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Pension ANALYST

Important Information Legislation June 2007

Pension Protection Act of 2006 Makes Additional Changes to Defined Contribution Plan Rules For 2008 and Beyond

This is one of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined contribution plans. This publication focuses on those changes that are effective in 2008 and beyond. A separate publication discussing those provisions that took effect in 2007 and earlier was previously published.

WHO'S AFFECTED These developments affect sponsors of and participants in qualified defined contribution plans, 403(b) arrangements and section 457(b) plans.

BACKGROUND AND SUMMARY On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The 1000 pages of this new law contain numerous provisions affecting defined contribution plans. Many of these provisions took effect in 2006 and 2007. However, additional provisions, designed to enhance the retirement security of American workers and their families, are effective in 2008 or later.

These changes include:

- Revisions to ERISA reporting and fiduciary responsibility rules;
- New plan distribution rules;
- Changes to rules that apply to various types of elective deferral contributions; and
- The availability of two new plan designs.

ACTION AND NEXT STEPS In most cases, additional guidance will be needed from the various regulatory agencies before plan sponsors can take action to comply with these new provisions.
In the interim, plan sponsors should familiarize themselves with the information provided in this publication and identify those items that may affect their defined contribution plans or programs.

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ERISA Requirements

PPA changes ERISA reporting and fiduciary requirements by:

- Requiring the electronic display of certain Form 5500 information;
- Increasing the maximum ERISA fidelity bond to $1,000,000; and
- Providing ERISA section 404(c) relief for a "qualified change in investment options."

Electronic Display of Form 5500 Information

Effective for plan years beginning after December 31, 2007, qualified plans and 403(b) plans that are subject to ERISA must electronically file identification and basic plan information from the Form 5500 annual return/report with the Department of Labor (DOL). Within 90 days after filing, the DOL must display this information on its Internet website. Within the same time period, a plan sponsor or administrator must display this information on an Intranet website, if such a website exists.

For a plan with a calendar plan year that uses the maximum Form 5500 filing extension available, the first electronic filing required under these new rules will be due on October 15, 2009. The first DOL Internet posting and plan sponsor Intranet posting will be due by January 13, 2010.

In mid-2006, the DOL issued final regulations requiring electronic filing of Form 5500 for plan years beginning after December 31, 2007. However, work has not yet begun on the systems enhancements needed to handle these filings. As a result, DOL representatives have recently indicated that the requirement to file Form 5500 electronically will be delayed to plan years beginning after December 31, 2008. At this time, it is unclear how this delay will affect the PPA electronic display requirement.

Increased Maximum ERISA Fidelity Bond

PPA also increases the maximum amount of the fidelity bond that must be provided for a plan fiduciary or plan official who handles funds or other plan property. Effective for plan years beginning after December 31, 2007, the maximum bond amount when a plan holds employer securities is $1,000,000, rather than $500,000. If employer securities are simply held within a mutual fund, insurance company separate account, or similar broadly diversified fund, the maximum bond amount remains $500,000.

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Additional Section 404(c) Relief

ERISA section 404(c) relieves plan fiduciaries of liability for investment losses when a plan participant or beneficiary exercises independent control over the investment of his individual account. PPA now provides a special rule that extends section 404(c) protection in situations involving "fund mapping," as long as specified requirements are met.

"Fund mapping" typically occurs when:

- Two or more plans are merged;
- A plan sponsor changes service providers; or
- A plan sponsor simply decides to change investment fund offerings as the result of a due diligence review.

In these situations, participants are given an opportunity to make new investment elections but default arrangements are also made in the event that a participant does not make new elections. These default arrangements involve the "mapping" of the old investment options to the most nearly comparable new investment options.

Under the new PPA rules, fund mapping will be eligible for section 404(c) protection if all of the following requirements are met.

- At least 30 days, but no more than 60 days before the effective date of the change in investment options, the plan furnishes a written notice of the change to participants and beneficiaries. This notice must provide information comparing the existing and new investment options. It must also explain that if the participant or beneficiary does not provide investment instructions, the account will automatically be invested in new options that have reasonably similar characteristics as the existing options. Hopefully, future DOL regulations will provide guidance regarding this "reasonably similar characteristics" requirement.

- The participant or beneficiary does not provide affirmative investment instructions before the effective date of the change.

- Immediately before the effective date of the change, the participant's or beneficiary's account was invested in accordance with elections made by the participant or beneficiary. At this time, it is not clear whether prior default investments, made as the result of participants' "negative elections," will satisfy this requirement.

In addition, PPA provides section 404(c) protection during temporary "blackout periods" (when participants and beneficiaries are unable to direct the investment of the assets in their accounts), as long as the plan provides the appropriate advance notices, as required by the Sarbanes-Oxley Act.

In general, these rules apply to plan years beginning after December 31, 2007. However, if a plan is maintained pursuant to one or more collective bargaining agreements, the new rules apply for plan years beginning after the earlier of (1) the later of (a) December 31, 2008, or (b) the date the last collective bargaining agreement expires, or (2) December 31, 2009.

Congress has directed the DOL to publish interim final regulations (i.e., regulations that plan sponsors may rely on but which are open for comment and may be revised in the future) regarding section 404(c) protection during blackout periods, no later than August 16, 2007.

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New Plan Distribution Rules

PPA provides new plan distribution rules that:

- Allow participants to make direct rollovers to Roth IRAs; and
- Require certain types of plans to offer a qualified optional survivor annuity.

Direct Rollovers to Roth IRAs

Prior to January 1, 2008, participants may roll over distributions from a qualified plan, 403(b) arrangement, or section 457(b) plan directly to a traditional individual retirement arrangements (IRA), but not directly to a Roth IRA. However, a traditional IRA holding rollover contributions may then be converted to a Roth IRA if the taxpayer has a modified adjusted gross income (AGI) of $100,000 or less.

Beginning January 1, 2008, participants in any of these types of retirement programs ("eligible retirement plans") may directly roll over their eligible rollover distributions into a Roth IRA, as long as the participant's AGI is $100,000 or less. In 2010, this $100,000 threshold is repealed (as a result of the Tax Increase Prevention and Reconciliation Act, which was signed into law on May 17, 2006), and all taxpayers will be able to make direct rollovers from an eligible retirement plan to a Roth IRA.

Currently, it is not clear whether plans will be required to permit distributions to be directly rolled over to Roth IRAs, or if this will be an optional provision, similar to non-spouse beneficiary rollovers.

Qualified Optional Survivor Annuity

All money purchase pension plans and some profit sharing plans must provide benefits in the form of a qualified joint and survivor annuity (QJSA). A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse, which is not less than 50% (and not more than 100%) of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

In general, effective for plan years beginning after December 31, 2007, these plans must offer a new qualified optional survivor annuity (QOSA). The QOSA is a joint annuity, for the life of the participant and his or her spouse, with a continuation of either 50% or 75% of the amount payable to the participant. A plan must offer a QOSA with:

- A 75% survivor annuity, if it currently provides a QJSA with less than 75% continuation; or
- A 50% survivor annuity, if it currently provides a QJSA with a 75% or greater continuation.

For example, a plan that currently provides a 50% QJSA will have to provide a 75% QOSA. A plan that provides a 100% QJSA will have to provide a 50% QOSA.

If a plan is maintained pursuant to one or more collective bargaining agreements, the QOSA requirement is effective for plan years beginning after the earlier of (1) the later of (a) December 31, 2008, or (b) the date the last collective bargaining agreement expires, or (2) December 31, 2009.

Sponsors of profit sharing plans that do not want to provide a QOSA may want to explore the possibility of redesigning their plans to eliminate the need to provide a QJSA and, as a result, the QOSA.

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Changes to Deferral Contribution Rules

PPA makes the following changes to the rules that apply to deferral contribution plans:

- Certain plans that provide for automatic deferral contribution may distribute "accidental" deferrals;
- The 2½- month deadline for correcting ADP and ACP Test excesses is extended to six months; and
- Plans are no longer required to pay gap period income on ADP and ACP Test corrective distributions.

Distribution of Accidental Deferrals

Effective for plan years beginning after December 31, 2007, eligible automatic contribution arrangements may distribute automatic contributions if the affected participant requests a refund within 90 days following the date the first automatic contribution was made, regardless of the participant's age. The distribution amount is limited to the amount of automatic contributions made within the 90-day period following the date of the first automatic contribution, and related earnings. This amount will be included in the participant's gross income in the year the distribution is made, but will not be subject to the 10% excise tax on early withdrawals. Any employer matching contribution related to the distributed deferrals must be forfeited.

For purposes of this provision, an "eligible automatic contribution arrangement" is a 401(k) plan, 403(b) arrangement or governmental section 457(b) plan that:

- Provides for deferral contributions to be made automatically at a specified percentage of compensation, unless a participant specifically elects not to participate or elects a different deferral rate;
- Invests automatic deferrals in accordance with default investment regulations to be issued by the DOL; and
- Provides advance notice of the automatic contribution arrangement to all affected participants.

Currently, it is not clear how the investment requirements will be met by 403(b) arrangements and governmental section 457(b) plans that are not subject to ERISA or related DOL regulations.

This special distribution provision is not automatic. Plan sponsors will have to decide whether to offer this option to participants and will then have to amend their plans to do so.

Extended Deadline for Correcting ADP and ACP Test Excesses

Also effective for plan years beginning after December 31, 2007, 401(k) and ERISA 403(b) automatic contribution arrangements will have a later deadline for making corrective distributions of excess contributions from failed ADP Tests (401(k) plans only) and excess aggregate contributions from failed ACP Tests. The plan sponsor will not have to pay a 10% excise tax on these excesses if the plan makes the corrective distributions by the last day of the sixth month following the end of the plan year. In addition, both the excess amounts and the related earnings paid out within this six-month period will be taxable to the individuals receiving them in the year distributed, regardless of the amount distributed.

Elimination of Gap Period Income Requirement

Under the final 401(k) regulations that took effect for plan years beginning after December 31, 2006, 401(k) plans and ERISA 403(b) plans must pay gap period income on ADP and ACP Test corrective distributions. "Gap period income" is the earnings on the corrective distribution amounts from the end of the plan year in which the contributions were made through the date the corrective distribution is made.

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PPA removes this gap period income requirement for plan years beginning after December 31, 2007.

However, it is not clear if 401(k) plans and ERISA 403(b) plans will be allowed to continue to pay gap period income on ADP and ACP Test corrective distributions. Some plan sponsors may want to apply a consistent approach to the processing of corrective distributions, and the Roth 401(k) final regulations issued on April 30, 2007, require the payment of gap period income on corrective distributions of excess deferrals, effective for tax years beginning after December 31, 2006.

New Plan Designs

Automatic Contribution Safe Harbor Design

Effective for plan years beginning after December 31, 2007, 401(k) plan sponsors may avoid ADP Testing, ACP Testing, and Top-Heavy Testing, and 403(b) plan sponsors may avoid ACP Testing, by adopting a qualified automatic contribution arrangement.

A "qualified automatic contribution arrangement" contains three components: required automatic deferral contributions, required employer contributions, and participant notification.

Automatic Deferral Contributions. A qualified automatic contribution arrangement must provide for deferral contributions to be made automatically at specified percentages of compensation, unless a participant specifically elects not to participate or elects a different deferral rate. The minimum required deferral amount increases following the first year of participation (automatic escalation), but may never exceed 10% of compensation. The minimum required automatic deferrals are as follows:

Plan Year of Participation	Minimum Deferral Percentage
First Year (i.e., through the end of the first plan year beginning after date the first automatic contribution is made for the participant)	3% of Compensation
Second Year	4% of Compensation
Third Year	5% of Compensation
All Later Years	6% of Compensation

In general, these automatic deferral requirements must apply to all eligible employees. However, plan sponsors are not required to apply them to employees who had already made a deferral election or an affirmative election not to participate immediately before the date the plan adopts these safe harbor provisions. If a plan converts from a traditional enrollment design to this safe harbor design, it is likely that employees who are not making deferral contributions have not made an affirmative election not to participate. As a result, these employees would be subject to these automatic deferral rules.

Required Employer Contributions. In addition, the employer must make either:
- A nonelective contribution equal to at least 3% of compensation; or
- A matching contribution that matches 100% of the first 1% of compensation deferred and 50% of deferrals that exceed 1% of compensation, with no match on deferrals exceeding 6% of compensation. Alternatively, the plan may provide an enhanced matching formula that results in

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matching contributions that are at least equal to the amount provided under the standard matching formula, with a rate that does not increase as the employee's rate of deferral contributions increases. To avoid ACP Testing, no matching contribution may be made on deferrals exceeding 6% of compensation.

Contributions made to satisfy this requirement may only be distributed when the participant reaches age 59½, dies, becomes disabled, or terminates employment. These contributions are not eligible for hardship withdrawals. In addition, participants must be 100% vested in these contributions after they complete two years of service.

Participant Notification. To qualify for safe harbor treatment, the plan must provide annual notices to participants about the plan's provisions. This notice must:

- Be provided before the start of the plan year;
- Accurately apprise employees of their rights and obligations under the plan;
- Be written in a manner that can be understood by the average eligible employee;
- Explain the employee's right to elect not to have deferral contributions made or elect a different contribution percentage;
- Explain default investment provisions; and
- Give the employee a reasonable time after receipt of the notice and before the first contribution is made to make contribution and investment elections.

DB(k) Plan Design

Effective for plan years beginning after December 31, 2009, PPA allows certain employers to establish "eligible combined plans," more commonly known as DB(k) plans. This plan design is only available to employers with fewer than 500 employees when the plan is established.

Under the new law, a "DB(k) plan" is:

- Funded through a single trust with a single plan document;
- Required to file just one Form 5500;
- Exempt from the top-heavy rules; and
- Deemed to satisfy the ADP and ACP tests.

Under this plan design, the defined benefit portion must provide either:

- A benefit equal to 1% of final average compensation for each year of service up to a maximum of 20 years, or
- A cash balance plan that increases benefits with the participant's age.

Benefits under the defined benefit portion must be 100% vested after three years of service.

The defined contribution portion must provide:

- Automatic enrollment with a contribution of 4% of pay;
- An employer matching contribution equal to 50% of the first 4% of employee deferrals; and
- 100% immediate vesting for matching contributions.

Nonelective employer contributions to the defined contribution portion of the plan are permitted but not required. However, they must be 100% vested after three years of service.

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Plan Amendments

In general, PPA provides that required plan amendments may be effective retroactively and will not violate the anti-cutback rule, as long as the plan is operated in compliance with the new provisions as of the appropriate effective dates and the amendments are adopted on or before the last day of the first plan year beginning on or after January 1, 2009. For governmental plans, this amendment adoption deadline is the last day of the 2011 plan year. While IRS guidance sets forth adoption deadlines for "interim amendments" (reflecting statutory or regulatory changes) and "discretionary amendments" (reflecting voluntary plan design changes), this guidance also provides an exception to these deadlines when a new law provides a different amendment deadline. IRS representatives have indicated that the PPA amendment deadline supersedes the standard interim and discretionary amendments deadlines.

If Prudential Retirement provides document services for your plan, we will work with you to ensure that the appropriate plan amendments are made in a timely manner.

If we provide recordkeeping service for your plan and a delayed amendment deadline applies to a provision that takes effect in 2008, we will contact you to get direction for appropriate plan administration until your plan is amended.

Prudential Retirement will help you to stay informed by providing information on select guidance provided by the IRS and DOL.

If you have questions of a non-legal nature regarding the PPA rules and your plan or program, please contact your Prudential Retirement representative. Since Prudential cannot provide legal advice, we suggest that you seek such advice from your own legal counsel.

A chart showing the effective dates of the provisions discussed in this publication appears on the next page.

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Effective Dates Chart

Item	401(k) Plans	Other Qualified DC Plans	403(b) Arrangements	457(b) Plans	Effective Date
Provisions Effective in 2008					
Electronic Display of Form 5500 Information	ERISA	ERISA	ERISA		Plan Years beginning after 12/31/2007
Increased Maximum Fidelity Bond	ERISA	ERISA	ERISA		Plan Years beginning after 12/31/2007
Additional Section 404(c) Relief: • For Fund Mapping • During Blackout Periods	ERISA	ERISA	ERISA		Plan Years beginning after 12/31/2007*
Direct Rollovers to Roth IRAs	All	All	All	All	Distributions made after 12/31/2007
QOSA Required	If subject to QJSA Rules	If subject to QJSA Rules			Plan Years beginning after 12/31/2007*
Eligible Automatic Contribution Arrangements May Distribute Accidental Deferrals	All		All	Gov't	Plan Years beginning after 12/31/2007
Automatic Contribution Arrangements Have 6 Months to Distribute ADP and ACP Test Excesses	ERISA		ERISA		Plan Years beginning after 12/31/2007
Gap Period Income Does Not Have to be Paid on ADP and ACP Test Corrective Distributions	ERISA		ERISA		Plan Years beginning after 12/31/2007
Automatic Contribution Safe Harbor Design is Available	ERISA		ERISA		Plan Years beginning after 12/31/2007
Provisions Effective in 2010					
DB(k) Plan Design is Available to Employers with Fewer Than 500 Employees	ERISA				Plan Years beginning after 12/31/2009

* Delayed Effective Date applies to collectively-bargained plans.

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