2006 PENSION LAW CHANGES

WHAT EMPLOYERS NEED TO KNOW

Table of Contents

Introduction 2

Defined Benefit Pension Plan Reforms 2

Cash Balance Plans 3

EGTRRA "Sunset" Provision 4

Automatic Enrollment 4

Investment Advice 6

Default Investment Safe Harbor 7

Diversification of Employer Securities 8

Reporting and Disclosure Provisions 8

DB(k) Plans 11

Portability and Distribution Rules 11

Miscellaneous Provisions 14

How We Can Help 16

Copyright ©2006 by NPI.

Touted as one of the most important pieces of retirement plan legislation in the past 30 years, the Pension Protection Act of 2006 has become law. Prompted by the need to address the ongoing funding issues facing many traditional defined benefit pension plans, Congress has passed a law that also covers a broad range of rules affecting qualified retirement plans in general, employers that sponsor those plans, and plan participants.

More specifically, the new law contains provisions introducing expanded portability and distribution rules, new and changed reporting and disclosure requirements, new automatic enrollment rules, clarifications regarding the giving of investment advice, and more. Other provisions affect Individual Retirement Accounts and similar retirement savings vehicles.

In this booklet, we summarize the retirement plan provisions of the Pension Protection Act (PPA) and explain how the new changes might affect your plan. The new law presents a number of planning opportunities, as well as new requirements that your plan may have to meet. Since many of the changes are complex, you'll want to seek professional assistance to help you best take advantage of the PPA and comply with its new rules.

DEFINED BENEFIT PENSION PLAN REFORMS

The new law overhauls many of the rules affecting defined benefit pension plans, generally effective for the 2008 plan year (with some exceptions). The new changes are complex. Among them:

- The minimum funding rules for both single employer plans and multiemployer (union) plans have been revised. For example, for single employer plans, the minimum required contribution for underfunded plans will be the sum of the plan's normal cost plus seven-year amortization of the plan's funding shortfall. Plans deemed to be "at risk" must use different assumptions to determine

target normal costs and funding targets than plans that are determined to be not at risk. Special funding relief for certain industries (e.g., airlines) is provided.

- The tax deduction limits for defined benefit pension plan sponsors are increased under certain conditions, and the computation of the combined limit on deductible contributions to the employer's defined benefit and defined contribution plans is updated and, in general, increased.

- Benefit payouts with respect to underfunded single employer plans are restricted, and significant penalties are imposed on executives whose employers set aside or reserve assets in a nonqualified deferred compensation plan when the employer's defined benefit plan is considered to be "at risk" or the plan sponsor is in bankruptcy. This follows the government's philosophy that senior management should fare no better than rank and file employees, even if there is no clear connection between the operation of the various plan types.

- The rules for calculating lump sum distributions from defined benefit plans are amended. These rules are phased in over five years.

- The provisions affecting premiums required to be paid to the Pension Benefit Guaranty Corporation to cover certain benefits of defaulted defined benefit plans are altered, and include a special reduced variable rate premium for employers with 25 or fewer employees.

CASH BALANCE PLANS

PPA also contains provisions affecting so-called "cash balance plans" and other hybrid retirement plans. For example, the new law imposes requirements on conversions of defined benefit plans to hybrid plans, generally effective for conversions occurring after June 29, 2005, and exempts defined benefit plans and cash balance plans from age dis-

crimination claims as long as certain standards are met. However, the law provides no clarification with respect to defined benefit plans that converted to hybrid plans in prior years.

EGTRRA "SUNSET" PROVISION

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) overhauled many retirement plan and Individual Retirement Account (IRA) rules. Among the changes:

- Higher maximum annual salary deferrals to 401(k) salary deferral plans, 403(b) tax sheltered annuity plans, and 457 deferred compensation plans;
- Increased IRA contribution limits;
- Allowance of Roth-type contributions to 401(k) and 403(b) plans;
- Additional qualified plan and IRA contributions ("catch-up contributions") for those individuals age 50 or older; and
- A tax credit for lower-income individuals who save for retirement (the so-called "Saver's Credit").

Most of the EGTRRA pension changes were set to "sunset" after 2010, while the Saver's Credit was due to expire at the end of 2006. PPA makes the EGTRRA provisions relating to retirement plans and IRAs permanent.

AUTOMATIC ENROLLMENT

Applicable to plan years beginning on or after January 1, 2008, PPA provides several incentives for sponsoring employers to adopt automatic enrollment in their 401(k) plans. Automatic enrollment, also known as "negative election," allows an employer to enroll employees in a salary deferral plan without the employees' consent, as long as the employees have the right to "opt out" of contributing. Among the incentives:

- The new law eliminates conflicts with state laws on wage withholding without employee consent, effective on PPA's enactment date. Accordingly, plan sponsors are no longer subject to state challenges that automatic enrollment withholding is contrary to state law. Employee notice requirements apply;
- The new law contains safe harbor rules that would relieve a "qualified automatic contribution arrangement" from nondiscrimination testing, with lower required employer contributions than under preexisting safe harbor matching contribution rules (see accompanying box);
- All eligible automatic enrollment arrangements (whether "qualified" or not, and whether part of a 401(k) plan, 403(b) arrangement, or eligible 457(b) plan) can allow employees to take penalty-free withdrawals of automatic deferrals and related earnings if the withdrawal request is made within 90 days of the first deferral;
- Nonqualified ("non-safe harbor") automatic enrollment arrangements will have additional time to test for discrimination and, if needed, make corrective distributions (six months after the end of the plan year, rather than 2½ months under pre-PPA law); and
- Relief from fiduciary liability is provided with respect to default investments (see *Default Investment Safe Harbor* on page 7).

A "qualified automatic contribution arrangement" will fall within the "safe harbor" and automatically comply with 401(k) nondiscrimination testing. A qualified arrangement:

(1) Provides for an automatic contribution percentage of at least a minimum specified percentage (ranging from 3% to 6% depending on how long contributions have been made for the employee) but no more than 10%;

(2) Does not have to automatically enroll current employees who (a) were eligible to participate in the plan before the automatic enrollment arrangement became qualified and (b) had deferral elections (or elections not to defer) in place at that time;

(3) Requires the plan sponsor to make *either* matching contributions (100% of the first 1% of compensation deferred plus 50% of the next 5% deferred) *or* nonelective contributions (at least 3% of compensation to all eligible non-highly compensated employees, whether the employees make deferrals or not);

(4) Provides that the employer contributions become 100% vested after an employee has completed no more than two years of service;

(5) Requires that, within a reasonable time prior to the start of the plan year, employees eligible to participate in the qualified arrangement receive written notice of the employees' rights and obligations, as spelled out in the law.

INVESTMENT ADVICE

One of the most often-heard comments from plan participants about retirement plan investing is that they need more in the way of investment advice. Until PPA, plan service providers and plan sponsors have been reluctant to provide full advice due to concerns and uncertainties about fiduciary liability for the advice.

The new law permits retirement plan service providers who offer investments to participant-directed plans ("fiduciary advisers") to provide advice and, if warranted, recommend their own funds without violating fiduciary rules. In general, PPA grants prohibited transaction exemptions for advice provided under an "eligible investment advice arrangement." Plan sponsors and other fiduciaries are, however, still responsible for prudent selection

and periodic review of the fiduciary adviser that provides the advice.

To be eligible, an investment advice arrangement would *either* have to make the adviser's fees "neutral" (meaning that the fees do not vary on the basis of which investment options are chosen) *or* use an unbiased computer model certified by an independent expert to create a recommended portfolio for a participant's consideration.

Before initially providing advice, the fiduciary adviser must provide a written notice (on paper or electronically) containing specified information. This information includes (among other items) the role of any related party in developing the advice program or selecting investment options, past performance and rates of return for each of the plan's investment options, and any fees or other compensation to be received by the fiduciary adviser.

In the case of an eligible investment advice arrangement under a defined contribution plan, such as a 401(k) plan, the law requires an annual independent audit for compliance, with an audit report provided to the fiduciary that authorized the arrangement. The new rules are generally applicable beginning in 2007.

Note that investment advisers for IRAs and similar accounts (e.g., Health Savings Accounts) may only use the "neutral fee" qualification requirement for an eligible investment advice arrangement. The government will conduct a feasibility study to determine if a computer model exists that could allow IRAs to use the certified computer model alternative.

DEFAULT INVESTMENT SAFE HARBOR

PPA amends Section 404(c) of the pension law, which addresses fiduciary liability with respect to participant-directed plan investments. Essentially, the law provides that participants who fail to exercise an investment election will be considered to exercise

control over a default investment (and potentially qualify the fiduciaries for protection under 404(c)) if the participants receive a notice a reasonable time before each plan year that explains their right under the plan to designate how contributions and earnings are invested and, in the absence of an investment election, the default investment into which those contributions and earnings will be invested. Participants must be given a reasonable amount of time to make an investment designation. The U.S. Department of Labor (DOL) will issue regulations fleshing out these requirements.

DIVERSIFICATION OF EMPLOYER SECURITIES

Some employers that sponsor defined contribution retirement plans encourage or even require participants to invest at least part of their plan accounts in the employer's publicly traded stock.

In general, for plan years beginning after 2006, these plans must permit participants to immediately divest any employer securities that were purchased with employee contributions (including deferrals) and diversify the proceeds into other plan investments. For employer securities bought with employer contributions, plans must allow divestment anytime after the participant has completed three years of service. The diversification rule is not applicable to separate Employee Stock Ownership Plans (ESOPs) that do not hold elective deferrals, other employee contributions, or employer matching or certain nonelective contributions. A three-year phase-in period applies to employer contributions in existing plans. Other requirements, restrictions, and exceptions apply.

REPORTING AND DISCLOSURE PROVISIONS

The new law expands the reporting and disclosure requirements with respect to retirement plans. Among the changes:

Benefit statements. Defined contribution plans (e.g., 401(k) plans, profit sharing plans) must provide benefit statements at least quarterly to participants who can direct their own investments and annually to those who cannot. Special requirements apply to the content of the statement for participant-directed plans. For defined benefit pension plans, employed participants having nonforfeitable accrued benefits must *either* receive a benefit statement at least once every three years *or* annually be furnished with a notice telling them how to obtain a statement. Electronic distribution is permitted. In addition, a defined benefit plan participant or beneficiary may make a written request for a statement once a year. The new requirements generally go into effect for plan years beginning after 2006.

Defined benefit funding notice. Effective for plan years beginning after 2007, single employer defined benefit plans will have to furnish participants with an annual funding notice, as is currently required of multiemployer plans. The notice must contain information specified in the law (including the status of the plan's funding target attainment percentage) and will have to be furnished no later than 120 days after the end of the plan year. A small plan having 100 or fewer participants can provide the notice concurrent with the filing of its Form 5500 annual report for the plan year.

Electronic display of annual report information. Identification and basic plan information (including any applicable actuarial information) included in the Form 5500 annual report for a plan year must be filed with the DOL in an electronic format (to be prescribed in regulations) that accommodates display on the Internet. The DOL shall then display this information on its website within 90 days after filing. The information must also be displayed on any nonpublic Intranet website maintained by the plan sponsor or plan administrator for communicating with employees. This provision is effective for plan years beginning after 2007.

Notice of right to diversify employer securities. In conjunction with the new rule on diversification of employer securities (see *Diversification of Employer Securities* on page 8), PPA requires that a plan provide participants who have a right to divest employer securities and diversify among other plan investments an advance written notice of the right to divest the employer securities and the importance of diversifying retirement account investments. The notice must be given at least 30 days before the first date on which a participant is eligible to exercise the right. Separate notices are required where a participant becomes eligible to exercise diversification rights at different times. The notice requirement is generally effective for plan years beginning after 2006.

Blackout notices. In 2002, the pension law was amended to require advance notice of a "blackout period" to plan participants and beneficiaries when their ability to direct investments, obtain loans, etc., would be restricted for more than three consecutive business days. PPA retroactively exempts from the blackout notice requirements one-participant plans (including plans that cover the spouse of the owner) and plans that cover only partners in a partnership (or partners and their spouses).

Form 5500 relief. The new law exempts one-participant plans with assets of $250,000 or less from filing a Form 5500-EZ annual report. Also, the government is directed to provide simplified reporting requirements for plans with fewer than 25 participants, if the plan meets certain other requirements. Both provisions are effective for plan years beginning after 2006.

Distribution notices. Starting in 2007, the 90-day notice periods with respect to plan distributions and rollovers (the "Section 402(f) notice"), qualified joint and survivor annuity requirements, and participant consent to mandatory distributions are increased to 180 days.

DB(K) PLANS

For plan years beginning in 2010 and later, an "eligible combined plan" will allow elements of a defined benefit plan to be combined with those of a 401(k) arrangement into a single plan. In other words, a traditional defined benefit plan will be able to accept 401(k) contributions. A sponsoring employer will be able to have no more than 500 employees. The 401(k) component must include a 4% of pay automatic enrollment feature and a fully vested 50% match on the first 4% of pay deferred. Several other requirements apply.

PORTABILITY AND DISTRIBUTION RULES

The Pension Protection Act also contains provisions that liberalize the ability of participants to move their retirement savings to other retirement arrangements and receive plan payouts.

Direct rollovers into Roth IRAs. Starting in 2008, participants will be able to make direct rollovers of distributions from their qualified plans, 403(b) tax-sheltered annuity arrangements, and governmental 457(b) plans to Roth IRAs. Any such rollover will be subject to the Roth IRA conversion rules in effect at the time of the rollover.* It is important to remember that this will still be a taxable event at the time of the rollover, which could impact how much of the distribution the participant will be able to afford to roll over to the Roth IRA.

Inherited benefits. Beginning in 2007, non-spouse beneficiaries of a decedent's balance in a qualified plan (such as a 401(k) plan), 403(b) annuity, governmental 457(b) plan, or IRA may roll over the inherited amounts to their own IRAs. Previously,

* Tax legislation enacted earlier in 2006 revised the rules on conversions to Roth IRAs, effective in 2010. Generally, taxpayers will be able to convert traditional IRAs to Roth IRAs without any income limits. Present law limits Roth IRA conversions to taxpayers with $100,000 or less in modified adjusted gross income.

only surviving spouses could do this. However, non-spouse beneficiaries must generally begin their distributions immediately, while surviving spouses can continue to defer payouts until they attain age 70½.

In-service distributions. Effective for distributions in plan years beginning after 2006, defined benefit pension plans can make in-service distributions to participants age 62 or older who are not separated from service. It is anticipated that this provision will make it easier for participants to phase into retirement.

After-tax amounts. Beginning in 2007, the portability of after-tax retirement plan contributions is expanded. The new law allows direct rollovers of after-tax contributions between different types of employer plans (for instance, from a 401(k) plan to a 403(b) annuity).

Tax refunds to an IRA. Starting in 2007, taxpayers can have all or part of their federal income-tax refunds directly deposited into an IRA, within applicable IRA contribution limits.

Waiver of penalty for withdrawals by reservists. The new law allows penalty-free withdrawals from IRAs and 401(k) and 403(b) plans (or similar arrangements) by a military reservist called to active duty for a period exceeding 179 days or an indefinite period. The withdrawal must occur during the period from the date of the call up to the end of active duty. The reservist may "roll over" the distribution tax free by recontributing the amount of the distribution to an IRA within two years following the end of the active duty period. This provision applies to post-September 11, 2001, distributions made to individuals called up after that date, and before December 31, 2007.

Withdrawals by public safety officers. Effective for distributions after PPA's enactment date, the 10% early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to

a qualified public safety employee who separates from service after turning age 50. A qualified public safety employee is an employee of a state or political subdivision of a state if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of that state or political subdivision.

Faster vesting. Generally applicable to contributions for plan years starting after 2006, employer nonelective (e.g., profit sharing) contributions must become nonforfeitable using the faster three-year cliff or six-year graduated vesting schedules applicable to employer matching contributions.

Employer Nonelective Contribution Vesting — Old vs. New

Pre-PPA Minimum Vesting	*Years of Service*	*Vested Percentage*
Cliff Vesting Formula	5 or more	100%
Graduated Vesting Formula	Less than 3	0%
	3	20%
	4	40%
	5	60%
	6	80%
	7 or more	100%

PPA Minimum Vesting	*Years of Service*	*Vested Percentage*
Cliff Vesting Formula	3 or more	100%
Graduated Vesting Formula	Less than 2	0%
	2	20%
	3	40%
	4	60%
	5	80%
	6	100%

Hardship withdrawals. Hardship withdrawals will be permitted for hardships of a person who is a participant's beneficiary under the plan, even if that beneficiary is not the participant's spouse or dependent. Similar rules will be applicable for unforeseeable financial emergencies for beneficiaries in 457(b) and 409A nonqualified arrangements. Therefore, if an event would constitute a hardship or unforeseeable emergency under the plan if it occurred with respect to the participant's spouse or dependent, such event shall, to the extent permitted under the plan, constitute a hardship or unforeseeable emergency if it occurs with respect to any beneficiary under the plan. Regulations modifying existing hardship withdrawal rules are to be issued within 180 days after the date of PPA's enactment.

MISCELLANEOUS PROVISIONS

Saver's Credit. The income limits applicable to the Saver's Credit will be adjusted for inflation.

IRA income limits. The income-related limits that apply to deductible contributions to traditional IRAs and after-tax contributions to Roth IRAs are made subject to inflation indexing.

Use of excess pension assets for future retiree health benefits. PPA contains several provisions affecting the ability of defined benefit plan sponsors to transfer pension plan assets in excess of the plan's current liability (or funding target) to a health account under the plan or a related health plan to cover estimated retiree medical costs.

Expanded role for PBGC. Upon the release of regulations by the PBGC, account balances of missing participants in terminated defined contribution plans may be sent to the PBGC rather than rolled over to an IRA established by the employer on the participant's behalf.

Added IRA contributions for victims of employer wrongdoing. Certain individuals may elect to make

additional IRA contributions of up to $3,000 to help compensate for the wrongdoings of their employers. An "applicable individual" must have participated in a 401(k) plan under which the employer matched at least 50% of the employee's deferrals with employer stock. In addition, prior to the taxable year of an additional contribution: (1) the employer (or any controlling corporation of the employer) must have been a debtor in a bankruptcy case and (2) the employer or any other person must have been indicted for or convicted of a crime resulting from business transactions related to the bankruptcy. The individual making the IRA contribution must also have been a participant in the 401(k) plan on the date six months before the bankruptcy case was filed. The additional contributions may generally be made in 2007 through 2009.

IRA distributions to charity. PPA provides an income-tax exclusion for otherwise taxable distributions of up to $100,000 paid to a qualified charity from a traditional IRA or a Roth IRA, provided the IRA owner is at least age 70½, applicable for 2006 and 2007.

Plan amendments. In general, plan amendments reflecting PPA's changes are required by the end of the 2009 plan year. Governmental plans have an additional two years to amend.

Section 529 Plans. Certain changes made in 2001 regarding the tax treatment of qualified tuition programs (so-called "529 plans") were scheduled to "sunset" after 2010. Included among those expiring changes: the provision that qualified withdrawals from qualified tuition accounts are exempt from income tax. The new legislation makes these changes permanent.

Other provisions. The new law also contains a number of other changes affecting federal income-tax charitable contribution deductions and exempt organizations, Tax Court modernization, corporate-owned and other life insurance, tariffs, and health benefits.

HOW WE CAN HELP

The Pension Protection Act of 2006 makes many significant changes to the rules governing retirement plans. These changes will affect nearly every plan sponsor and plan participant. To make sure that your plan is ready for the changes, it is important that you talk to your retirement plan adviser as soon as you can.

We can help. Our organization offers a broad range of services that can help retirement plan sponsors understand and implement the new rules and meet their obligations in the most cost-effective manner. Our professionals stand ready to assist you.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. The general information in this publication is not intended to be nor should it be treated as tax, legal, accounting, or other professional advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax adviser based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

PEN 8/06