On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006. Although the new law has generated a lot of press coverage because of its overhaul of the defined benefit pension system, it also makes permanent certain existing rules for 401(k) plans, as well as new and substantial changes in the 401(k) and defined contribution plan arena. The following is a brief summary of the relevant provisions regarding 401(k) plans and other defined contribution plans. At the end of this alert is also a summary of certain new restrictions added to Section 409A of the Internal Revenue Code, relating to the interplay between nonqualified deferred compensation plans (e.g., top-hat plans) and defined benefit plans.

Permanency of EGTRRA

Most important in practical terms is that the new law makes permanent the provisions relating to retirement plans and individual retirement accounts and annuities (IRAs) under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For example, the rules regarding catch-up contributions, Roth 401(k) contributions, the repeal of the “same desk” rule and “multiple use” test, accelerated vesting for matching contributions, and the annual elective deferral limit are some of the provisions made permanent.

New Changes for 401(k) Plans and Other Individual Account Plans

The new law makes substantial changes in the defined contribution realm especially dealing with 401(k) plans, including the addition of automatic enrollment and new plan design features.

State Law Preemption for Automatic Enrollment. The new law clarifies that the Employee Retirement Income Security Act of 1974 (ERISA), as amended, preempts state laws that directly or indirectly prohibit automatic enrollment provisions in 401(k) plans, provided that a plan must provide notice to affected employees within a reasonable period before each year for preemption to be available. In California and other states, the new law’s changes mean that a 401(k) plan can disregard state law requirements for employee written authorization for withholding from compensation. The ERISA preemption rule is effective on August 17, 2006.

Safe Harbor 401(k) Plans and Automatic Enrollment. The new law provides that a 401(k) plan with an automatic enrollment feature will be eligible for safe harbor treatment if certain conditions are met for plan years beginning after December 31, 2007. Safe harbor treatment generally allows a plan to be deemed as satisfying the nondiscriminatory testing for elective deferrals, nondiscriminatory testing for matching contributions, and top-heavy requirements. The automatic contribution rules generally apply only to new employees (that is, the employer would not have to apply the automatic enrollment feature to current employees who already have made elections to participate), but certain contribution requirements apply. The requirements for a safe harbor automatic contribution arrangement include:

- uniform application to every new employee and to every current employee who has not already elected to participate in the plan;
- the automatic enrollment percentage must not be less than 3% of compensation in the first year of participation, not less than 4% of compensation in the second year of participation, not less than 5% of compensation in the third year of participation, and not less than 6% of compensation thereafter;
- the automatic enrollment percentage cannot be more than 10% of compensation;
- either (i) a match of at least 100% of the first 1% of compensation deferred and at least 50% of the next 5% of compensation deferred, or (ii) at least a 3% nonelective contribution;
- employer contributions would have to be 100% vested after two years of service, rather than the immediate vesting rule for other safe harbor 401(k) plan contributions; and
- employees must have the opportunity to elect out of the automatic contribution arrangement after receiving notice (as described below) before the start of the plan year that explains the parameters of the automatic contribution arrangement.

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Notice Requirement for Automatic Enrollment 401(k) Plans. The new law codifies IRS Revenue Ruling 2000-8, which requires that a 401(k) plan that provides for automatic enrollment must give each eligible employee a notice of the employee’s right not to have elective contributions made on the employee’s behalf or to change the percentage of such contribution. The notice must explain the default investments under the plan in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice, and such notice must be given before the first automatic contribution is to be made in order to provide an opportunity to make an election with respect to contributions and investments.

Unwinding Automatic Contributions. Beginning after December 31, 2007, a plan may unwind and return automatic enrollment contributions to participants, but only if the participants elect to have the automatic contribution returned within 90 days after the first pay roll period when the first automatic contribution was made. The returned contributions are payments of compensation and as such, not subject to the 10% penalty generally applicable to early withdrawals from plans.

Default Investment Fiduciary Protection. The new law adds protection for plan fiduciaries by requiring that the Department of Labor issue regulations to clarify that a qualified domestic relations order (QDRO) will not fail to be a QDRO merely because of the timing of the order or because it modifies a prior order or prior QDRO.

Fiduciary Responsibility Regarding Investment Advice. The new law removes certain prohibited transaction barriers and permits investment advisers who are fiduciaries to recommend their own funds to plan participants beginning after December 31, 2006, provided the advisers meet certain conditions. Specifically, the eligible investment advice arrangement, in addition to other safeguards, would have to either (i) provide that the adviser’s fees (including commissions) will not vary depending on the investment option selected, or (ii) use an impartial computer model (certified by an independent expert) to generate a recommended portfolio. If the adviser meets one of these conditions, the employer would have no duty to monitor the specific advice given to any participant or beneficiary, but, of course, the employer would be responsible for prudently selecting and monitoring the professional investment advisers.

Diversification Rights for Plans Holding Company Stock. The new law expands diversification rights for plan participants who hold publicly traded company stock in certain defined contribution plans, such as 401(k) plans (the new law excludes ESOPs and one-participant plans). Participants can immediately diversify their elective deferrals and employee contribution accounts. Additionally, participants can diversify their employer nonelective and matching contribution accounts after three years of vesting service. Generally, these changes take effect for employer stock contributed in 2007 or later. For company stock acquired before 2007, participants age 55 or older with at least three years of service can diversify in 2007 or later. For other participants with company stock acquired before 2007, the diversification rule for employer contributions phases in equally over a three-year period beginning in 2007.

Excess Contributions. The new law also extends the excess contribution distribution date in order to enable the plan to pass its nondiscrimination tests for elective deferrals and/or matching contributions without the plan sponsor having to pay an excise tax on such distributions. Effective for plan years beginning after December 31, 2007, the excise tax does not apply to such contributions and the income allocable thereto, so long as they are distributed or forfeited within six months after the close of the plan year (i.e., June 30 for a calendar-year plan). Currently, the law requires that such distributions be made within two-and-a-half months after the close of the plan year (i.e., March 15 for a calendar-year plan) in order to avoid the excise tax.

Accelerated Vesting. For plan years beginning after December 31, 2006, the new law requires that profit sharing and other nonelective employer contributions must vest (at a minimum) under either a three-year cliff or two-to-six-year graded schedule, which mirrors the current rules regarding matching contributions.

Hardship Distributions. The new law provides that prior to February 14, 2007, the Treasury Department must provide guidance for expansion of financial hardship and unforeseeable emergency distributions for tax-qualified retirement plans and nonqualified deferred compensation plan participants under Section 409A. Currently, such distributions are limited to the financial condition of the plan participant and his or her spouse or dependents. The new law expands the current rules and provides that a plan participant may receive a hardship distribution based on the unforeseeable emergency or financial hardship of the participant’s designated beneficiary, regardless of whether the beneficiary is a spouse or dependent (for example, a grandchild, parent, or domestic partner).

Spousal Protection. The new law requires that the Department of Labor issue regulations to clarify that a qualified domestic relations order (QDRO) will not fail to be a QDRO merely because of the timing of the order or because it modifies a prior order or prior QDRO.
In addition, the new law adds a notice requirement. A company must notify plan participants who hold publicly traded company stock at least 30 days before the first date on which the participant is eligible to divest his or her account of such company stock. The notice must describe the right to divest employer stock and the importance of diversifying investments. Separate notices may be required if a participant's accounts become subject to the diversification requirement at different times. The new notice requirement is effective for plan years beginning after December 31, 2006, and the Secretary of Treasury must publish a model notice prior to February 14, 2007.

Increase in Bonding Requirements. Effective for plan years beginning in 2008, the new law increases the fiduciary bonding requirement to a maximum of $1 million from $500,000 for plans that hold employer securities.

Distributions to Active Reservists. The new law creates an exception to the 10% penalty tax on early withdrawals from elective deferrals from a 401(k) plan prior to attaining age 59½ for a military reservist called to active duty for more than 179 days on or after September 11, 2001, and before December 31, 2007. The distribution will not violate the distribution restrictions found in 401(k) plans.

Mapping of Accounts. The new law amends ERISA Section 404(c) for the following changes, which are effective for plan years beginning after December 31, 2006. First, Section 404(c) relief will be available to 401(k) plan fiduciaries if they implement a blackout period in a manner consistent with ERISA and the underlying Department of Labor regulations. Second, Section 404(c)(4) is added to provide generally that Section 404(c) relief will be available to 401(k) plan fiduciaries for any mapping that constitutes a qualified change in investment options. A change in investment options is qualified under the new law if certain conditions are satisfied, including:

- the reallocation is made to one or more investment options that bears a reasonably similar risk and rate of return as the investments in place prior to the change;
- the plan must send a notice at least 30 days and no more than 60 days before the change;
- the participant must not have provided investment instructions prior to the change that are contrary to the reallocation; and
- the investments in place prior to the change (that are to be mapped) must be the product of exercise of control by the participant or beneficiary.

Missing Participants Program for Terminated Plans. The new law extends the Pension Benefit Guaranty Corporation’s (PBGC’s) missing participant program to defined contribution plans. The administrators of defined contribution plans are not required to participate in the missing participant program, but have the option to do so.

Plan Amendments to Comply with the Act. The new law provides that amendments to 401(k) plans and other defined contribution plans must occur before the end of the plan year beginning in 2009 (December 31, 2009, for calendar-year plans). Until that time, plans will be required to comply with the new law operationally on the relevant dates provided above.

New Restrictions on Deferred Compensation Plans

The new law provides certain restrictions that may require employers to pay more attention to the interplay between defined benefit plans and nonqualified deferred compensation arrangements. It amends Section 409A of the Internal Revenue Code to restrict funding of nonqualified deferred compensation arrangements (e.g., top-hat plans) maintained for certain covered employees by plan sponsors who maintain troubled single-employer defined benefit pension plans. The rules apply to plan sponsors during the period where any one of the following triggering events occurs:

- a defined benefit plan is in “at-risk status” (that is, the plan is less than 80% funded);
- the plan sponsor is a debtor in bankruptcy; or
- a defined benefit plan is terminated in an involuntary or distress termination by the Pension Benefit Guaranty Corporation (although the period is limited to 12 months and begins 6 months before the termination date).

The triggering event related to a defined benefit plan’s “at-risk status” does not go into effect until January 1, 2008. However, the bankruptcy and termination triggering events listed above went into effect on August 17, 2006.

The new restrictions also apply broadly. The rules apply on a control-group basis, meaning that adverse tax consequences under Section 409A will apply to a covered employee even if another member of the control-group experiences one of the triggering events. The definition of “covered employee,” which references Code Section 162(m), generally includes the chief executive officer and the other four highest paid officers for the taxable year, as well as the named executive officers as identified in Section 16(a) of the Securities Exchange Act of 1934.

Funding in a deferred compensation arrangement occurs when an employer directly or indirectly sets aside, reserves, or

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transfers funds to a trust or other arrangement to fund a nonqualified deferred compensation plan. The new rules also prohibit an employer from restricting funds upon the occurrence of the triggering events in order to provide for later payments of deferred compensation. The rules apply even if the assets set aside by the company remain available to satisfy creditors’ claims (e.g., in a rabbi trust). However, amounts set aside before the triggering events will not subject the covered employee to taxation.

Furthermore, if the employer contributes a gross-up for the resulting tax, the employer may not take a deduction for the gross-up amount and the covered employee will incur an additional 20% tax and interest charges on the gross-up amount.

For more information about the Pension Protection Act of 2006, please contact Wilson Sonsini Goodrich & Rosati’s Employee Benefits and Compensation practice, including John Aguirre, Heather Aune, Melody Barker, Ralph Barry, Jessica Bliss, Madeleine Boshart, Jessica Janov, Thuy Le, John Ludlum, Scott McCall, Cisco-Palao-Ricketts, Roger Stern, David Thomas, Michelle Wallin, or David Wollenziehn.

If the new Section 409A restrictions are violated, the assets set aside for the covered employee will be subject to immediate taxation, plus a 20% tax and interest charges.