

# Henson & Efron

PROFESSIONAL ASSOCIATION

## PENSION PROTECTION ACT NEWSLETTER

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December 1, 2006

### **INTRODUCTION**

During 2006, the Pension Protection Act (the "Act") was enacted. The Act contains many provisions which will impact tax-qualified retirement plans during 2006 and 2007. This newsletter will highlight provisions that are effective in 2006 and 2007 with respect to defined contribution plans, such as profit sharing, 401(k) and employee stock ownership plans.

Please review the following information and determine whether any of these required changes apply to your plan, or whether you wish to take advantage of any of the optional provisions now available.

### **DEFAULT INVESTMENT OPTIONS**

Beginning January 1, 2007 the Act offers to employers broader protection under ERISA when selecting a default investment option for use with plans offering participant directed investment arrangements. The default investment option is used in those cases where a participant has a plan account but has not designated how the account balance will be invested. Generally, employers have selected very conservative options for this purpose, like money market funds, but other options, such as an asset management or life cycle fund, can now be used. To obtain relief from fiduciary liability for this decision, the employer must provide a notice that explains the plan's default investment rules before the beginning of each plan year. This notice must be given during December of 2006 if your plan year starts January 1, 2007 and you wish to take advantage of this relief. This notice can be combined with other applicable required notices.

The Department of Labor has issued proposed regulations which allow use of balanced funds, life-cycle funds and managed portfolios as default investments. Final regulations are due February 17, 2007.

### **NOTICE AND CONSENT PERIOD**

Generally, before plan benefits are distributed, a notice is provided which discusses information relevant to a distribution from a qualified plan. Currently this notice must be provided no less than 30 days and no more than 90 days before the date of the distribution. For plan years beginning on or after January 1, 2007, the applicable notice and consent period will be no less than 30 days and no more than 180 days. This notice requirement applies, for example, to a distribution in excess of \$5000 or to a survivor's benefit election.

### **AUTOMATIC ENROLLMENT**

Employers currently are permitted to automatically enroll employees in their 401(k) plan at a contribution level set by the employer, so long as the employee is given the opportunity to elect to make no contributions or to contribute at a different rate. While these arrangements have been available for a few years, some state laws, such as those prohibiting reductions in compensation without employee consent, directly or indirectly prohibit or restrict these opt out automatic deferral arrangements. The Act

preempts any state laws which have the potential to interfere with an employer's ability to make such a wage deduction.

As a condition of receiving this protection, the employer must give a notice to participants prior to the beginning of the plan year during which the deductions will be made which discusses the automatic deferral arrangement and the ability to opt out. This means employers who intend to make these deductions for a plan year beginning January 1, 2007, must issue the required notice in December of 2006. This notice must explain both the employee's right to opt out of automatic enrollment and the default investment arrangement for those participants who neither opt out nor make an election designating investment options for their contributions. The default investment arrangement must follow rules issued by the Department of Labor.

### **REVISED VESTING RULES**

For plan years beginning on or after January 1, 2007, all employer contributions to profit sharing and 401(k) plans, such as discretionary contributions, must vest on either a six year graded vesting schedule, with 20% vesting each year beginning with the second year of service, or a cliff vesting schedule where all employer contributions are 100% vested after three years of service. Previously, these contributions could vest over a seven year graded vesting schedule or a five year cliff vesting schedule.

The revised vesting rules also apply to employee stock ownership plans, but if the plan has borrowed money to purchase stock, these new vesting rules will not apply until that loan is repaid.

### **INVESTMENT ADVICE**

Effective January 1, 2007, employers will have more flexibility to provide participants with access to personalized investment advice from sources such as broker dealers, banks, insurance companies, registered investment advisors, or similar types of organizations so long as certain safeguards are met. These safeguards include providing disclosure notices and obtaining an annual independent audit of the program. By

meeting all of the requirements, the employer does not have to monitor the advice given, so long as the selection of an advisor was prudently made and the advisor is monitored.

To be able to offer these advisory services, the investment advisors must also meet certain standards as to the manner in which the advice is provided. These advisors may provide advice for a fee which does not vary based on the investment selected (i.e., a flat fee), or they may use a computer modeling program which has been certified by an independent third party. The advisors must disclose their fee arrangement and any affiliations with either recommended investments and the developer of any computer model used. In addition, the investment advisor will need to obtain an annual audit of the arrangement.

### **ROLLOVER OF AFTER-TAX CONTRIBUTIONS**

For plan years beginning on or after January 1, 2007, trustee to trustee transfers of after-tax contributions may be made to other tax-qualified plans, so long as the receiving plan separately accounts for those contributions and earnings. This is an optional provision; no plan will be required to accept a rollover of an after-tax amount.

### **2001 RETIREMENT SAVINGS CHANGES MADE PERMANENT**

Several provisions relating to the amounts which could be saved in retirement plans and IRAs were added to the tax Code in 2001, and were due to expire in 2010. These provisions include higher 401(k) plan limits, higher IRA contribution limits, catch-up contributions for participants age 50 and older and enhanced portability rules. The Act removes the 2010 expiration date for these provisions.

### **HARDSHIP DISTRIBUTIONS**

Effective February 13, 2007 hardship distributions may be requested on account of an unforeseeable emergency of the participant's plan beneficiary, regardless of whether the beneficiary is the participant's spouse or other dependent.

## **SAVER'S TAX CREDIT**

The Saver's Tax Credit, a refundable tax credit available to low and middle income taxpayers who contribute to a qualified plan, has been made permanent. This credit was scheduled to expire in 2010. The maximum credit, currently 50% of contributions up to \$2000 (or a maximum credit of \$1000), will now be adjusted for inflation. The income limit to qualify for this credit is \$26,000 for single taxpayers and \$52,000 for married taxpayers filing jointly.

## **PROVISIONS RELEVANT TO IRAs**

Beginning in 2007, non-spouse beneficiaries will be able to roll over qualified plan benefits to an IRA and treat the IRA as an inherited IRA. Previously, only a deceased participant's spouse named as the beneficiary could roll over plan benefits into an IRA, treat the IRA as an inherited IRA, and avoid current taxation on the amount paid from the plan.

Also starting in 2007, the gross income limitations which apply to the ability to make tax deductible contributions to an IRA or to tax deferred earnings on contributions made to a Roth IRA will be adjusted for inflation. This will permit more individuals to make these types of IRA contributions.

During 2006 and 2007, individuals who are age 70-1/2 and older can withdraw up to \$100,000 tax free from an IRA, so long as the amount withdrawn is contributed to a charity. The amount withdrawn will not be treated as taxable income,

## **PLAN AMENDMENTS**

Many of the provisions discussed in this letter, as well as other changes made by the Act, will require plan amendments. While the adoption of these amendments is not required before the end of the plan year beginning in 2009, plans must comply in practice with required changes from the time the change is effective until the amendment is adopted. If a plan decides to adopt a provision of the Act which is optional, amendments may be required by the end of the plan year in which the change is implemented. Also, recent changes made to 401(k) regulations may mean that your 401(k) plan must be amended yet this year.

If you have any questions about the information contained in this newsletter, or if you require assistance with any required plan amendments, please contact either Stephen Hopkins or Karen Johnston at (612) 339-2500.

nor will the individual be entitled to a deduction for the contribution. The amount withdrawn will count toward any required minimum distributions from the IRA.

Lastly, the IRS has been directed to issue regulations during 2007 that will permit tax refunds to be deposited directly into an IRA.

## **ERISA ADMINISTRATIVE CHANGES**

Some new rules impact the administration of ERISA covered retirement plans. These include:

- Once final DOL regulations are issued, administrators will have more guidance and flexibility when buying annuity contracts to pay plan benefits.
- Pension plans can now allow in-service distributions at age 62. Given pending IRS guidance on phased retirement, however, it generally makes sense to wait for more complete regulatory guidance before using this provision.
- Effective in 2007, and subject to expected DOL guidance before year-end, plans have to provide more frequent and more detailed benefit statements to participants. These changes are most significant for plans which allow participant directed investments like 401(k) plans. In general, for such plans benefit statements must be provided each calendar quarter and must include additional investment-related disclosures. Failure to follow these rules may result in a penalty of \$110 per day, per failure.