Legislation Made Real

Legislative & Regulatory Updates brought to you by Nationwide® and McKay Hochman Co., Inc.

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Legislative and regulatory issues surrounding retirement plans are increasingly complex. With the passage of the Pension Protection Act of 2006, Nationwide® will continue to support you every way we can.

Together with McKay Hochman Co., Inc., we're pleased to bring you this periodic newsletter highlighting legislative, regulatory, and administrative changes that impact you and your clients. McKay Hochman Co., Inc. is one of America's most respected and recognized consulting firms serving the employee benefits field.

We hope that you will find this and future newsletters timely and useful.

Preparing for 2007

In light of the Pension Protection Act of 2006 (PPA), what changes should defined contribution plan administrators and sponsors be preparing for with the 2007 plan year approaching? Following are the provisions that become effective the first day of the 2007 plan year. (PPA provisions covering statements and default investments are addressed at length in separate articles in this newsletter.) Some of these changes are awaiting guidance from the IRS, DOL, or PBGC before they are available for use.

TOP-HEAVY VESTING FOR ALL EMPLOYER CONTRIBUTIONS (PPA §904)

EGTRRA mandated the use of a top-heavy cliff or graded vesting schedule for matching employer contributions. PPA extends this requirement to all other employer contributions to defined contributions plans. The accelerated vesting need only apply to employees who have worked at least one hour in 2007. This poses a potential recordkeeping issue where multiple vesting schedules may apply to the same contribution source. Thus, plan sponsors will need to consider added administrative complexity and cost when deciding whether to limit the new vesting requirements to post-2006 assets or apply the new schedule across the board, and when considering which employees to include.

NONSPOUSE INHERITED ROLLOVER (PPA §829)

Beginning in 2007, nonspouse beneficiaries in a qualified plan (such as a 401(k) plan) may roll over their inherited amounts to an inherited IRA. Previously, only surviving

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spouses could do this. However, nonspouse beneficiaries must begin taking required distributions immediately using the so-called "minus one" method, while spouses may defer required distributions until December 31 of the calendar year in which the decedent would have attained age 70½. Alternatively, the spouse could roll over the amount and postpone minimum distributions until he or she reaches age 70½, if later.

The law states that this provision is effective for distributions occurring after December 31, 2006. Therefore, beneficiaries of a participant who died in 2006 or later will be able to use these rules. However, IRS guidance is needed to determine whether this treatment will be extended to the beneficiary of a participant who died *before* 2006 if the beneficiary will continue receiving distributions *after* December 31, 2006.

PROHIBITED TRANSACTION EXEMPTION FOR INVESTMENT ADVICE (PPA §601)

Retirement plan service providers who offer investments to plans ("fiduciary advisers") will be allowed to recommend their own funds without violating fiduciary rules. For an investment advice arrangement to qualify, either the adviser's fees must be neutral with respect to the investments a participant chooses *or* it must use an unbiased computer model, certified by an independent expert, to create a recommended portfolio for a participant's consideration.

These new rules are generally applicable in 2007. "Eligible investment advice arrangements" will be required to comply with a *new* annual independent compliance audit for years beginning in 2007. To take advantage of this provision, vendors will have to accept "fiduciary" status that many have tried to avoid in the past.

Nationwide® is awaiting additional guidance from the Department of Labor on this provision.

DIVESTITURE OF EMPLOYER STOCK IN NON-ESOP PLANS; NOTICE REQUIREMENT (PPA §901; 507)

Beginning with the 2007 plan year, certain plans holding employer stock must permit participants to immediately divest employer securities purchased with elective

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PPA Provisions Currently in Effect (Some await regulations)

PENALTY FREE WITHDRAWALS FOR RESERVISTS (PPA §827)

Reservists who have served at least 179 days may make penalty-free qualified plan withdrawals effective for distributions occurring after September 11, 2001.

PBGC MISSING PARTICIPANT PROGRAM (PPA §410)

The PBGC missing participant program has been extended to terminating defined contribution plans and certain defined benefit plans with fewer than 25 participants. However, this extension will only occur after the PBGC issues regulations.

HARDSHIP WITHDRAWALS FOR BENEFICIARIES (PPA §826)

The IRS has been instructed to issue regulations within 180 days after August 17, 2006, to extend a participant's ability to take a hardship withdrawal for the benefit of any beneficiary under the plan, not just a spouse, qualifying child, or dependent. We anticipate that the guidance will, at a minimum, require plans that offer a hardship provision be amended to incorporate this option. Whether the provision can be used before the amendment is still an unknown.

DEDUCTION RULES FOR DB AND DC PLAN COMBINATIONS (PPA §803)

For contributions to a combination of one or more defined contribution and defined benefit plans, the overall limit on deductions (generally the *greater of* the defined benefit funding requirement or 25% of eligible compensation) now applies only to the extent that the employer contribution to the DC plan exceeds 6%. This change applies to contributions made in taxable years after December 31, 2005.

Preparing for 2007 *(continued)*

deferrals (or other employee contributions) and diversify the proceeds into other plan investments. Plans must allow participants to divest employer securities bought with employer contributions after completing three years of service. The divestiture requirement does not apply to Employee Stock Ownership Plans that do not hold elective deferrals or other employee contributions, or employer matching or certain nonelective contributions.

A three-year phase-in period applies to employer contributions in existing plans. The IRS is required to issue a model participant notice within six months after August 17, 2006. We will provide additional information on this subject in a future article.

TAX REFUND MAY BE SENT TO AN IRA (PPA §830)

Starting in 2007 (with income-tax returns for 2006), taxpayers may have all or part of their federal income-tax refund deposited directly into an IRA. Statutory contribution limits apply (i.e., $4,000 and $1,000 catch-up). The IRS already has issued Form 8888 in draft form, and we await its finalization.

ROLLOVER/402(f) NOTICE (PPA §1102)

The rollover or 402(f) notice explains the rollover and taxation rules for distributions from a qualified plan. The time frame for providing the notice has been changed from 30 to 90 days in advance of a distribution date to 30 to 180 days in advance of a distribution date. This will simplify operations for plans administered under the balance forward method while still allowing the 30-day waiting period to be waived. The rule requiring a minimum seven-day waiting period for plans subject to qualified joint and survivor rules remains in effect. The extension of the notice period may also allow certain defined benefit plans to avoid retroactive annuity starting date considerations.

Along with the description in the notice of a participant's right (if any) to defer receipt of a distribution, the IRS has been instructed to include an explanation of the consequences of failing to defer such a receipt. The IRS will no doubt also update the notice to include information on the nonspouse beneficiary rules and direct rollovers from a qualified plan to a Roth IRA (effective 2008). We recommend remaining with the 30- to 90-day time frame until the IRS issues guidance and/or a new 402(f) notice.

ROLLOVER OF AFTER-TAX AMOUNTS IN ANNUITY CONTRACTS (PPA §822)

The Act permits rollovers of after-tax amounts in 403(b) plans. However, the plan must be able to separately account for the after-tax contribution amount for this provision to be allowed.

QUALIFIED DEFAULT INVESTMENT ARRANGEMENT (PPA §624)

See separate article on this topic.

Participant Statement Requirements for 2007

Before the Pension Protection Act of 2006 (PPA), employers were only obligated to give active plan participants an account or accrued benefit statement once a year; and then, only if a participant requested a statement in writing. The only other statement requirement applied to a terminated participant with an account balance or accrued benefit, or a participant who had a "break in service" during the year.

THE RULES

Under PPA §508, a defined contribution plan (such as a 401(k), profit sharing, or money purchase plan) that permits participants to select their own investments must provide statements quarterly. When participant investments are directed by a fiduciary, only annual statements are required.

Active participants in defined benefit plans who have nonforfeitable accrued benefits must generally be given a benefit statement at least once every three years, or annually upon written request. Under an exception for defined benefit plans, it appears that if active participants are provided with an annual notice about their right to request a written statement, then statements are required only for participants who formally request them.

DEFINED CONTRIBUTION STATEMENT REQUIREMENTS

The quarterly benefit statements for participants or beneficiaries who have the right to direct their own investments must disclose the value of each investment, including employer securities, determined as of the plan's most recent valuation date. This statement must indicate the accrued benefit and the vested amount or the earliest vesting date. The statement must also include the following:

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Participant Statement Requirements for 2007 *(continued)*

1. An explanation of any limitations or restrictions on the individual's rights to direct an investment;
2. A plain English explanation of the importance of a well-balanced and diversified investment portfolio for the long-term security of participants and beneficiaries, including a statement of the risk that holding more than 20% of a portfolio in the security of one entity (such as an employer's securities) may not provide adequate diversification; and
3. A notice directing the participant or beneficiary to the Department of Labor Web site for sources of information on individual investing and diversification.

The quarterly statement mandate applies to both daily valued and balance forward plans that permit participants to direct their investments. This will mean that balance forward plans that usually issue one or two statements a year will now have to issue quarterly statements, resulting in additional administrative complexity and expense. Similarly, plans with both pooled and participant-directed assets will also have to issue quarterly statements — at least for the participant-directed portion.

EFFECTIVE DATE

These requirements generally go into effect for plan years beginning after 2006. The DOL has been instructed to issue model benefit statements within 12 months after August 17, 2006 (PPA's enactment date). Obviously, there is a gap between when the quarterly notices must be provided and when the DOL models may be available. (Use of the DOL's model benefit statements is optional.)

Statements may be provided in written or electronic form as long as they are accessible to participants. Regulations could permit benefit statements to be made available on a continuous basis on a secure Web site. Average plan participants must be able to understand such statements.

Nationwide® can help you meet your obligation as a plan administrator as it pertains to benefit statements. Effective March 31, 2007, all participant statements will include an explanation of the importance of a well-balanced and diversified investment portfolio as defined in section 508 of the Pension Protection Act, along with a notice directing the participant to the Department of Labor Web site.

Nationwide also provides the opportunity to present participant vesting, by source, on participant statements. Vesting information may be uploaded via a Nationwide defined comma delimited file at any time prior to quarter-end statement generation. Your case administrator can assist your staff in the upload process if necessary.

Nationwide is awaiting further regulatory guidance regarding the individual's rights to direct an investment.

Proposed Default Investment Rules

The Pension Protection Act of 2006 (PPA) includes an ERISA amendment designed to assist plans with automatic enrollment and participant investment direction. The Department of Labor, which was instructed to design safe harbor criteria for default plan investments within six months after August 17, 2006, has issued a proposed regulation.

Newly added ERISA Section 404(c)(5) provides that participants who receive a notice that (1) explains their right to designate how their contributions are invested and (2) describes the default investment into which their contributions will be directed in the absence of an investment election, will be deemed to have exercised control over the default investment. Fiduciaries of a plan using a default investment that meets the DOL criteria, called a Qualified Default Investment Alternative (QDIA), will not be liable for any losses that occur as a result of investment in the QDIA. This change would apply for plan years beginning after December 31, 2006, and the final regulation will become effective 60 days after it is published in the Federal Register.

NOTICE REQUIREMENTS

Participants and beneficiaries must be notified 30 days in advance of the first investment in a QDIA and annually thereafter (at least 30 days before the start of each plan year). This is to give participants ample time to make investment choices before the plan year begins. The notice must describe the circumstances under which investments will be made in the QDIA. In addition, the notice must disclose the investment objectives of the QDIA and the right of the participant or beneficiary to move money out of the QDIA without penalty.

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Proposed Default Investment Rules *(continued)*

PERMITTED INVESTMENTS

Investments are to include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or a blend of both. In 2004, when the DOL drafted the default investment regulations for automatic rollovers, it placed an emphasis on the preservation of capital. However, over the long term, capital preservation funds are unlikely to yield an adequate investment return for most active participants or beneficiaries, so Congress modified the QDIA rules based on the need to yield adequate savings for retirement.

FIDUCIARY RELIEF

The statutory language will provide relief to the fiduciaries of any participant directed individual account plan that complies with the terms of the plan document and the DOL's default investment regulation as ultimately finalized. Relief is not contingent upon a plan having "ERISA 404(c) plan" status or otherwise meeting the requirements of DOL Reg. Sec. 2550.404c-1.

However, nothing in the proposed regulation relieves an investment manager from his or her general fiduciary duties or from any liability that results from a failure to satisfy those duties, including liability for investment losses. Therefore, if the plan offers more than one investment that meets the definition of a QDIA, the investment manager should consider the effect of fees and expenses when deciding which QDIA is to be used.

There are six conditions that must be met for fiduciary relief.

1. The participant's or beneficiary's assets must be invested in a QDIA.
2. Participants or beneficiaries must have had the ability to select their own investments before the QDIA was implemented. Once a participant or beneficiary makes an investment election, the QDIA may not be used.
3. Notice must be provided to participants at least 30 days in advance of the first investment in a QDIA and 30 days in advance of each subsequent plan year.
4. Investment materials provided to the plan regarding the QDIA, such as account statements, prospectuses, and proxy voting materials, must also be provided to participants or beneficiaries.
5. Participants or beneficiaries must be permitted to transfer assets out of the QDIA to another plan investment without penalty. Such transfers must be permitted with the same frequency that applies to other plan investments, but not less than quarterly.
6. The plan must offer participants and beneficiaries the opportunity to invest in a "broad range of investment alternatives" as defined in DOL Reg. Sec. 2550.404c-1. A range of investment alternatives is defined as a selection sufficient to permit investment in a diversified portfolio. (The ERISA 404(c) investment rules would be the standard for this determination.)

QDIA REQUIREMENTS

According to the proposal:

1. A QDIA may not be invested in employer securities, with two exceptions:
   a. Employer stock held or acquired by a mutual fund (or similar investment vehicle) that is regulated and subject to periodic examination by a state or federal agency. Investment in such securities must have been made in accordance with the stated objectives of such investment fund, independent of the employer or its affiliate.
   b. Employer securities acquired (by a matching contribution or at the direction of the participant or beneficiary) before implementation of the QDIA. For this exception to apply, there must be no restriction on transferability. If such a restriction exists, the safe harbor is not available until the restriction expires.

      Note: This could occur if the individual had previously given direction with respect to employer securities but failed to provide a new investment direction after a change in investment alternatives. This assumes the plan terms indicate that the subsequent investment in a QDIA would permit the investment management service to hold or manage those employer securities in the absence of direction from the individual. In any event, the investment management may not acquire any additional employer stock after this point.
2. No restrictions may be placed on the transfer of funds from a QDIA to any other investment alternative available under the plan. Transfer must be permitted with the same frequency that applies to other plan investments, but not less than quarterly. No financial penalties may be imposed when funds are moved from the QDIA to other plan investments.

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3. A QDIA must be managed by an investment manager or mutual fund. (Thus, those responsible for the QDIA are "investment managers" within the meaning of ERISA Section 3(38).)
4. A QDIA must be diversified to minimize possible investment losses.
5. A QDIA must be one of the following three types of investment products:
   a. *A life cycle or targeted-retirement-date fund.* This option focuses on the age, target retirement date, or life expectancy of the participant. The investment might be a "stand-alone" fund or a "fund of funds" portfolio comprised of various investment options available under the plan. A "fund of funds" may include a money market, stable value, or similar capital preservation investment along with equity and fixed income investments.
   b. *A "balanced fund."* This option focuses on an investment fund product or model portfolio designed to provide long-term appreciation and capital preservation (through a mix of equity and fixed income investments) at a target level of risk determined by treating the plan's participants as a whole. This approach would not require the age of individual participants to be taken into account but rather is based on the demographics of the entire group. Changes in demographics may require new or additional investment fund products. A balanced fund also may be a "stand-alone" or "fund of funds" investment.
   c. *A professionally managed account.* This choice features investment management services for individual participants based on age, target retirement date, or life expectancy and becoming more conservative as a participant ages. However, the investment manager is not required to take into consideration an individual's risk tolerance, other investments, or other preferences.

Note: A person who is named as fiduciary with respect to the control or management of the assets of the plan may appoint an investment manager. If an investment manager is appointed, then the trustee(s) shall not be liable for the acts or omissions of such investment manager(s) or required to invest or manage any assets placed under the investment manager's responsibility. Nonetheless, plan fiduciaries are responsible for the prudent selection and monitoring of the QDIA.

We are currently analyzing the proposed rule and commit to follow up with our partners as we learn more.

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