Pension Protection Act of 2006

An overview by:

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Summary of Recommendations

Increase Deduction Limits: Adopt a second plan now (see Deduction Limits – Combined Plan under 2006)

Increase the Refund Time for ADP and ACP Test Failures: Add the new Automatic Enrollment feature to non-Safe Harbor 401(k) Plans (see Automatic Enrollment 401(k) Plans under 2008)

Reduce the Cost of a Safe Harbor 401(k) Plan: Consider the Automatic Enrollment Safe Harbor feature in 2008

Cash Balance Plans: Make sure a hybrid plan with its new disadvantages accomplishes your objectives (see Excess Plan under 2006)

The DB(k): The Eligible Combined Plan (ECP): The ECP is not available until 2010. Do not wait. Combo Plans are available now without the disadvantages of the ECP (see The DB(k) under 2010)

When legislation is proving favorable for the Taxpayer, the taxpayer should not smile so broadly as to attract attention. After the passage of ERISA in 1974, subsequent legislation in the retirement plan arena was in a large measure revenue raising. This trend was so negative to the private pension system that we published a paper entitled "Salvaging Qualified Retirement Plans." Nevertheless, starting with Pension Simplification (PS 1996), the trend for the taxpayer has been positive and the Pension Protection Act (PPA 2006) has not reversed the trend. The cost (lost tax revenue) has been estimated to be $66 billion − these are monies that you, the taxpayer, get to keep.

We wish to explain PPA 2006 provisions in the chronological order of each provision's effective date setting forth a practical application of the new advantages. The first provision that should broaden the taxpayer's smile is the higher contribution and benefit limits provided by EGTRRA, which were to lapse (sunset) in 2010, were made permanent, including the $500 tax credit for the first three (3) years attributable to 50% of the administrative costs for an employer establishing a new qualified plan who did not maintain such a plan during the immediate preceding three (3) years. Such a plan must cover at least one (1) non-highly compensated employee (NHC) (IRC Sec 45(E)). The following are the new enhancements to the private pension system:

2006 Enhancements

Deduction Limits - Combined Plans

One of the most significant changes made by PS 1996 was the repeal of the Combined Defined Contribution (DC) and Defined Benefit (DB) limit at the participant level effective in the year 2000. Therefore, a plan participant could thereafter obtain the maximum benefit in both types of plans. However, the ability to fund and deduct the cost of funding maximum combined benefits has been restricted by the deduction limits of IRC Sec 404(a)(7), which stipulates that the maximum deduction for the combined plans is 25% of covered compensation; whereas, the DB funding may substantially exceed this limit.

The first relief from this 25% restriction was provided by EGTRRA which excluded 401(k) Salary Reduction from this limit. Thus, without an employer contribution to the 401(k) plan, the employer could maintain both a DB and 401(k) plan and fund and deduct the DB cost significantly in excess of the 25% of compensation limit. Since many of the 401(k) plans did not pass the Average Deferral Percentage (ADP) Test, the Highly Compensated Employees (HCE) were restricted in their 401(k) deferrals.

PPA 2006 solves this restriction in 2006 by excluding an employer contribution to the DC plan not to exceed 6% of covered compensation. The immediate result, then, is that the limitation on DB funding is eliminated if the 401(k) plan is currently a Safe Harbor plan. If the 401(k) Plan is not currently a

Safe Harbor Plan, the taxpayer may make this election for year 2007. This election for the employer Safe Harbor contribution, not to exceed 6% of covered compensation, eliminates the ADP Test that previously restricted the 401(k) salary reductions by the HCE.

In summary, in the event an employer chooses to increase plan contribution limits under these specified facts, the following action may be taken:

1) If an employer is currently maximally funding a DB Plan – adopt a Safe Harbor 401(k) Plan that may add an additional $33,200 to your annual addition; or

2) If an employer currently has a Safe Harbor 401(k) Plan – adopt a DB or increase the DB benefit formula; or

3) In either of the above cases the employer contribution to the 401(k) Plan must never exceed 6% of covered compensation; and

4) If the DB Plan is covered by the Pension Benefit Guaranty Corporation (PBGC) ─ pursue additional options available in 2008 as will be discussed.

Defined Benefit Plan – Deduction Limits

Using rather simple terms, the current limitation on tax deductible contributions to a DB Plan is equal to 100% of the plan's current liability minus the market value of the plan's assets. This rule would remain the same if the DC employer contribution exceeded 6% of covered compensation in a DB/DC combination as explained above.

PPA 2006 changes the maximum deduction for DBs commencing in 2006 to 150% of the current liability minus the plan's assets. The additional 50% is referred to as the "cushion". Your smile should broaden still more as this gets better in 2008.

Excess Plan

In the case of an employer using a DB Plan to apply the balance of the 25% deduction limit in excess of the employer's contribution to the DC plan (generally a 401(k) Plan), the increase in the deduction limit set forth above and the 50% "cushion" for the DB plan do not apply since the employer DC contribution exceeds 6% of covered compensation. In these fact situations, we anticipated that the best type of plan for the use of the excess deductible limit would be a Cash Balance Plan (a hybrid plan). However, PPA 2006 mandates full vesting in no more than three (3) years of service for such plans effective in 2008. This vesting schedule is not a good fit for these situations in which the use of the excess plan is contemplated; therefore, this paper will not address the provisions of PPA 2006 applicable to hybrid plans.

Compensation for Defined Benefit Plans

Compensation for benefit calculation purposes for a DB plan has been a participant's highest consecutive three (3) year average during years of participation. PPA 2006 amended IRC Sec 415(b)(3) deleting the requirement that the years utilized be years of participation. Therefore, depending on future IRS guidance, this new definition of compensation appears to offer a great degree of flexibility. For example, a sole proprietor's pre-plan compensation will not be reduced by the Plan deposit thereby significantly increasing DB Plan deposits in the event the net Schedule C for the first plan year will not be large enough to cover both the plan deposit and the compensation needed.

Missing Participants

Significant effort by the plan sponsor can be expended in locating participants when the sponsor terminates a plan. Also, the plan termination can not be finalized until all participants are paid their plan benefit. PBGC established a missing participant program to eliminate this problem for DB Plans covered by PBGC. This program is now available for all terminating plans (i.e., all DC and DB Plans not covered by PBGC, as well as PBGC Plans).

The Pension Benefit Guarantee Corporation (PBGC)

Many of the DB Plans we implement and administer are covered by PBGC. These are those DB Plans sponsored by professional entities covering 25 or more non-licensed professional employees or any other entity covering one (1) or more non-owners. Since our client-sponsors are generally funding the maximum benefit, the new PBGC rules created by PPA 2006 will be little more than a slight additional administrative burden commencing in 2006. However, any DB Plans not adequately funded will see an increase in PBGC premiums, as previously has been the case, as well as the requirement to fully fund the plan before it can be terminated.

2007 Enhancements

Non-Spouse Beneficiaries Given an Option

Prior law permitted the spouse beneficiary of a deceased participant to postpone distributions from the deceased spouse's account or its rollover to an Individual Retirement Account (IRA) until the deceased spouse would have attained age 70½, at which time, the Minimum Required Distributions (MRD) would commence based on the surviving spouse's life expectancy (IRC Sec 402(c)(9)). This provision was amended effective in 2007 to include the non-spouse beneficiary's ability to roll the deceased's benefit from a qualified plan

into an IRA. But the non-spouse beneficiary must commence his MRD based on his life expectancy before the end of the calendar year following the year of death. Otherwise, the non-spouse beneficiary must take a full taxable distribution of all of the benefit received within five (5) years following the year of death of the participant.

Vesting for Defined Contribution Plans

When calculating account balances in 401(k) and Profit Sharing Plans attributable to employer contributions we must now use the six (6) year graded top heavy plan vesting schedule on any such employer contribution amounts subject to a vesting schedule. Previously, a seven (7) year graded vesting schedule was available for plans that were not top heavy. Although this provision does not apply to DB Plans, most of our client's DB Plans are top heavy, as well as a majority of our DC Plans. This change in 2007 will not have a significant negative result for many or our plans.

Form 5500

Currently, in the event a plan covered only owners and their spouses, the plan sponsors need not file Form 5500EZ unless the plan's assets exceed $100,000 at the end of that year. This exemption has been expanded to $250,000 beginning in 2007, unless Form 5500EZ filings have already commenced. Further, a simplified Form 5500 is mandated for plans with less than 25 participants starting in 2007. This relief is another good reason for plan sponsors to make distributions to terminated participants as soon as is administratively feasible.

Employee Stock Ownership Plans (ESOP)

In the event the employer stock is not publicly traded, the only change for ESOPs by PPA 2006 is a 30-day notice requirement before the first date on which a participant is now permitted to exercise the right to diversify out of employer stock. On the other hand, an ESOP plan with publicly traded employer stock will be required to provide diversification for the participants after three (3) years of participation with a three (3) year phase in for existing plans starting in 2007.

In-service Distributions for Defined Benefit Plans

Beginning in 2007, DB Plans may authorize in-service distributions to participants starting at age 62 (i.e., taxable distributions) without the requirement of a distributable event such as a separation of service. This provision provides some very welcome flexibility for DB Plans. Current proposed Internal Revenue Service (IRS) regulations concerning "phased-in retirement" will undoubtedly be

changed to provide the needed guidance to plan sponsors on in-service distributions from a DB Plan.

Investment Advice

Studies show that the average 401(k) plan participant with control of his account investment decisions needs help called “Investment Advice.” Participants with complaints have hindsight on their side and, therefore, investment advice is rarely and then often reluctantly provided. A significant portion of PPA 2006 is an attempt to remedy this dilemma. One technique is the establishment of a prohibited transaction (PT) exemption for investment advice provided by a “fiduciary advisor” under an “Eligible Investment Advice Arrangement” (EIAA) *to plan participants*. This PT exception does not provide protection from fiduciary responsibility for investment advice provided to plan fiduciaries.

A fiduciary advisor is a fiduciary by virtue of providing advice to participants and one who satisfies the following qualifications:

1. Is a Registered Investment Advisor (RIA); or

2. A bank or similar financial institution; or

3. An insurance company; or

4. A broker or dealer; or

5. An affiliate or employee of any of the above.

An EIAA is an arrangement which either:

1. Has fees and/or commissions that do not vary depending on the investment option selected; or

2. Uses a computer model which must:

    a. Apply accepted investment theories relative to historic returns of asset classes; and

    b. Use relevant information about the participant; and

    c. Use prescribed objective criteria which are not biased; and

    d. Consider all investment options without inappropriate weighting; and

e. All of the above having been certified as being satisfied by an “eligible investment expert” who is someone meeting the requirement prescribed by the Treasury.

An EIAA also has an annual audit and detailed participant notice requirements. *Good luck!*

Default Investments

If a plan participant is exercising control over his account under the provisions of ERISA Sec 404(c), then fiduciaries are shielded from liability for investment losses. In the event a participant fails to exercise such control, a plan fiduciary will more than likely be responsible for any default investment results. In the case of plans with an automatic enrollment feature, participants will not initially have the opportunity to exercise investment control and subsequent failure to do so is probable. PPA 2006 addressed this problem by directing the Department of Labor (DOL) to issue regulations concerning default investments within six (6) months of enactment to shield fiduciaries from liability for automatic enrollment participants and default investment design features.

The DOL published a proposed regulation on 27 September 2006, which provides the guidance for the fiduciary relief if the default investment is a Qualified Default Investment Alternative (QDIA). A QDIA must have the following features:

1. May not hold employer securities; and

2. May not penalize or restrict a transfer to another alternative; and

3. Must be managed by an investment manager (ERISA Sec 3(38)) or investment company; and

4. Must be diversified; and

5. Must be one of the following Investment Products:

   a. A life-cycle or targeted-retirement date fund; or

   b. A long term appreciation and capital preservation fund appropriate for plan participants as a whole; or

   c. A managed account for varying degrees of long-term appreciation and capital preservation based on the participant’s age, target retirement age, or life expectancy.

These products are not required to reflect each individual’s risk tolerance or investment preferences.

The QDIA relief is contingent upon a notice to the participant thirty (30) days prior to the first QDIA investment and each plan year thereafter giving the participant the opportunity to direct the investments in his account along with all the appropriate materials (i.e., account statements, prospectuses, etc.) assuming the plan is otherwise satisfying ERISA Sec 404(c).

2008 Enhancements

Defined Benefit Plan Deduction Limits

In addition to the 50% "cushion" commencing in 2006, the maximum deduction is increased in 2008 by projected benefit increases attributable to increases in participant compensation in future years. Further, if the plan does not base benefits on past service (i.e., pre-plan years) compensation, the deduction limit can be increased by funding for benefit increases that are anticipated to occur in the future based on average annual benefit increases over the immediate preceding six (6) years. In the case of a DB Plan with fewer than 100 participants, the only limit is that increases for HCEs by plan amendment for the two (2) immediately preceding years may not be used. Any such increase may not exceed the maximum compensation limit under IRC Sec 401(a)(17), which is currently $220,000 in 2006.

Deduction Limits – Combined Plans

Further, keep broadening your smile, if the DB Plan is covered by PBGC, there is no limit on the employer contribution to the DC Plan or the DB Plan as a result of the employer sponsoring both. What's more, the projected compensation used may exceed the maximum compensation limit under IRC Sec 401(a)(17).

A Word of Caution: Voluntarily causing a Plan to be covered by PBGC is not an option.

In summary, an employer with a DB Plan which is covered by the PBGC may increase plan contribution limits simply by increasing the DC employer contribution to the maximum, or the DB benefit to the maximum, or both in 2008.

Automatic Enrollment 401(k) Plans

A universally recognized problem is that employees do not save enough. Congress has seized upon the concept of automatic enrollments, previously referred to as the "negative election" as the solution. The following are the means by which employers are encouraged to use automatic enrollments in their 401(k) plans in 2008:

1. Refunds for ADP and ACP Test failures. The current rule is that in the event refunds are not made within two and one-half (2½) months following the plan year of the failure, the employer pays a 10% excise tax on the amount of the refunds. However, if the plan has an automatic enrollment feature, the refund period becomes six (6) months. *Unless an employer can afford a Safe Harbor feature to eliminate the ADP and ACP Test, all 401(k) Plans (except Safe Harbor Plans) should add the automatic enrollment feature in 2008.* The refunds have been made friendlier even without the automatic enrollment feature in that all refunds will be taxed in the year of the refund and the Gap period earnings need not be distributed.

2. Automatic Enrollment Safe Harbor. ADP and ACP Tests, as well as top heavy plan requirements, are deemed satisfied if the plan uses the following automatic enrollment Safe Harbor features:

   a. The automatic enrollment percentage must be at least 3% of compensation in the first year of participation, 4% in the second year, 5% in the third year, and no less than 6% in the subsequent years, but never in excess of 10%; and

   b. The automatic enrollment feature need not apply to existing participants; and

   c. The employee contributions. Salary Reduction Amounts (SRA) receive a match of 100% of the first 1% of compensation SRA plus 50% of the next 5% of compensation SRA; or

   d. A 3% of compensation employer contribution to all eligible employees including those who elect out; and

   e. The employer contribution is subject to 100% vesting after two (2) years of service rather than the immediate 100% vesting applicable to a regular Safe Harbor Plan.

Employers currently sponsoring a Safe Harbor Plan with a 3% employer contribution in which the 3% Safe Harbor contribution counts as part of the 5% new comparability employer contribution threshold amount for such plans should add the automatic enrollment feature in 2008. In doing so, the 3% of compensation employer Safe Harbor contribution is subject to the two (2) year vesting requirement assuming the Safe Harbors are treated the same for new comparability purposes.

Employers using the current Safe Harbor Match may want to add the automatic enrollment feature so as to reduce the required maximum match from 4% to a maximum of 3½% starting in the fourth year of participation and less in

the earlier years of service as well as the use of the two (2) years of service for 100% vesting in lieu of the current immediate 100% vesting of their Safe Harbor plan.

Corrective Distributions

Any distribution after 31 December 2007, to correct an erroneous contribution from an employee's compensation including the distribution of automatic enrollment contributions for an employee-participant who elects no or a lesser amount of 401(k) salary reduction will not be treated as a contribution to the plan but as compensation and the 10% early withdrawal penalty does not apply. In the case of automatic enrollment contribution refunds, the employee's election must be made within ninety (90) days after the first pay period of such automatic salary reduction and must be distributed within six (6) months after the close of the plan year. These distributions, to the employee, will be taxable income in the calendar year of distribution.

Direct Rollovers to Roth IRAs

IRC Sec 408(e) has been amended effective in 2008 to permit direct rollovers from a qualified plan to a Roth IRA provided the distributee's Adjusted Gross Income (AGI) for the calendar year of transfer does not exceed $100,000 and, if married, the taxpayer does not file a separate return (IRC Sec 408A(c)(3)(B)). The distribution is taxed as ordinary income, however, the 10% premature distribution excise tax does not apply.

Increase in the Fidelity Bond

Only in the case of ESOP and Eligible Individual Account Plans is the amount of the fidelity bond increased from a maximum of $500,000 to $1,000,000 beginning in 2008.

2009 Enhancements

Plans are required to be amended to comply with PPA by the end of the 2009 plan year.

2010 Enhancements

The DB(k)

For employers with 500 employees or less, but at least two (2), one (1) Plan with both DB and DC plan features including 401(k) salary reductions will be available in 2010. The taxpayer has a lot of time to evaluate this option,

however, subject to future clarification following are some of the perceived advantages of the new “Eligible Combined Plan” (ECP):

1. The plan files only one (1) Form 5500; and

2. The required match for the 401(k) feature is 50% of the employee’s contribution up to 4% of compensation. (i.e., the required match is capped at 2% rather than the 4% of the stand-alone Safe Harbor Match 401(k) plan; and

3. The match satisfies the ADP Test; and

4. The ECP satisfies the top-heavy requirements.

The disadvantages of the ECP appear to be as follows:

1. Permitted disparity with regard to the employer funded benefits is not available. That is, the HCE may not benefit from the social security integrated allocation method and, if older than other participants, may not benefit by means of an age weighted or new comparability allocation method. Clarification on this issue is needed; and

2. The 401(k) salary reduction feature must satisfy the automatic enrollment requirements but the employer match must be 100% vested when made rather than after two (2) years under the normal automatic enrollment requirements; and

3. The DB benefits and the employer discretionary contribution to the DC plan must be fully vested in three (3) years rather than the six (6) year graded top heavy schedule as the fastest vesting available to a non-ECP.

The Loren D. Stark Company, Inc. is now designing and implementing two plans to achieve the deduction and benefit results currently available as set forth on page four (4) entitled “Deduction Limits – Combined Plans”. We will refer to this design as “Combo Plans” with a special discounted fee structure relative to the facts. Combo Plans are available immediately and are potentially better in 2008 without any of the disadvantages of the ECP but, of course, they still require separate (i.e., two (2)) Form 5500s.

We hope this discussion has left you as encouraged as we feel with regard to the private pension system. As clarification on some of these points becomes apparent, we will pass this information on to you. In the meantime, please contact the Loren D. Stark Company, Inc. for guidance with respect to your specific needs.