	PYs beginning after Dec. 31, 2006
Form 5500 Annual Reports filed only in electronic format	PYs beginning after Dec. 31, 2007
Prohibited transaction exemptions for block trading, cross-trading, etc.	Transactions after Aug. 17, 2006
Correction of securities and commodities transactions corrected promptly after discovery (usually within 14 days)	Transactions discovered after Aug. 17, 2006
Tax refunds sent directly to IRAs permitted	Taxable years beginning after Dec. 31, 2006
Missing participant PBGC program for multiemployer plans, defined contribution plans and other plans not covered under PBGC protections	After final regulations implementing the program are issued

What a Difference for DB Plan Funding

By Tom Veal

The Pension Protection Act fundamentally changes the philosophy underlying the minimum funding standards.

The rules contained previously in ERISA followed traditional actuarial concepts, whose objective was to spread the cost of pensions equitably over successive generations of contributors. In that way, today's corporate shareholders (and today's workers, in contributory plans) bore their fair share — but no more than that — of the ultimate burden.

This approach to funding was essentially the same as for financial statement accounting. It is unsurprising that Financial Accounting Standards Board Statement No. 87 (FAS 87) operates in much the same way as the ERISA minimum funding standards. The differences between the two sets of rules result from FAS 87's demand for comparability, so that constraints were imposed on the choice of actuarial method and assumptions.

Prior Law Took the Long View

On this “long view” of pension funding, the plan is an ongoing enterprise of indefinite duration. In the very long run, its cost (the amount that must be covered by contributions and earnings) equals the benefits paid. The patterns of cost accumulation and benefit payout are, however, dissimilar. To take the simplest example, in a plan with only one participant, all of the cost is incurred — and all of the contributions are made — during his working lifetime, whereas all of the benefits are paid after he retires.

Several consequences follow from this philosophy of funding:

- Whether the plan can meet all of its liabilities on a termination basis, that is, if compelled to pay them immediately in full, is not a key consideration. It does not enter into traditional actuarial calculations, nor are any restrictions imposed on plan operations or design simply because a “snapshot” picture shows the value of plan assets is less than the present value of liabilities.
- Actuarial assumptions are based on the experience of decades rather than months. That is why, for instance, interest rate assumptions have tended to change slowly and often seem to diverge widely from what is happening in the financial markets. Eventually, actuaries assume, the financial environment will revert to the mean.
- Assumptions look forward as well as back. In a pay-related plan, participants' service in the current year entitles them to benefits that will depend on their compensation at or near retirement. Hence, actuarial methods almost invariably require a salary scale assumption. Similarly, the actuary will project turnover (which takes into account the likelihood that many participants

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will terminate prematurely and thus accrue less in the future than if they had remained until normal retirement age), early retirement (tending to increase costs, because early retirement benefits are often subsidized) and other factors.

- The impact of unexpected events is spread out, rather than accounted for all at once. Thus the market value of plan assets may be averaged over a period of years, and the gain or loss from plan amendments, deviations from actuarial assumptions and so on is amortized, sometimes over as many as 15 or 30 years.
- Contributions made before the corresponding cost has been incurred under the plan's funding method are credited against future costs. There have in the past been no limitations on that practice.

All of this makes good sense for a plan with perpetual existence. But what if the plan is brought to a sudden end? That possibility was not a focus of pension policy when ERISA was enacted in 1974, and there were good empirical grounds for relegating it to a secondary role. A Department of Labor (DOL) study undertaken in 1973 to examine proposals for a pension insurance scheme found that, while plan terminations were not uncommon, it was unusual for participants to lose any substantial amount of benefits as a result. It thus appeared that conventional actuarial concepts were adequate to preserve plan solvency and that insuring defined benefit plans against underfunded termination would provide a small benefit at a small cost.

The PBGC Becomes a Surprisingly Pivotal Player

The initial premium charged by the Pension Benefit Guaranty Corporation (PBGC), \$1 per participant per year, was established on the basis of this experience.

One Congressman argued against establishing the PBGC, on the ground that its commitment to cover liabilities that companies failed to fund was bound to affect employers' and workers' behavior, most likely in ways detrimental to the pension insurer's interests. Nobody listened to such carping.

Thirty years later, PBGC premiums are an order of magnitude higher than at the outset, and the insurance fund labors under a \$23 billion deficit. Other factors may have been at work, but one imagines that future treatises on the economics of "moral hazard" will have much to say about this episode.

A real case illustrates how poorly the ERISA funding rules meshed with a healthy pension insurance system. One fairly large plan that terminated in the mid-1980's was just 3 percent funded at the time of its demise, meaning that virtually all of its benefits wound up being paid from the resources of the PBGC. Yet the employer's contributions had more than met the minimum funding requirements throughout the plan's existence. In fact, the funding standard account had a healthy credit balance.

A number of factors came together to produce this seeming anomaly. During an early period of prosperity, the plan sponsor contributed more than the statutory minimum. When its business began to decline, reductions in force generated large benefit payouts. In some cases, terminated workers were entitled to shutdown benefits, which increased the plan's liabilities. Often, they elected lump sums, which drained assets. This unfavorable experience did generate higher minimum required contributions,

but the adjustment was sluggish. In any event, the nominal requirements meant nothing until the abundant funding standard account credits, created by past contributions above the minimum required level, were absorbed.

1986 Law Turned Toward Deficit Reduction

The PBGC's deteriorating condition gave the federal government a strong reason to reconsider minimum funding concepts. Amendments adopted in 1986, when the PBGC's situation was weakening but far less dire than it was to become, introduced accelerated funding for severely underfunded plans in the form of "deficit reduction" and "liquidity shortfall" contributions.

Short-term Concerns Key to New Law's Approach

The Pension Protection Act (PPA) carries that concept further by making deficit reduction the basis for a revised funding methodology. Comparison with the traditional funding standards reveals what this change means:

- The principle that plans should be treated as ongoing enterprises is defunct. The goal is not equity among generations of shareholders and workers but solvency in the short run. The ideal is for every plan always to be fully funded, on a termination basis, for all accrued benefits. To the extent that goal is achieved, the PBGC will be like a fire insurance company in terrain saturated by water.
- To minimize the development of new unfunded liabilities, employers are required both to fund the present value of the benefits participants earned in the current year and to amortize any funding shortfall over no longer than seven years (with some relaxation for certain favored industries). For the worst-funded plans, stigmatized as "at risk," required contributions are artificially increased so the shortfall is amortized more rapidly until the plan emerges from at-risk status.
- As another safeguard, at-risk plans and their sponsors are forbidden to take actions that would further undermine funding. The targets of these restrictions, which grow steadily more severe as funding worsens, are plan amendments that increase liabilities, lump sum distributions and the payment of shutdown benefits. Plans judged to be in extremely serious straits must be frozen, eliminating future benefit accruals.
- Two crucial actuarial assumptions — interest rate and mortality — are taken out of the employer's hands and instead prescribed by law. The mortality changes will not have a major impact on most plans, but the interest rate will. The mandated rate (actually a set of rates, with the different ones used to value liabilities of different duration) will be based on high-grade corporate bond yields averaged over the most recent two-year period. Interest assumptions thus will change far more rapidly in the future than they have historically. The conventional expectation is that they will also be lower, though it is possible that a return of economic conditions that have prevailed at times in the past, *e.g.*, the double digit inflation of the 1970's, could have the opposite effect.

The mandated rate will be based on high-grade corporate bond yields averaged over the most recent two-year period.

- The use of an averaged “actuarial value” of plan assets has been restricted further, though not abolished. The maximum averaging period is now two years, and actuarial value must be between 90 and 110 percent of actual fair market value. Five-year averaging had been allowed, and the permitted corridor was 80 to 120 percent. Under the new system, averaging will make asset values only slightly less volatile.
- A corollary of keeping attention tightly on what would happen if the plan terminated right now is that forward-looking actuarial assumptions have been largely eliminated. Most notably, salary scale is not a mandatory assumption, though it can be employed for determining maximum deduction limits. Assumptions concerning early retirement and forms of benefit distribution are required in limited circumstances but ordinarily can be dispensed with.
- Over the years, the pattern of contributions required by the new law will look like that resulting from the unprojected unit credit method, which shifts costs heavily to participants’ later years rather than spreading them smoothly. Prior law did not regard unprojected unit credit as a reasonable, much less a favored, actuarial method in most circumstances. The new law takes the opposite tack, because it is uninterested in the pattern of contributions, so long as full or nearly full funding is constantly maintained.
- Contributing “in advance” by exceeding the minimum funding requirements brings less benefit than before. “Excess” contributions can still be carried over to offset those needed in future years, but can be utilized only when the plan is at least 80 percent funded. Moreover, the amount of “prefunding” is subtracted from plan assets. As a result, it may be to the employer’s advantage to cancel prefunding credits where, for instance, their existence might throw the plan into at-risk status.

There has already been much commentary on the impact of these radical funding changes, but one fact must not be forgotten: Funding rules do not determine a plan’s cost. Ultimately, that cost is simply the amount that the plan pays out in benefits, and it must be met through some combination of contributions, investment earnings and, in extreme cases, subsidies from the PBGC. If companies were indifferent to cash flow, and if funds invested by a pension plan earned as much as those used in the sponsor’s business, no one would care what the minimum funding standards mandated.

The new law shifts costs heavily to participants’ later years rather than spreading them smoothly.

Deduction Limits Will Be Higher

While employers rarely have much eagerness to contribute more than necessary to their pension plans, situations could arise under prior law when contributions they considered “necessary” exceeded the maximum amount they could deduct. The PPA makes that dilemma much less likely by sharply increasing the deduction limits.

For 2006 and 2007, the limit is increased so that it will never be less than 150 percent of the plan’s “current liability” (the value of accrued benefits determined in accordance with specified assumptions) minus the value of plan assets. Beginning in

2008, the maximum deduction equals the value of all benefits earned during the current and prior years plus a “cushion” minus the value of plan assets. The “cushion” equals the greater of:

- 1) 50 percent of the value of benefits earned in prior years plus an adjustment for anticipated future benefit increases; or
- 2) the amount by which the value of prior and current-year benefits would increase if they were calculated using the assumptions that apply to “at-risk” plans.

The disconnect between the minimum funding standards and generally accepted accounting principles is the main reason deduction limits should be higher than required contributions.

The main reason why deduction limits need to be higher than required contributions is the disconnect between the minimum funding standards and generally accepted accounting principles. In its current form, which is likely to be tightened within the next year or so, FAS 87 requires companies to calculate pension expense using the projected unit credit method rather than the unprojected method the PPA mandates. Hence, if contributions merely equal the legally required minimum, they may lag behind the expense reported on the financial statements, creating a book funding deficiency. That consequence is not inevitable, because FAS 87 actuarial assumptions tend to reflect higher interest rates than are permitted for funding purposes, but it can occur. Moreover, a very small deficiency can under certain circumstances trigger a disproportionate charge to earnings.

To keep a plan fully funded on a FAS 87 basis may, then, demand more than the minimum required contributions. Under the old rules, some of the “excess” might be nondeductible in the current year. It would have to be carried forward until room for a deduction was available. Even if deductible on its own, a large contribution might make contributions to other plans nondeductible, because amounts contributed to defined contribution plans were generally nondeductible to the extent that, when added to defined benefit plan contributions, they exceeded 25 percent of participants’ aggregate compensation. As a final insult, nondeductible contributions can be subject to a 10 percent excise tax, though changes to the law enacted in 2001 greatly mitigated that prospect.

By allowing the deduction of a substantial “cushion” above the minimum funding requirement, PPA reduces the risk that pension contributions will not be fully deductible when made. It also repeals the combined defined benefit/defined contribution plan limitation, though only if the defined benefit plan is insured by the PBGC. (Retaining the combined limit for noninsured plans is intended to restrain small businesses, for which qualified plans serve as tax shelters, from funding defined benefit and defined contribution plans to the maximum possible level simultaneously.)

For 2006 and 2007, the higher limits are intended to make it easier for companies to improve plan funding rapidly before the requirements become more severe. In particular, employers with underfunded plans may want to use the higher limit on deductions to contribute enough to their plans to reach at least 92-percent funding for 2008 and thereby avoid the huge spike of required funding that would go with falling into “at-risk” status (see discussion of “at-risk” status above).

The firms most likely to benefit from the higher deduction limits are self-employed individuals and owners of small companies, who will be able to accelerate the funding of their plans. For most small plans, the employer's ability to stuff in more cash will be a short-term phenomenon. Once plan assets fully fund the maximum benefit permitted by Code Section 415 (currently, a single life annuity of \$175,000 a year beginning at age 62 or its actuarial equivalent in a different form), nothing more can be contributed. There may be opportunities, though, for large professional firms. Under the PPA, plans with more than 100 participants may anticipate future increases in the Section 415 limit, giving them a further funding acceleration.

For many companies, the PPA will transform deduction limitations into a trivial issue.

For the average company — one that is neither worried about a FAS 87 shortfall nor otherwise desirous of increasing contributions above the mandatory level — it is fair to say that the PPA will transform deduction limitations into a trivial issue. The effective rule will be, deduct whatever you put in.

Cash Flows May See Big Ups and Downs

“All” that the PPA does is alter the rate at which cash goes into plans. Two effects are obvious:

- 1) required contributions will fluctuate more widely from year to year; and
- 2) distressed companies will be less able to put the needs of their plans off till another day.

Much of the controversy about the PPA centered on speculation that dislike of volatile cash demands will push companies to leave the defined benefit (DB) universe and turn instead to defined contribution plans. That was a major argument against drastic change. Now that the subject of the controversy has become law, it is useful to consider its likely effects in a more nuanced way. They are not the same for all parts of the DB spectrum.

For traditional DB plans, the new rules are undoubtedly troublesome, even for employers with abundant cash and no pressing worries about future business hardship. The values of plan assets and liabilities vary with two principal factors: interest rates and investment performance. The two can offset one another, as when interest rates are low, giving liabilities a high value at the same time the stock market booms, or when high interest rates accompany declining stocks. Or they can work in tandem, for good or ill. That happened after the collapse of the Internet bubble in 2000 and during the subsequent recession. Assets were down sharply, while interest rates declined simultaneously, resulting in the unprecedented funding shortfalls. The major goal of the PPA is to deal with any future iteration of that disaster.

Deficits May Change to Surplus

The PPA does not, however, provide any mechanism for adjusting to the opposite “double whammy,” when — as has also happened before — interest rates rise and economic growth is strong. Liabilities then fall in value while assets rise, leading to surplus assets. Historically, it has not been uncommon for plans to become substantially overfunded. When extreme overfunding first attracted attention in the early

Ways to Dissipate Substantial Surpluses

- 1) wait for benefit accruals to catch up, which may take a very long time;
- 2) wait for adverse changes in economic conditions (a combination of declining interest rates and declining asset values); or
- 3) pay a prohibitive excise tax in order to return cash to the employer's business.

1980's, employers could neutralize it by annuitizing benefits in a "termination-reestablishment" or "spinoff-termination" transaction. The pension liability was transferred to an insurance company, while the employer received a reversion of all plan assets in excess of the insurer's price for annuities.

Although this technique secured participants' benefits while enabling plan sponsors to recover funds that would otherwise have been locked away in passive pension plan investments, it was politically unpopular. An excise tax on reversions, initially 10 percent, now either 20 or 50 percent depending on circumstances, made the economics of surplus recovery unattractive.

Even Surplus May Not Help Traditional DB Plans

It is all but inevitable that widespread surpluses will recur. To the extent that the new funding rules accelerate contributions, they will aggravate the build-up. Under current law, there are only three ways to dissipate substantial surpluses (see box).

Since none of those alternatives is particularly desirable, companies will try to avoid facing them. The easiest way to do that is to shun traditional DB pension plans.

Attitude and Law Changes May Kill Traditional DBs

Changes in workers' and employers' attitudes and expectations have undermined the traditional paradigm. So have changes in the law. The prohibition against cessation of benefit accrual at normal retirement age weakened the incentive to retire. The expansion of the anti-cutback rule to include early retirement subsidies and optional forms of benefits limited the adaptability of plans to changed conditions. The steadily ramifying complications of the ERISA and plan qualification rules, more marked for DB than for defined contribution (DC) plans, coupled with closer IRS scrutiny, increased compliance costs. The PPA is merely another blow — perhaps a fatal one.

Hybrid Plans Emerge Better Off

The same difficulties do not arise to nearly the same extent for untraditional hybrid plans with cash balance or pension equity designs. In a cash balance plan, the present value of participants' benefits is fixed at the time of accrual. (That was not always the case under prior law, because of the controversial "whipsaw effect," which could make lump sum distributions higher than hypothetical account balances, but the PPA eliminates that issue.) Since the value of liabilities does not depend on interest rates, the plan's funding level is more controllable and predictable than under a traditional design.

Similarly, the value of liabilities in a pension equity plan is unrelated to interest rates. Benefits earned in the past will increase as participants' compensation rises, but the PPA makes the resulting liability increase an element of the annual normal cost. Unlike current law, it does not require advance funding to reflect anticipated pay changes. Hence, as in a cash balance plan, it is relatively easy to keep assets and liabilities in balance.

Hybrids (and Other DB Plans) Retain Some Advantages

But why should companies bother with defined benefit plans of any variety when they can switch to defined contribution plans and not have to worry about funding rules or PBGC premiums? The answer is that DC plans are, in essence, personal savings plans for employees, in which a portion of current compensation is deferred into a tax-advantaged vehicle. The tax savings inure entirely to participants, while the employer pays the same total compensation for the same services. From its point of view, the plan's existence is a matter of indifference, except for costing something to administer.

Traditional defined benefit plans are *not* repositories for employees' savings. Rather, they came into existence to serve employers' interests by encouraging older employees to retire and by giving experienced workers, in whom the employer had a substantial investment, an incentive not to leave prematurely. At the same time, workers who left at young ages after short periods of service cost very little, because their accrued benefits are of trifling value.

Hybrids in cash balance or pension equity designs can surpass DC plans in a number of areas (see box).

However, 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.

Broader Range of Interest Rates for Cash Balance Plans

In some respects, the two types of plan may start to blend. The elimination of the whipsaw problem will foster a greater range of interest crediting rates in cash balance plans. Previously, the prudent course was to adopt one of the “safe harbor” rates in IRS Notice 96-8. Under the new law, 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's 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.

How Creative Pension Design May Flourish

Now that fears that judges will outlaw “hybrid” plans, *à la* the recently reversed district court decision in *Cooper v. IBM Personal Pension Plan*, have been dispelled, there are great opportunities for creative plan design. We may see a greater tendency

How Hybrid Plans Can Surpass DC Plans

- 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, that 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, risk and reward inure to the employer — which generally leaves everyone better off.

The PPA's effects will go well beyond protecting the government's pension insurance program against exposure to catastrophic losses.

to offer different benefit structures to groups of employees with different levels of sophistication and different retirement needs. 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.

Overall, the PPA will have effects that go well beyond its narrow purpose of protecting the government's pension insurance program against exposure to catastrophic losses. Few of the collateral consequences were intended. Congress did not aim to push employers toward cash balance and pension equity plans, as is shown by the restrictions, admittedly modest, imposed on conversions of traditional plans to those designs; nor did it expect to make traditional designs unattractive to healthy companies. Fortunately, unintended consequences do not have to be disastrous. The next few years could well prove to be the golden age of creative pension plan design.

401(k)s and the Pension Protection Act of 2006

By David L. Wray

With the enactment of the Pension Protection Act of 2006 (PPA), the final pieces necessary to bring the employer-sponsored defined contribution plan system to its full potential are now in place. The regulatory structure the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) established is now permanent; the Saver's Credit has been renewed, made permanent, and indexed. The barriers to automatic enrollment have been removed. These changes combined with today's economic and demographic realities will bring tens of millions of new participants into 401(k) and other employer-sponsored defined contribution programs — and this is a very good thing for America.

Permanence

The defined contribution system's future is founded on permanence and the predictability it provides. Without permanence, the defined contribution system — like the defined benefit system, which has been subject to continuing significant rule changes — would face utilization restraints. If companies are to maximize the benefits of their defined contribution plans, or more importantly change the philosophy of their plans from opt-in to opt-out, they need to know that the rules today will apply years from now. The PPA will give them that confidence. This certainty will also encourage continued capital investment by plan service providers in the recordkeeping and compliance technology that is making the cost of small plan administration less expensive.

Saver's Credit

One of the more overlooked provisions of EGTRRA was the Saver's Credit. This tax credit of up to \$1,000 a year for low- and moderate-income savers was virtually ignored by 401(k) sponsors and providers because it was temporary and was scheduled to terminate this year. As a result, many of the 10 million workers eligible for the credit did not take advantage of it. More importantly, the credit didn't spur 401(k) participation among this group.

Now that the Saver's Credit is permanent, companies will communicate to their lower-paid workers just how wonderful 401(k) participation is. They will tell them that not only do they get the tax deduction and the employer match, they can lower their federal income tax bill by up to \$1,000 (indexed). The Saver's Credit will be a significant tool in the effort to convert lower-income workers from merely being eligible to actually participating 401(k) savers.

Automatic Enrollment

The third important accomplishment of the PPA was the removal of barriers to automatic enrollment. Historically, the 401(k) system has been an opt-in program. Employees have had to decide to join their 401(k) and determine how much they would save and how it would be invested. Employer-provided educational support helped them in

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this process. This approach successfully increased 401(k) participation from under 40 percent in the mid-1980s to over 70 percent today for those who do not have traditional pension coverage. However, the growth in participation appears to have reached a plateau and new strategies must be adopted if participation is to increase further.

That solution appears to be automatic enrollment or an opt-out approach. In a plan using automatic enrollment, the employer not only enrolls the employee in the plan at a contribution rate determined by the employer but also decides how the employee's savings are to be invested. Those not wanting to participate or who want to save or

New strategies must be adopted if participation is to increase further. That solution appears to be automatic enrollment.

invest differently than the employer determines are free to make a different choice, including one not to participate at all. Participation in 401(k) plans based on this opt-out approach can reach over 95 percent. Already a number of companies are using automatic enrollment. Research from the latest PSCA survey shows that automatic enrollment is up 50 percent, with 16.9 percent of companies using this approach.

However, the growth of automatic enrollment has slowed because no ERISA attorney in the U.S. would write a letter guaranteeing to a plan sponsor that the company would not have a problem in the future with a state wage garnishment law that prohibits deductions from an employee's paycheck without his or her written permission. Some potential sponsors of automatic enrollment have also been concerned about the liability the company assumes when it decides how the money is to be invested.

The PPA deals with both of these barriers to automatic enrollment. It clarified that ERISA preempts any state law that directly or indirectly would prohibit or restrict automatic enrollment. It also grants the protection of ERISA's Section 404(c) for plan sponsors' default investment decisions, so long as the sponsor provides:

- 1) an annual notice informing those eligible for the plan of their right to opt out;
- 2) the method for making or modifying their deferral election; and
- 3) how their money will be invested if they fail to give investment direction.

The Department of Labor (DOL) will soon publish guidance that will help employers feel comfortable adopting a diversified strategy for the management of funds invested by default.

The PPA includes a new nondiscrimination safe harbor for companies when they implement automatic enrollment. The required maximum match of 3½ percent of pay under this new safe harbor is slightly lower than the 4-percent maximum of the earlier 401(k) safe harbor (which remains available). Also, the new safe harbor lets employer use two-year cliff vesting in contrast to the immediate vesting the pre-existing safe harbor provision required. However, the new automatic enrollment safe harbor requires that employee deferrals increase to no more than 10 percent of pay. Companies that have decided to implement automatic enrollment should consider both safe harbors if they want to avoid the discrimination tests.

Now that 401(k) rules are permanent and the barriers to automatic enrollment are removed, I believe that within five years as many as half the companies sponsoring defined contribution plans will have changed their plan philosophy from opt-in to

opt-out. The result will be a dramatic increase in 401(k) plan participation and overall retirement savings.

Small Companies

Making the rules permanent will also spur plan formation by making it easier for small companies to say “yes” to sponsorship. Permanence gives companies the comfort that decisions made today will be valid in the future. It means that today’s plan design approaches and employee expectations will not have to be reset in the future with potential negative workplace fall out. This is especially important to small company owner-managers who have little or no benefits expertise. Permanence will also continue the current trend of lower administration and compliance costs by reducing the amount providers need to spend to keep their systems in compliance with the law.

Vesting

At a more mundane level the PPA will affect current plan design decisions and make administration somewhat more complex. For example, all defined contribution plans must now operate within the tighter limits of three-year cliff or six-year graduated vesting EGTRRA imposed on 401(k) matching contributions. According to the Profit-Sharing Council of America’s (PSCA) 49th annual survey, which reports on 2005 plan designs, 2.9 percent of plans used service-weighting in their company contribution formula. Companies forced to change their vesting schedule because of the PPA may want to consider using service-weighting if they want to reward their longer service employees.

PPA Provisions Affecting Company Stock in 401(k) Plans

- A required right for a participant to diversify out of company contributions after three years
- A new requirement that individuals be notified of their right to diversify company stock not later than 30 days before the first date they are eligible to do so for any type of contribution (i.e., elective deferrals and employer contributions)

Company Stock

The PPA also contains provisions related to the ENRON scandal that affect company stock in 401(k) plans (see box).

The notice must describe the importance of diversifying the investment of retirement assets. Unfortunately, it will be difficult — if not impossible — to comply with the minimum of 30 days’ notice before the first date someone is eligible to diversify since often the actual date of a company stock distribution into the plan may not be known 30 days in advance.

Plan Communications

The new law requires that “identification and basic plan information and actuarial information included in the annual report” be filed in electronic format. This will accommodate display of each plan’s annual report or summary plan description (SPD) on the Internet. The DOL will establish a Web site to display these reports within 90 days of the filing date. The SPD must also be displayed on sponsors’ intranet sites maintained to communicate with employees and not the public, if such a site exists.

When the New Prohibited Transaction Exemption Applies

The new exemption applies to parties that provide investment advice if:

- 1) any fees received do not vary depending on the basis of the investment option selected, or
- 2) the advisor uses a computer model developed and used under conditions designed to protect participants from an advisor's potential conflict of interest.

Current law is amended to require administrators of 401(k) and other individual account plans (except one-participant plans) to furnish a benefit statement once each quarter in a participant-directed plan and once each calendar year otherwise and upon written request to other plan beneficiaries. It is standard 401(k) practice to provide quarterly statements. However, the requirements of the new law are specific and lengthy, and non-compliance serious penalty. Plan sponsors need to pay attention to what seems to be an innocuous provision.

Investment Advice

The law creates a new prohibited transaction exemption for certain parties that provide investment advice. Specifically, this covers a party that is a fiduciary as the result of providing advice to a participant or beneficiary of a participant-directed individual account plan as long as one of two conditions are met (see box).

It is important to note that this law does exempt a plan sponsor or other fiduciary from any requirement for the prudent selection and periodic review of a fiduciary advisor arrangement.

What's Next

As with all laws, exactly what each provision of the PPA means is open to interpretation. There are many explanations of the legislation and what it means. However, there is no certainty until the provisions have been officially interpreted by the Treasury Department and DOL. Additionally, there is the possibility of a "corrections" bill that may address some confusing or troubling provisions.

For instance, it is worth noting that the Saver's Credit, which the PPA has made permanent, is nonrefundable; the earned income credit (EIC), however, is refundable. When employees take advantage of the EIC, this very often nullifies any benefit they could get from the Saver's Credit (e.g., when all their federal tax is refunded under the EIC, there's nothing further left to credit). If Congress made the saver's credit refundable, employees could get the benefit of both in the same year.

Nevertheless, this law is extremely important. I believe that within a short period nearly every full-time worker will be participating in or eligible to participate in an employer-sponsored defined contribution retirement program, already a very successful system.

By the end of 2005, American workers had accumulated more than \$3 trillion of retirement assets in their defined contribution plans and rolled over trillions more into individual retirement accounts (IRAs). Bringing more workers into this system is good for employees saving for retirement and their employers which are competing in a challenging economic environment. However, as this system will be the bedrock of retirement saving in the United States, it is important to review again why this is good for workers.

Saving. Employers provide incentives for saving and simplify the saving process. Eighty percent of plan sponsors reward 401(k) savings by matching employee

contributions with contributions from the company. Typically, they provide an additional 50 cents for every dollar saved up to 6 percent of pay. Plan sponsors not making matching contributions often make profit-sharing contributions to all eligible employees.

Investing. Employers carefully provide a limited range of diversified, high-quality investment choices in their 401(k) plans, sparing participants the intimidating process of choosing from among the thousands of available investment options.

Only in the 401(k), where there are no minimum fund balance requirements, can someone save \$70 a month, putting \$10 in each of seven investments. Participants can freely manage their investments and rebalance their portfolios knowing that there are no tax consequences.

Importantly, investment returns in 401(k) plans are enhanced because fees charged in plans are typically lower than fees paid when investing outside a plan. This is particularly true for small accounts. Some employers even pay some or all of the plan-related fees.

Taxation. Contributions to a 401(k) plan receive special tax consideration.

- Employer and employee contributions to 401(k) plans, and the earnings thereon, are not subject to federal and, in most cases, state income taxes until the employee takes a distribution from the plan.
- Employer contributions are not subject to Social Security and Medicare taxes.
- The capital gains on employer stock held in a plan are eligible for preferential tax treatment.
- Some plans include a Roth 401(k) feature that provides participant contributions the same tax treatment in a 401(k) as is available in a Roth IRA.
- The Saver's Credit returns a significant portion of a low-wage worker's voluntary contribution to a 401(k) in the form of a tax credit.

Security. The assets in a 401(k) plan belong to participants and beneficiaries and must be managed solely for their benefit. 401(k) plans have plan trustees, administrators and service providers who have specific obligations under federal law to carefully manage the plan's assets.

Portability. No matter what their working situation, participants can preserve their 401(k) retirement savings in tax-deferred status and build on them as they move from job to job until they retire.

In-service Access. 401(k) plans allow participants to take withdrawals when an employee is faced with economic hardship. Most plans permit participants to borrow half their account balance up to \$50,000.

Phased Retirement. 401(k) plans can facilitate phased retirement by workers age 59½ or older by allowing them to work fewer hours and take distributions from their 401(k) plan while continuing to save and receive company contributions.

Bankruptcy Protection. Assets accumulated in a 401(k) are excluded from the bankruptcy estate in the event a plan participant declares bankruptcy. A bankruptcy court cannot interrupt the participant's repayment of a plan loan.

It cannot be overstated how important this legislation is at this time. It will lead to dramatic expansion of employer-sponsored defined contribution programs. There will be a dramatic shift in companies moving to automatic enrollment.

We will see greater and more creative uses of profit-sharing in the form of direct company contributions and matching.

At the same time, plan designs will be highly customized, and we will see the re-introduction of cash and deferred profit-sharing plans. Additionally, we will see greater and more creative uses of profit sharing in the form of direct company contributions and matching. As companies and participants continue to recognize the importance of saving for retirement, participation in these programs will grow significantly. Within 10 years, participation in defined contribution plans will approach 90 percent.

Finally, the providers who have made the commitment will see an increase in cash flow, and savers will be saving increased amounts. The defined contribution system will become a universal aspect of the workplace.

By offering defined contribution plans, of which 401(k) is the predominant type, employers provide a wonderful structure for saving and investing that has resulted in employees accumulating trillions of dollars of retirement savings. With the passage of the PPA, many more American workers will be put on the path to the retirement security we all desire.

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