2 The PPA Permits Plans to Provide Participants with Investment Advice for Self-Directed Accounts. One of the biggest changes made by the PPA is the enactment of a prohibited transaction exemption for Investment Advisers who give investment advice to participants that self-direct their 401(k), profit sharing or other defined contribution plan under certain circumstances. All investment advisers to a plan are fiduciaries under ERISA. Currently, fiduciaries are prohibited under ERISA's prohibited transaction rules from giving investment advice to participants for compensation. Fiduciaries may provide general investment education to participants. The reason for this rule is concern over the inherent conflict of interest that a fiduciary might steer participants into an investment in which the adviser receives a bigger commission rather than what is the best investment for the participant.

Beginning in 2007, the PPA provides a prohibited transaction exemption and relief from fiduciary liability for eligible investment advice arrangements provided by qualified fiduciary investment advisers. Qualified advisers include banks, insurance companies, broker-dealers, registered investment advisers and their employees and representatives.

There are two types of eligible investment advice arrangements: a flat fee arrangement; and a computer model arrangement. Under the flat fee arrangement, the investment adviser's compensation for providing the advice must not vary based on the investment option selected. The computer model arrangement is one whereby the adviser uses a computer model that applies generally accepted investment theories to the participant's individual information (i.e., age, life expectancy, risk tolerance) and is not biased in favor of investments offered by the adviser or its affiliates and takes into account all investment options under the plan. The computer model must be certified by an independent investment expert and an independent auditor must annually certify that the model is appropriate. The only advice that may be given under the computer model arrangement is that provided by the computer model and all transactions must result solely from the participant's decisions. For either type of arrangement, the compensation received by the fiduciary adviser or its affiliates in connection with a transaction must be reasonable and at least as favorable as an arms-length transaction.

In addition, before any advice is given, the adviser must provide a notice written in a manner to be easily understood by participants that discloses: that the adviser is a fiduciary; the role of all parties involved in the program; past performance of the investment options; the fees or other compensation received by the adviser; how any participant information will be used; and that participants may arrange for their own advice from another adviser.

While the relief for providing investment advice is a significant development, many questions still remain as to its operation. For example, who qualifies as an investment expert or auditor under the computer model must be clarified. It should also be noted that while a fiduciary is relieved from liability for advice given by the qualified fiduciary adviser under an eligible investment advice arrangement, the fiduciary remains responsible for the selection and monitoring of the qualified fiduciary adviser.

And the NUMBER ONE thing you should know about the PPA is…

1 There Is a Lot More to Consider. As mentioned in the introduction, the PPA is over 900 pages and the most significant reform to the pension laws since ERISA. Some provisions are already effective, some become effective in 2007 or 2008, and still others are effective later. While this pamphlet has identified what I feel are the most significant changes you should know about at the time of its writing, there are many provisions not addressed. Examples are: changes to reporting and disclosure rules; the requirement that plans provide a 75% survivor annuity; permitting in-service "working retirement" distributions from defined benefit plans; changes to corporate owned life insurance; penalty-free distributions from IRAs or 401(k) plans for reservists called to active duty; and permitting charitable contributions to be made from IRAs.

The breadth of the PPA demonstrates how it has changed the landscape of employee benefits. Employers need to determine which changes affect their current plans now and which will affect them in the near future. Likewise, employers should consider what new opportunities the PPA presents to improve the design of their plans. For example, should the employer adopt automatic enrollment? Should the employer adopt a cash balance plan? Should the employer adopt a combination DBK plan?

Employers can't and shouldn't go it alone. We understand the PPA's changes and can apply them to your particular plan and circumstances to advise you on how to meet your company's benefits goals.

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Scott E. Galbreath is a partner in the transactional practice group. He has 20 years experience representing businesses and business owners in general business transactions, estate planning, and tax, with a focus on employee benefits and executive compensation. He counsels clients on choosing appropriate retirement, deferred compensation, and other benefit plans, ERISA and Internal Revenue Code compliance, including new Section 409A; investments, prohibited transactions, and fiduciary duties; as well as drafting plan documents and correcting plans.

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THE TOP 10 THINGS YOU NEED TO KNOW ABOUT PENSION REFORM

THE PENSION PROTECTION ACT OF 2006

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 ("PPA"), over 900 pages of legislation hailed as the biggest reform of the U.S. pension laws in over 30 years. While the main purpose (and publicity) for the PPA was to improve the underfunding of the nation's defined benefit pension plans, by changing the rules for required actuarial funding of such plans, it also contained many other provisions impacting all retirement plans. This brochure provides an explanation of my top 10 things you should know about the PPA.

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The Top 10 Things You Need To Know About Pension Reform
The Pension Protection Act Of 2006

10 The PPA Increases Funding Requirements for Defined Benefit Plans. As mentioned, the primary purpose for the PPA was to shore up the funding of the nation's defined benefit pension plans. Retirement plans are categorized as either defined benefit plans or defined contribution plans. The distinction is in the way the plan defines the benefit provided by the employer. Defined benefit plans generally require the employer to provide a benefit at retirement such as a life annuity paying 75% of the employee's average compensation for his/her three highest years with the employer. The employer must then annually fund the benefits for all employees based on reasonable actuarial assumptions. On the other hand, in a defined contribution plan, each participating employee has an individual account under the plan and the employer promises to make a contribution to the employee's account which is then invested. The employee's benefit is then based on his/her account balance.

Defined benefit plans have certain minimum funding requirements and generally pay premiums to the Pension Benefit Guaranty Corporation ("PBGC") the agency that guarantees defined benefit plan benefits to employees should an employer go out of business. In recent years many big businesses have gone bankrupt, with severely underfunded defined benefit plans and pushed the plan's liabilities on the PBGC. This caused the PBGC financial strain. Therefore, the PPA makes many changes to how employers must fund their defined benefit plans.

In general, the PPA requires defined benefit plans to accelerate the funding of their liabilities under such plans. Beginning in 2008, employers must fund 100% of the plan's funding target instead of 90% under current law. Failing to fund at this level subjects the plan to certain benefit restrictions such as prohibiting lump sum distributions of benefits or prohibiting increases in benefit accruals. In addition, the PPA increases by 50% the amount of contributions that are deductible, generally allowing an employer to fund and deduct 150% of its funding target. There are also transition rules for 2006 and 2007.

9 EGTRRA Changes are Made Permanent. Back in 2001, the Economic Growth Tax Relief and Recovery Act ("EGTRRA") was enacted and, among other changes, it made substantial changes to the landscape of employee benefits. Key among these changes were the raising of the deduction limit for profit sharing plans from 15% to 25%, the removal of 401(k) elective deferrals from the definition of employer contributions for deduction purposes, the enactment of Age 50 catch up contributions, and an increase in the amount of permitted 401(k) and IRA contributions. All of these provisions promote increased benefits from private retirement plans. Most provisions of EGTRRA were scheduled to expire in 2010 due to the procedure by which it was enacted. This applied not only to the retirement plan provisions but other provisions such as → estate tax reform and the reduction of capital gains tax. The PPA has now made the retirement plan provisions permanent. This is significant because the other matters face serious challenges in Congress after the 2006 elections.

8 The PPA Requires Faster Vesting for All Defined Contribution Plans. Beginning next year, all contributions to defined contribution plans (e.g., profit-sharing, 401(k), and money purchase pension plans) must have a faster vesting schedule. Contributions must vest at least as fast as: i) 3-year cliff vesting where the participant is not vested until becoming 100% vested after three years; or ii) 6-year graded vesting whereby after 2 years the participant is 20% vested and earns an additional 20% vesting annually until 100% vested after six years. These are the current required vesting schedules for any matching contributions and for top-heavy plans. The PPA merely makes it applicable for all defined contribution plans. Thus, whether or not a defined contribution plan is top heavy will have no effect on the vesting schedule. All defined contribution plans will have to be amended for this change.

7 The PPA Makes Rollovers to Roth-IRAs More Flexible. Beginning in 2008, distributions from qualified plans, Section 403(b) annuities or Section 457 plans may be rolled over directly to a Roth-IRA. This allows the rollover and conversion of pre-tax dollars directly to an after-tax Roth-IRA, thus, making subsequent qualified distributions of contributions and earnings tax-free. Before 2008, the participant must rollover the pre-tax money into a traditional IRA and convert the IRA to a Roth-IRA by paying income tax on the fair market value of the IRA. Currently, only individuals with $100,000 or less of income can convert a traditional IRA to a Roth-IRA. This restriction still applies to these direct rollovers in 2008. However, the Tax Increase Prevention Act of 2006 enacted in May, removed this income limitation beginning in 2010.

Therefore, beginning in 2010 anyone can convert a traditional IRA to a Roth-IRA and/or directly rollover pre-tax money from a qualified plan into a Roth-IRA. Due to the significant estate planning advantages of Roth-IRAs, this provision is key to both retirement and estate planning.

6 The PPA Permits Non-Spouse Beneficiary Rollovers. Many retirement plans require beneficiaries of participants who die to take the decedent's benefits in a lump sum distribution. Surviving spouses of such employees can treat such benefits as their own and roll them over into their IRA or another tax-favored retirement plan. Non-spouse beneficiaries cannot roll over such benefits and are immediately hit with a → tax. Beginning next year, the PPA permits non-spouse beneficiaries of a decedent's tax-favored retirement account to roll it over into an IRA and have the inherited IRA rules apply. Under those rules, a non-spouse beneficiary of a decedent will have to take distributions at least as fast as the decedent was taking required minimum distributions. If the decedent was not yet in pay status, the beneficiary must take the entire distribution within 5 years of the decedent's death or over his/her life expectancy beginning within 1 year of the decedent's death.

5 The PPA Removes the Controversy Over, and Makes Cash Balance Plans Legitimate. Cash balance plans are defined benefit plans that operate similar to defined contribution plans in that the promised benefit is stated in terms of a hypothetical account balance, although participants do not actually have an individual account as in a defined contribution plan. Interest is credited to the hypothetical account balance as provided in the plan rather than based on investment performance like a defined contribution plan. Should the interest credited be too little to give an employee their accrued benefit, the employer must fund the difference. One reason for the creation of these cash balance plans was that they were easier for participants to understand.

In recent years, many employers have converted their traditional defined benefit plan into a cash balance plan. However, the legal status of these plans has been uncertain due to recent litigation. Some courts have held that the conversion from a pure defined benefit plan to a cash balance plan violated the Age Discrimination in Employment Act ("ADEA") because the accrued benefit of younger employees when projected to age 65 and converted to a lump sum, was worth more than that of older employees due to more years of interest credits. For example, if a 30-year old and a 60-year old worker each had accrued a 5% of pay benefit, the 30-year old's account balance would be higher due to having 35 years of interest versus only 5 years for the 60-year old.

The PPA has reversed these cases and legitimized cash balance plans effective June 29, 2005 by not only amending the Internal Revenue Code and ERISA but amending the ADEA. Thus, employers should consider cash balance plans when looking at plan design.

4 The PPA Creates a New Combined Defined Benefit and 401(k) Plan. The PPA authorizes, beginning in 2010, a new combined defined benefit and 401(k) plan for employers with fewer than 500 employees. The combined plan, known as a "DBK" plan, eases administration by permitting two types of plans contained in one document that only needs one trust and need only file one Form 5500 return. This is a new tool for employers to consider when looking at the design of their retirement plans.

3 The PPA Legitimizes Automatic Enrollment for 401(k) Plans. Recently, many employers have adopted plan designs that provide for automatic enrollment of employees into 401(k) plans in order to increase employees' participation. These plans provide that every employee is automatically enrolled with a certain deferral level unless the employee makes an election, sometimes called a negative election, to change the amount of deferral or to not participate. While studies have shown that automatic enrollment has helped increase participation, particularly among the lower paid, controversy has always surrounded such plan designs because Code Section 401(k) calls for the employee to "elect" to defer compensation into the plan in lieu of taking it in cash. Therefore, there was concern whether an automatic enrollment, even with a right to opt out, met this requirement. In addition, the law was silent as to many aspects of administering such plans. For example, without the employee making an election of an investment, it appeared the employer still had fiduciary liability for any default investment chosen. In addition, many state's laws prohibit an employer from withholding anything from an employee's paycheck (other than taxes) without the employee's express written consent. There was a question whether the deferrals under automatic enrollment violated these statutes.

The PPA has now clarified this uncertainty by authorizing an automatic enrollment safe harbor 401(k) plan available in 2008. Employers can adopt a safe harbor plan providing for automatic enrollment and be exempt from the usual nondiscrimination testing for 401(k) plans and, fiduciaries will be exempt from liability for any losses arising from the default investment. Further, the Federal law of this safe harbor now expressly preempts any state statute regarding withholding.

However, this relief comes at a price. Like other safe harbor 401(k) plans, the new automatic enrollment safe harbor plan requires a mandatory contribution by the employer. Employers must provide a matching contribution or make an employer contribution of 3%. Unlike the current design-based safe harbor 401(k) plan which requires a fully vested employer contribution of 3%, these contributions need not be fully vested until after 2 years of service. The matching contribution must be at least dollar for dollar for the first 1% deferred, plus 50% for the next 5% of deferral for a total maximum of 3-1/2%. Additionally, the safe harbor requires a mandatory schedule of automatic deferrals. The automatic deferral may not exceed 10% and must be at least 3% for the employee's first year of participation. This minimum automatic deferral then increases 1% annually up to 6% in the fourth year of participation.

In order to receive the benefits of this safe harbor, administrators must provide employees with a notice within a reasonable time before a plan year begins, explaining the rights and obligations of the participant. The notice must be written in a manner that the average participant could understand and be accurate and comprehensive enough to apprise the participant of his/her rights under the plan.