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IMPLICATIONS OF THE PENSION PROTECTION ACT OF 2006 FOR 2007 PLAN ADMINISTRATION

by
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The Pension Protection Act of 2006 signed by the President in August reflects some of the most far reaching changes affecting benefit plans since the passage of the Employee Retirement Income Security Act of 1974. Although much of the Act is directed at attempting to shore up the funding status of the nation's defined benefit plans, much less reported in the public press have been the significant changes made to the more common types of retirement plans for smaller employers -- defined contribution plans, such as 401(k) and profit sharing plans and employee stock ownership plans. In this Benefits Brief, we will explain some of the more significant changes affecting defined contributions plans which go into effect in calendar year 2007 and the 2007 plan year and suggest actions to be taken by plan sponsors and plan administrators in order to assure continued compliance¹.

OVERVIEW OF SIGNIFICANT CHANGES

Accelerated Vesting Requirements: The faster vesting schedules made applicable to employer matching contributions in the Economic Growth and Tax Relief Reconciliation Act of 2001 have now been extended to apply to all employer contributions. With a limited exception for certain

¹A discussion of the plan administration changes occasioned by the PPA affecting defined benefit plans is beyond the scope of this Benefit Brief. Further, this Benefits Brief describes the changes affecting single employer qualified defined contribution plans and does not describe changes applicable to Section 403(b) or Section 457 plans.

leveraged employee stock ownership plans, employer contributions must now vest at least as rapidly as under one of two vesting schedules: (1) three-year cliff vesting, under which the participant must be 100% vested after 3 years of service, or (2) six-year graded vesting, under which contributions must be 20% vested after two years of service and the vested percentage increases 20% each year until the participant is fully vested after six years of service. These vesting schedules are the same as have always applied to top heavy plans (i.e., plans where 60% of account balances are attributable to key employees).

These new vesting requirements are effective for contributions made after December 31, 2006 with respect to employees who have an hour of service after that date. Plan sponsors may continue to apply the prior vesting schedules to contributions (and attributable earnings) made prior to December 31, 2006 provided separate accounting is maintained for those contributions. For ease of administration and participant understanding, many (and probably most) sponsors will likely adopt one of the new vesting schedules for all employer contributions, even those made before 2007.

Expanded Hardship Withdrawal Options: The PPA expands the scope of hardship withdrawals by directing the Treasury Department to issue regulations to permit distributions

with respect to a participant's designated beneficiary even if he/she is not the participant's dependent for tax purposes. Examples include parents, grandchildren, and domestic and same-sex partners. This change is effective within 180 days of enactment. Note that plans still are not required to permit hardship withdrawals; if a plan permits hardship withdrawals, it may also be required to permit them for qualifying hardships of a participant's non-dependent beneficiary.

Rollovers By Nonspouse Beneficiaries: Under current law, only beneficiaries who are surviving spouses can roll over a distribution tax free to an individual retirement account or another eligible employer plan. In contrast, nonspousal beneficiaries of deceased participants generally incur immediate taxation because most retirement plans, as a matter of administrative convenience, require that distributions to nonspousal beneficiaries be made within a short period of time after the participant's death. The PPA substantially expands the tax-free rollover options by permitting nonspousal beneficiaries, such as children, trusts, and domestic or same-sex partners, to roll over distributions made after December 31, 2006 from a deceased plan participant's qualified plan account to an individual retirement account.

Periodic Benefit Statements: New timing and content requirements will apply to participant statements effective in

the first plan year beginning after December 31, 2006. In plans in which participants direct the investment of their account, statements must now be provided automatically each quarter; in plans not subject to participant direction, statements must be provided automatically once a year. In addition, statements must also be provided upon request no more frequently than annually. Regardless of frequency, plan administrators may generally utilize electronic technologies to distribute the statements.

For all defined contribution plans, the statement must reflect, on the basis of the latest information, the participant's accrued benefit; the portion of his/her benefit in which he/she is vested, the earliest date in which benefits will become vested; and, if the benefit is determined under the permitted disparity provisions (i.e., integration with social security), an explanation of how the benefit is calculated. In addition, the statement must also include the value of each investment in which the participant is invested (determined as of the most recent valuation date). Statements for participant directed plans must also include an explanation of any limitations or restrictions on the right to direct investments, an explanation of the importance of diversification and the risk of holding more than 20% of the value of an account in a single investment, and a notice directing the participant to the Department of Labor's website for information on investing and diversification.

As with the summary plan description, these explanations must be written in a manner as to be understood by the average plan participant. The Department of Labor is directed to issue a model benefit statement no later than August 17, 2007. A failure to comply may result in penalties of up to \$110 per day per participant.

Since enactment, the Department of Labor has issued a field assistance bulletin which sets forth a good faith compliance standard with respect to periodic benefits statements and provides guidelines on what constitutes good faith compliance on a number of specific issues. Among the guidelines included in the bulletin are: the ability to use multiple documents to satisfy the requirements so long as advance notice explains how and when that information will be provided; permission to utilize electronic technologies that satisfy either DOL or IRS regulations; a 45-day period after the end of the relevant period to provide the statements; guidance on the required descriptions of the limitations or restrictions on the right to direct investments; and suggested language to explain the importance of a diversified portfolio and the address of the DOL website to which participants are to be directed for further information on retirement plan investing.

Distribution Notices and Participant and Spousal Consents: Under present law, certain distribution notices may not be

given and participant and spousal consents to distributions may not be obtained earlier than 90 days prior to the distribution date. That time period has now been increased to 180 days, effective for years beginning after December 31, 2006. In a related change, the PPA directs the Treasury Department to issue regulations requiring that plan administrators include an explanation of the tax and retirement savings consequences of not deferring receipt of a distribution as part of the notice to the participant explaining his/her right to defer the distribution that is required under current law. Until final regulations are issued, plan administrators must make a "reasonable attempt" to comply with this disclosure requirement.

Miscellany: There are a few other 2007 changes that merit brief mention:

•*Investment Advice* - The Act includes a new prohibited transaction exemption which permits investment providers to plans and their affiliates to provide participant level advice, beginning in 2007. The advice provided must be made pursuant to a fee arrangement under which the compensation does not vary according to the advice given or must be given pursuant to certain tested computer models. Suffice it to say that the requirements for qualification are quite detailed and raise a host of interpretational issues. As a practical matter, investment vendors and providers are not likely to offer these programs until clarifying guidance

is issued by the Department of Labor.

•*Diversification* - Most defined contribution plans which mandate that all or part of a participant's accounts be invested in employer securities must satisfy new diversification requirements if those securities are publicly traded. Generally speaking, participants must be given the right to diversify employer securities attributable to employee deferrals and contributions immediately and to diversify employer securities attributable to employer contributions after three years. At least 30 days before becoming eligible to diversify, each affected participant must be provided notice of the right to diversify and the importance of diversifying the investment of retirement plan accounts.

•*Default Investments* - The Act provides relief to plan fiduciaries in participant-directed plans for default investments made on behalf of participants who fail to make an affirmative investment election. To qualify for the relief, the participant must be provided an annual explanation and the participant's contributions must be invested in accordance with regulations to be promulgated by the Department of Labor. Shortly after enactment, the Department of Labor issued proposed regulations generally authorizing for this purpose the use of lifecycle, target maturity, or balanced funds or managed accounts which operate in a

manner similar to a lifecycle fund.

AMENDMENT AND OPERATIONAL COMPLIANCE DEADLINES

Under the PPA, plan documents for single employer plans must be amended to reflect its provisions by the last day of the plan year beginning on or after January 1, 2009. Although the amendment deadline has been extended, operational compliance with the changes is required as of their respective effective dates.

In recent years, the IRS has required plan sponsors to adopt interim "good faith" amendments when significant changes in the law have occurred, notwithstanding a later statutory amendment deadline. At this time the IRS has not announced whether an interim "good faith" amendment will be necessary in 2007 nor whether it will publish a model amendment that can be used for this purpose. If recent history is a guide, it would not be surprising to see the IRS require a good faith amendment but not provide suggested language to be used for that purpose.

ACTION ITEMS FOR PLAN SPONSORS AND PLAN ADMINISTRATORS

Periodic Benefit Statements: Perhaps the most pressing of the action items for plan administrators of participant directed plans is assuring that procedures are in place to satisfy the new quarterly statement disclosures. Although the

legislation directs the Department of Labor to issue a model benefit statement that can be used to satisfy the new disclosure requirements, it is not required to do so before August 16, 2007, therefore it is very likely that plan sponsors and plan administrators will be required to comply without the benefit of the Department of Labor's suggested language. Despite the Department of Labor's recent field assistance bulletin, there remain uncertainties about the required disclosure. Our advice is for plan administrators to first consult with the investment provider or other vendor which provides their periodic benefit statements to determine what actions they are taking to assure satisfaction of the requirements. Note, however, that the plan administrator remains the party legally responsible for these disclosures notwithstanding it contracting with a third party administrator or other party to prepare these disclosures on its behalf. Given the steep penalties that can be imposed, this is an obligation that plan administrators can ignore at their peril. Fortunately though, for plan administrators, compliance will not be as onerous as originally thought given the Department of Labor's recent guidance.

Update Administrative Forms: The change in the distribution options for payments to beneficiaries of deceased participants will require updates to the forms used for that purpose as well as any associated checklists. Because those distributions will now be eligible

for rollover, they will be subject to the mandatory 20% withholding rules rather than the current voluntary withholding rules. In my experience, the payment of benefits to the beneficiary of a deceased participant is fairly rare, so plan administrators with similar experiences may prefer to defer the revision of these forms until the need arises.

As a result of the extended deadline for delivering distribution notices and consenting to distributions, those forms and checklists will also need to be updated.

The required tax notice form (explaining the federal income tax consequences of the distribution) will also need to be revised to reflect the new required disclosure concerning the benefits of deferral of retirement plan distributions. A cynic may question whether the addition of an explanation of the evils of cashing out will serve any useful purpose other than lengthening an already lengthy tax explanation.

Although the hardship rules will change in 2007 to permit withdrawals on account of hardships of a non-dependent beneficiary, those changes will not be effective until the Internal Revenue Services issues clarifying regulations. The regulations are expected to address who is considered a beneficiary for this purpose and the effect of changes in beneficiary. Once those regulations are issued, the forms used for processing hardship withdrawals will need to be updated.

Determine Vesting Schedule(s) to be Used: Plan sponsors with nonconforming vesting schedules should determine whether to maintain separate vesting schedules for pre-2007 and post-2006 employer contributions or to apply the new vesting schedule to all contributions, even those made before 2007. The plan sponsor should communicate its decision to the party responsible for administration and, if separate vesting schedules will be maintained, assure that procedures are in place for the required separate accounting.

Keep Apprised of Developments: Plan sponsors and plan administrators would be well advised to keep attuned to guidance interpreting the Act coming out of the Department of Labor and the Treasury Department. Indeed, the ambiguities already discovered in the statutory language and the number of provisions of the legislation the specifics of which were left to regulations and other guidance of the Department of Labor and the Treasury Department makes many of these changes a work in progress.

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