

KEY PROVISIONS IN THE PENSION PROTECTION ACT OF 2006 FOR DEFINED CONTRIBUTION PLANS

While the Pension Protection Act of 2006 (PPA) began life as defined benefit funding reform legislation and contains many changes to defined benefit plans, it also contains a number of provisions dealing with 401(k) and other defined contribution plans. This brief overview highlights a few of the key PPA provisions applicable to single employer defined contribution plans, including, among others, provisions relating to employer securities, default investments, automatic enrollment arrangements and vesting.

Diversification of employer securities: Under PPA, a defined contribution plan that holds publicly traded employer securities must:

- Provide three alternative investment options (other than employer securities), each of which is diversified and has materially different risk and return characteristics.
- Allow participants to “diversify” (that is, invest in something other than employer securities) participant contributions at all times.
- Allow participants to “diversify” employer contributions after three years of service.
- For Plans that initially restrict a Participant’s ability to diversify out of employer securities, provide participants a notice describing the diversification right and the importance of diversifying investment of retirement account assets at least 30 days before they are eligible to diversify out of employer securities.

These rules do not apply to ESOPs to which no 401(k) or matching contributions are made, so “traditional” employee-ownership ESOPs are exempt. These rules generally take effect in 2007.

Default investment options: A question that comes up with respect to automatic enrollment programs, but may come up in other circumstances as well, is how to invest contributions where there is no affirmative participant election. Some sponsors default to a guaranteed income fund or money market fund, others default to balance or lifestyle funds. The PPA provides new protections for plan sponsors where certain notice and default fund requirements are met. Under the PPA, ERISA Section 404(c) protection is extended to

plans that use default provisions to invest participant accounts if (i) the defaulted amounts are invested in accordance with regulations prescribed by the Secretary of Labor (to be issued within six months of the enactment of PPA), (ii) affected participants receive an annual notice explaining their right to direct investments, and (iii) affected participants have a reasonable opportunity to exercise investment control. The notice must follow the safe harbor rules relating to notices being accurate, comprehensive, and written in an understandable manner. These rules are effective for plan years beginning after December 31, 2006.

Automatic Enrollment/Preemption of State Laws: In an attempt to increase participation in a 401(k) plan, many plan sponsors have considered implementing an automatic enrollment provision for their employees. Under such a program, employees are automatically enrolled in the 401(k) plan and salary deferral contributions are taken from their pay. In many instances, the only out of pocket cost associated with the automatic enrollment programs was any matching contribution resulting from increased participation. However, automatic withdrawals from an employee’s salary may violate state payroll laws which prohibit deductions from an employee’s pay without the employee’s written consent. The PPA removes this concern for automatic enrollment arrangements if a specified notice is given. Under the PPA, ERISA preempts state laws (e.g., wage withholding laws that require a signature for withholding) that would directly or indirectly prohibit or restrict an automatic enrollment feature in defined contribution plans, provided the specified notice is given. The preemption of state laws is effective immediately.

New ADP/ACP Safe Harbor: The PPA adds a new safe harbor provision to provide employers with yet another alternative for complying with the ADP test of IRC Section 401(k) and the ACP test of IRC Section 401(m). This provision also contains an automatic rollover requirement. The matching contribution is less under the PPA safe harbor than under the existing safe harbor matching option. However, the effective cost of the program may increase for a plan sponsor because participants are automatically enrolled to contribute and receive the match unless and until they affirmatively elect out of participation. This provision is effective for plan years

beginning after December 31, 2007. To qualify:

- Each eligible employee must be treated as electing to make elective contributions in an amount equal to a “qualified percentage of compensation” unless the employee opts out. This automatic election need not apply to current employees with an election in effect. The qualified percentage of compensation must be at least three percent of pay for the first plan year and increase by one percent each year up to six percent for year four and after. The automatic election must cease to apply if the employee makes an affirmative election.
- The plan must provide either a non-elective contribution of three percent of pay or a matching contribution equal to 100% of the first one percent of a participant’s contribution and 50% of the next two to six percent of a participant’s contribution.
- Other 401(k) rules must apply (e.g., withdrawal restrictions) to the participant’s contribution.
- Employer contributions must vest after two years.
- An employee subject to the automatic enrollment program must receive a notice that explains his or her right to elect not to have elective contributions made and how contributions will be invested if no investment election is made. The employee must have a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an affirmative election.

Vesting: Under old law, employer non-matching contributions to a defined contribution plan could be made subject to 5-year cliff or 7-year graded vesting. Under the PPA, with respect to all employer contributions, minimum vesting must be on a 3-year cliff or 6-year graded vesting schedule. EGTRRA (2001 tax law) previously required this faster vesting schedule for employer matching contributions, but not for other employer contributions. This change is generally effective in 2007.

EGTRRA Permanence: The PPA makes the EGTRRA pension reform provisions (i.e., higher benefit contribution limits, catch-up contributions, Roth 401(k)s, etc.) permanent.

Plan Amendments: The IRS has not yet provided guidance on how plan amendments to comply with the PPA will fit into the new five and six-year staggered remedial amendment program that began this year. In the PPA, Congress provided that amendments must be made before the end of 2009 and that anti-cut-back relief would be provided for these amendments. The IRS has informally stated that some amendments may be required before 2009. Future guidance will be forthcoming.

This alert discusses only some of the defined contribution aspects of PPA. The PPA also contains provisions that affect other employee benefit plans and programs. Employers should familiarize themselves with the new law and assess its effects on their employee benefit plans. Key decisions will need to be made about retirement plans going forward, especially about defined benefit plans. Employers might also have to make modifications to administrative and compliance systems. In nearly all cases, new communications and disclosures also will have to be developed. In many instances, new notices will be required even before the plan is formally amended. Employers should keep careful records regarding any operation modifications that occur regarding The PPA since these changes may need to be reflected in an amendment to the plan. **Please contact any member of the McAfee & Taft Employee Benefits practice group if you have questions about the PPA.**

McAfee & Taft will sponsor the **Oklahoma Labor & Employment and Employee Benefits Super Conference** on October 5, 2006, at the Cox Center in downtown Oklahoma City. An entire session will be devoted to discussion of the Pension Protection Act of 2006 and how it will affect defined contribution and other retirement plans sponsored by an employer. We encourage you to RSVP early for this seminar by contacting any of the members of our employee benefit practice group or by email at events@mcafeetaft.com.

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