

News &amp; Resources on legal issues that impact Employee Benefits Management

AUGUST 2006

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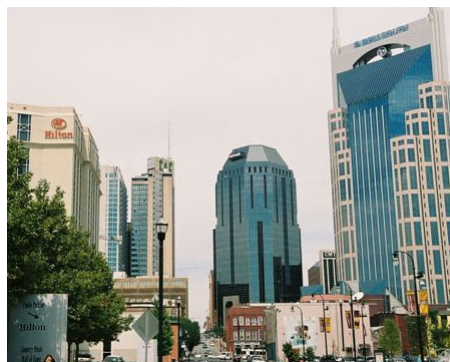
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Our new attorney in the Atlanta office is **F. Maria Sheffield** (Insurance, Healthcare and Government Relations). New attorneys in Nashville include: **Lawrence R. Ahern III** (Creditors' Rights, Workouts & Insolvencies and Corporate & Commercial Law), **W. Davidson Broemel** (Insurance, Litigation, and Government Relations), **Kevin M. Doherty** (Insurance, Entertainment, and Healthcare), **David W. Houston IV** (Creditors' Rights, Workouts & Insolvencies and



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Corporate & Commercial Law), **Sandra A. Keifert** (Healthcare and Insurance), **Darlene T. Marsh** (Environmental & Land Use and Commercial Real Estate), **Alisa C. Peters** (bar admission pending) (Corporate, Real Estate & Tax)

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## PENSION PROTECTION ACT OF 2006 (PPA) TAKES FRONT AND CENTER STAGE

**Introduction**

Earlier this month, Congress and the President laid a huge pension reform bill on us. Here are some quick statistics to help you appreciate the size and scope of this legislation:

- Number of pages in the legislation: 907;
- Number of pages in the Conference Report: 376;
- Number of Tax Code sections amended: 99;
- Number of ERISA sections amended: 52;
- Number of news articles about the PPA located by Google as of August 23, 2006: 466; and,
- Number of articles or references on BenefitsLink ([www.benefitslink.com](http://www.benefitslink.com) – one of our favorite websites) to PPA as of August 23, 2006: 65.

Clearly, we are in an age of information overload. Clearly, also, summaries of the entire PPA are almost useless because they are necessarily required to describe the legislation in extremely broad terms.

My plan in this issue of our newsletter is the discuss only the following portions of the PPA – all of which are directed towards making 401(k) plans more successful in allowing employees to accumulate enough funds to retire. Currently (in this author's opinion), the retirement system in this county is in real trouble because so many employers establish 401(k) plans as the principal retirement plan for their employees, employees either don't save at all, or save too little, and employees are notoriously poor when it comes to investing their 401(k) savings. I do not by any means intend to suggest that employers are dropping the ball – since World War II our workforce has become so mobile (for the most part) that traditional pension plans have little value for most employees. So employers are by and large simply responding to the labor force's market demands by placing so much reliance on 401(k) plans.



### **Eligible Investment Advice Arrangements**

Current law precludes (in the absence of a prohibited transaction exemption (PTE) from the Department of Labor) “disqualified persons” and fiduciaries from receiving any fees from plan assets for their own personal accounts arising from the rendering of investment advice to the plan or its participants. While this prohibition makes sense if one is trying to prevent self-dealing by fiduciaries, it has hobbled the efforts of the professional investment community to advise 401(k) plan participants how to wisely save and invest over long time horizons for retirement.

Title VI of the PPA attempts to address from the ground up the relationship between 401(k) plan participants, mutual funds, and investment advisors. One hopes that what comes of this will be a cleaner and simpler model for employers and employees to understand. For example, Section 601 of the PPA allows fiduciaries to provide investment advice to plan participants for a fee so long as the advice is provided through an “eligible investment advice arrangement.” Investment advice is considered to be provided through an eligible investment advice arrangement if (i) the advisor's fee does not vary depending upon the basis of the investment option selected by the participant (question: does this mean that the fee can be either a flat dollar amount or a flat percentage of invested assets?), or (ii), the

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So the question is... what has Congress done in the PPA to make 401(k) plans function in a more successful manner? In answer to this question, this issue of our newsletter will focus on the following:

- exemption from the prohibited transaction rules for professional investment advice through an “eligible investment advice arrangement;”
- new safe harbor relating to reallocations of accounts during blackout periods;
- new Section 404(c) protection for default investment options ;
- new safe harbors pertaining to automatic enrollment and increases in deferral percentages; and,
- shorter vesting periods.

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<sup>1</sup> For a discussion of Section 404(c) in broader terms see New Section 404(c) Protection for Default Investments of our Employee Benefits newsletter.

advisor uses an approved computer-driven model in connection with the provision of investment advice. What Congress appears to have in mind with this computer-driven model idea is that an advisor will be allowed to recommend and receive a fee for designing a portfolio for a participant using information about the participant, the funds available in the plan, and historical rates of return relating to those funds and to market indexes generally. Assuming such a model is used (and properly approved in advance), the advisor may apparently receive a fee not only based upon the investment options selected for the participant but an additional fee related to design of the participant's portfolio.

There are various checks and balances built into the new law intended to prevent abuse. For example, a "super fiduciary" of sorts must approve the eligible investment advice arrangement in advance. There are annual audit requirements, and there are written notice requirements.

For the most part these changes all become effective as of the first of next year.

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### **New Safe Harbor for Reallocation of Account Balances During Blackout Period**

Section 621 of the PPA addresses this issue with a wonderful double negative. Section 621 says that a participant or beneficiary shall not be treated as having not exercised control over his account investments if – during a blackout period – there is a realignment or change in investment options that qualifies as a "qualified change in investment options." A qualified change in investment options means the following:

- the substitution of one investment option for another during a blackout period so long as the risk and return characteristics of the new fund are reasonably similar to the fund that it replaces;
- the participant is given – no less than 30 and no more than 60 days prior to the effective date of the change – written notice of

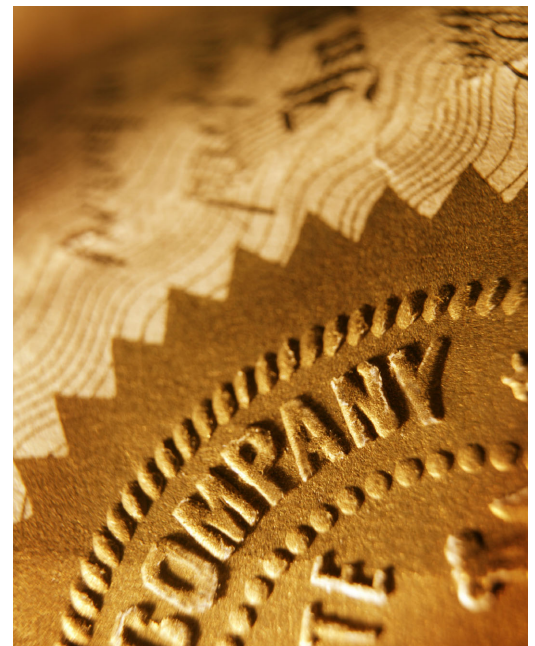
the substitution and the opportunity to pick another fund instead;

- the written notice must provide sufficient comparison in fund performance and characteristics to allow the participant to make an informed decision;
- the written notice must tell the participant what will happen in the absence of picking another fund; and,
- the fund that is being replaced in the plan must have been one over which the participant had previously exercised control within the meaning of Section 404(c) of ERISA.

This change will be generally effective beginning in 2008.

### **New Section 404(c) Protection for Default Investments**

Section 624 of the PPA says that a participant shall be deemed as having exercised control over his account under Section 404(c) if – in the absence of instructions to the contrary – the participant's account is invested in a default investment that "includes a mix of asset classes consistent with capital preservation or long-term capital appreciation or both." Section 624 of the PPA charges the Department of Labor with promulgating regulations telling plan sponsors how they are supposed to do this. Once the plan sponsor has designed a default investment option in accordance with regulations, the employer must give written notice within a reasonable period of time preceding the plan year of what the default investment option will be and that it



will apply to the participant unless the participant provides contrary instructions. Assuming that all of this properly occurs, Section 404(c) protection will apply to the employer with respect to the default investment election.

These changes generally take effect beginning January 1, 2007.

### New Safe Harbors Pertaining To Automatic Enrollment And Increases In Deferral Percentages

Section 902 of the PPA deals with this topic. It adds a new paragraph 13 to Section 401(k) of the Internal Revenue Code. Paragraph 13 creates something called a “qualified automatic contribution arrangement.” Right off the bat, Section 902 straightforwardly asserts that qualified contribution arrangements “shall be treated as meeting the requirements” of the 401(k) ADP tests. This is a remarkable – although somewhat cryptic – statement. The Conference Report clears up any mystery though; the Report clearly states that if a 401(k) plan contains a “qualified automatic contribution arrangement” the plan not only satisfies the ADP and ACP tests but is also given a green light on the top heavy test. On the face of it, this is pretty strong medicine for 401(k) plans. So what does all this mean when one looks under the hood?

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It is hard to overstate just how massive and complex this new legislation is.

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There are three parts to a qualified contribution arrangement. They are as follows:

- The plan must provide that – unless an employee elects otherwise – he will be enrolled in the plan with deferrals at the following levels:

| Participation Year | Required Minimum Deferred Percentage | Maximum Permitted Deferral Percentage |
|--------------------|--------------------------------------|---------------------------------------|
| 1                  | 3%                                   | 10%                                   |
| 2                  | 4%                                   | 10%                                   |
| 3                  | 5%                                   | 10%                                   |
| 4 & thereafter     | 6%                                   | 10%                                   |

*These percentages must be applied uniformly to all eligible employees.*



- The employer must make matching or non-elective contributions in the following amounts. If matching contributions, then the match must equal 100 cents on the dollar up to the first one percent of pay, and 50 cents on the dollar up to six percent of pay. At this point, matching contributions must stop. If the plan provides for additional matching contributions it no longer qualifies under this special test. In lieu of making these matching contributions, the employer is given an option of making an across the board 3% qualified nonelective contribution (QNEC). Matching contributions and QNECs are required to comply with a special two year cliff vesting schedule. Matching and special QNECs under this rule are subject to the same withdrawal restrictions that apply to elective deferrals.
- The employer must provide employees with a written notice that explains all of this and explains how the employee’s funds will be invested in the absence of an investment election. If the employee does not wish to contribute at the default level – he or she must be given a reasonable period of time to contribute at another level. Note, however, that the matching contribution may not exceed the levels noted above – even if the employee contributes more than the default amount as a percent of pay or in dollar terms.

All of these changes generally apply beginning January 1, 2008.

### Conclusion

It is hard to overstate just how massive and complex this new legislation is. It will take some time before employers and their advisors are able to come to full grips with everything that is in there. 🌐



## NEXT ISSUE

Barring any unforeseen developments, the next issue of our EB Newsletter will either focus on other aspects of the new law (probably the case), or will discuss the JCEB (Joint Committee on Employee Benefits) Q&As from the May ABA Tax Section Meeting. 🌐

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