

# TRISTAR PENSION CONSULTING

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## Participant Cruise Control: Automatic Enrollment

- Introduction
- Introduction to Automatic Enrollment
- PPA Automatic Enrollment Provisions
- Default Investments
- DOL's Proposed Regulations
- Qualified Default Investment Alternative
- Investment Products and Services Approved by the DOL
- Products That Do Not Qualify
- Plan Sponsor Liability
- Conclusion

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On August 17, 2006, President Bush signed into law the most widespread retirement plan changes of the past five years. One goal of the Pension Protection Act of 2006 ("PPA") is to strengthen ailing defined benefit pension plans, whose funding deficiencies and distress terminations have left the federal Pension Benefit Guaranty Corporation with a large deficit. But the Act goes much further, impacting defined contribution plans as well. What follows is an overview of the most relevant portions of the new law.

## **EGTRRA PROVISIONS MADE PERMANENT**

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") contained many advantageous changes to qualified plan and IRA rules, such as increased contribution and deduction limits. But the EGTRRA provisions were scheduled to "sunset," or end, in 2010 due to budgetary concerns. The PPA eliminates the sunset requirement so that all of EGTRRA's qualified plan and IRA provisions are now permanent. This will allow plans to continue to operate in many ways as they have been since 2002, without having to revert to the pre-EGTRRA rules in 2011.

## **VESTING SCHEDULES**

Top heavy plans (where owners and certain officers have more than 60% of the total benefits) must provide for, at the very least, full vesting after 3 years of service or a six year graded schedule providing 20% per year beginning with the second year of service.

When EGTRRA was enacted in 2001, it extended the top heavy vesting rules to matching contributions. Under PPA, all defined contribution plans, such as 401(k) and profit sharing plans, must vest at least as rapidly as one of the top heavy vesting schedules. The vesting change is effective as of 2007 and only applies to participants who work at least one hour after the effective date.

Defined benefit plans can still use full vesting after five years of service or a seven year graded schedule providing 20% per year beginning with the third year of service.

## **HARDSHIP WITHDRAWALS**

Under the new law, hardship distributions will be expanded to meet the financial needs not only of the participant, his spouse and dependents, but also any person who is listed as the participant's beneficiary under the plan. The change is effective February 13, 2007.

## **AUTOMATIC ENROLLMENT**

PPA creates an eligible automatic contribution arrangement under which salary deferrals to an applicable employer plan (401(k), 403(b) and 457(b) plans) will automatically be deducted at a specified uniform rate unless an employee elects otherwise.

The deferrals will continue until the employee elects not to have contributions made or elects a different percentage. The contributions will be invested in accordance with regulations to be prescribed by the Department of Labor ("DOL"), and a notice requirement must be met which:

- Explains the employee's right to elect not to have contributions deducted or to elect a different percentage;

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- Gives the employee a reasonable period of time to make an election; and
- Explains how contributions will be invested in the absence of an investment election by the employee.

Plans that meet the above requirements are subject to relaxed rules for making corrective distributions for failed Average Deferral Percentage ("ADP") and Average Contribution Percentage ("ACP") tests. The 2½-month period for making such distributions without a 10% excise tax is extended to six months. In addition, timely corrective distributions from all plans will be taxable in the year received and not the year of the excess. These provisions take effect in 2008.

PPA also provides that ERISA supersedes any state law which would prohibit or restrict an automatic enrollment arrangement. This preemption of state law takes effect immediately.

### **AUTOMATIC ENROLLMENT SAFE HARBOR**

The new law also creates an optional safe harbor arrangement that is automatically deemed to satisfy the ADP, ACP and top heavy requirements. The requirements for this arrangement are:

- Each eligible employee who does not elect otherwise will be deemed to have elected at least a 3% deferral in his first plan year, 4% in the second, 5% in the third and 6% thereafter, not to exceed 10% in any year; and
- The employer makes either a 3% nonelective contribution for all eligible non-highly compensated employees (in general, non-owners and those earning less than \$100,000) or a match contribution equal to 100% of the first 1% deferred and 50% of the next 5% deferred. These employer contributions must be fully vested after no more than two years of service.

### **INVESTMENT ADVICE**

A major concern in recent years has been participants' ability to prudently invest the assets of their salary deferral accounts or other accounts under their control. Plan fiduciaries and others providing services to the plan have been prevented from dispensing investment advice to participants for a fee or other compensation under the prohibited transaction rules.

PPA changes this as of 2007, by creating a statutory exemption for investment advice provided by a "fiduciary advisor" under an "eligible investment advice arrangement." The arrangement must be authorized by an independent plan fiduciary not providing the advice and is subject to an annual audit by an independent auditor. The fiduciary advisor's fees/commissions cannot vary among investment options or else a computer model must be used.

### **DEFINED BENEFIT PLANS**

Growing concerns over the solvency of defined benefit plans has led to the enactment of more stringent funding requirements, as well as increased deduction limits as of 2008. The calculations of lump sum distributions will also be altered.

As of 2007, a qualified defined benefit plan will be allowed to distribute benefits to a participant who has reached age 62 and is not separated from employment. In addition, as of 2010, salary

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deferrals will be allowed in defined benefit pension plans if certain benefit, contribution and other requirements are met.

## **REPORTING AND DISCLOSURE REQUIREMENTS**

### **BENEFIT STATEMENTS**

As of 2007, all defined contribution plans will have to provide quarterly benefit statements to participants who have the right to direct their account investments, and annually to all other participants. The statements must include total accrued benefits, vested accrued benefits (or the earliest date any benefits will vest) and an explanation of the contribution allocation formula.

Quarterly statements for directed investment accounts must also contain:

- The value of each investment;
- An explanation of any investment limitation or restrictions;
- An explanation of the importance of a well-balanced and diversified investment portfolio for long-term retirement security, including a statement of the risks that holding more than 20% of a portfolio in the security of one entity may not be adequately diversified; and
- A notice directing the participant to the DOL website for information on investing and diversification.

Defined benefit plans are required to furnish benefit statements once every three years to each active employee with a vested benefit, and to all other participants upon written request. DOL is required to publish model benefit statements by August 17, 2007.

### **CHANGES TO ANNUAL REPORTS (FORM 5500)**

As of 2007, a simplified annual report will be used for plans that cover less than 25 employees if certain parameters are met. One-participant plans eligible to file form 5500-EZ will not be subject to the filing requirement until the assets of all plans of the employer exceed \$250,000 (increased from \$100,000). Another change is that even though a 5500-EZ has been filed, it can be discontinued if assets fall below \$250,000.

### **NOTICE AND CONSENT PERIODS EXTENDED**

Plan distributions require written explanations of the tax consequences, availability of rollover treatment and qualified joint and survivor annuity ("QJSA") rules (if applicable). A QJSA waiver form must also be provided. These materials must be furnished no less than 30 and no more than 90 days before the distribution begins. In addition, distributions in excess of \$5,000 require the participant's consent within the 90-day period.

Under the new law, the 90-day provision is extended to 180 days for the distribution notice and consent requirements, effective for 2007. The contents of the notice will also change.

### **DEFINED BENEFIT FUNDING NOTICE**

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An annual funding notice which currently applies only to multiemployer plans will also be required for single-employer plans as of 2008. Notices as of that date must include additional information for both multiemployer and single-employer plans. DOL is to publish a model form for such notice.

Additional information will be required on the annual report (form 5500) for defined benefit plans, but they no longer will have to distribute a summary annual report to participants.

## **ROLLOVER PROVISIONS MODIFIED**

### **ROTH ROLLOVERS**

Most plan distributions (other than hardship and required minimum distributions) are eligible to be rolled over to another qualified plan or a traditional individual retirement account ("IRA") to avoid current taxation. As of 2008, Roth IRAs will also be able to accept rollovers. However, a rollover to a Roth IRA will not be tax-free, but will be taxed the same as a Roth IRA conversion. The 10% penalty for early withdrawal from a qualified plan will not apply.

### **ROLLOVERS BY NONSPOUSE BENEFICIARIES**

Currently, upon the death of a participant, only a spouse beneficiary can roll over the benefits to an IRA to avoid current taxation. As of 2007, any beneficiary will be able to roll over the deceased's benefits to an IRA. But whereas the spouse can delay distributions until age 70½, the nonspouse beneficiary must begin distributions immediately.

## **CONCLUSION**

The PPA makes numerous revisions to the rules affecting qualified retirement plans. The pension and IRA provisions of EGTRRA which were scheduled to expire in 2010 are now permanent. Other changes increase rollover distribution options, speed up vesting, increase the availability of investment advice to participants and provide stricter defined benefit funding rules.

Overall, the new law should have a positive effect on the private retirement system, and encourage plan participation. Each plan will need to be reviewed to determine how and when the PPA will impact its operation.

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