Pension Protection Act of 2006 ("PPA")
10.17.06

While you may have already seen general descriptions of the PPA, this ESOP Blog focuses on the PPA provisions that relate to ESOPs, and provides some planning considerations for ESOP companies.

1. New, Faster Vesting for ESOPs – Contributions made to a defined contribution plan for plan years beginning after December 31, 2006 will now be subject to an accelerated 3-year "cliff" or 6-year "graded" vesting schedule. These alternatives replace the existing 5-year cliff and 7-year graded alternatives.

Special ESOP transition Rule – For an ESOP which had a loan outstanding on September 26, 2005, which was used to acquire employer stock, the new, faster vesting rules will not apply until the earlier of (a) the date the loan is fully repaid or (b) the date the loan was (as of September 26, 2005) scheduled to be fully repaid.

ESOP Planning Note – ESOP sponsors will want to review their outstanding loan documents to determine the first year in which the new vesting schedules will apply. Also, employers do not have to keep two sets of vesting records, and may choose to apply the new vesting rules to all ESOP shares, including amounts contributed prior to 2007.

2. 401(k) Auto Enrollment – A new safe-harbor for the ADP and ACP test is created for plans that meet 3 requirements: (a) automatic enrollment for salary deferrals; (b) matching or non-elective contributions and (c) notice to employees. The automatic deferral requires a deduction of salary of 3% in the first year, 4% in the second year, 5% in the third year and 6% thereafter. This only need apply to new 401(k) Plan participants. In addition, the matching requirement is 100% on the first 1% of deferrals and then 50% on the next 5% of deferrals for all eligible non-highly compensated employees. As an alternative to the match, a non-elective contribution of 3% of compensation can be made for all eligible employees. These safe harbor contributions must fully vest after two years of service. The notice requirement is similar to the existing safe harbor match notice, and must explain how the contributions will be invested and the participant's right to elect to not participate. The new safe harbor is effective for plan years beginning after December 31, 2007.

ESOP Planning Note - If your ESOP is currently being used to meet the 401(k) safe harbor, you may wish to consider switching to the PPA safe harbor in order to use the two year vesting schedule and avoid the immediate full vesting required under current law. Depending on deferral patterns in your 401(k) plan, the new PPA safe harbor may save you money on your company match.

3. Expanded Diversification For Employer Securities –

First thing to know: the expanded diversification election does not apply to an ESOP or a profit sharing plan that invests in employer stock if the employer's stock is closely-held. In addition, ESOPs are excepted from the new diversification requirement even if the employer's stock is publicly traded if: (a) the ESOP does not have contributions that are subject to 401(k) or matching contribution rules and (b) the ESOP is a stand alone plan.

The new rule generally applies to: (a) 401(k) salary deferral contributions, matching contributions and discretionary employer contributions; (b) that are invested in employer stock in a profit sharing plan ; and (c) the employer (or a member of its controlled group) has outstanding a class of stock that is publicly traded.

Slightly gray area: The new diversification rule applies to an ESOP that has a 401(k) feature, but it is unclear if it applies to an ESOP which merely accepts a transfer of 401(k) salary deferral contributions. Employers who previously converted their 401(k) Plans to ESOPs to qualify for the dividend deduction under Section 404(k) should check their plan terms to see if they are exempt from the new diversification rule.

What is the new rule? The defined contribution plan must permit immediate diversification of all salary deferral contributions invested in employer stock. For matching contributions (or any discretionary employer contributions) invested in employer stock, diversification is required to be offered after the participant has at least three years of service. Notice must be given to participants 30 days prior to the date on which they will have the right to divest employer stock.

Transition Rule - (1) Employee's Salary Deferral Contributions – If invested in employer stock, there is no transition rule. Diversification is effective in the first plan year beginning after December 31, 2006.

(2) Company Contributions – For employer stock acquired by the plan prior to January 1, 2007, the new diversification election is phased in 1/3 per year in 2007, 2008 and 2009. However, for a participant who had attained age 55 and completed 3 years of service before the first plan year beginning after December 31, 2005, this transition rule does not apply and the new diversification rule is effective in the first plan year beginning after December 31, 2006.

4. Benefit statements – Benefit statements must now be distributed at least annually. ERISA did not previously require an automatic annual statement. Most ESOP companies have provided automatic annual statements anyway. In addition, the new law requires quarterly statements if the participant can direct the investment of his account. ESOPs that have satisfied the age 55 and 10 years of participation requirement by creating investment funds in the ESOP will be subject to this rule. This new quarterly notice must also provide investment information on diversification strategy. The benefit statement rules apply for plan years beginning after December 31, 2006.

5. Bonding – The fidelity bond maximum is increased from $500,000 to $1 million. This requirement is only for Plans holding employer securities. It is effective for plan years beginning after December 31, 2007. We suppose Congress was especially concerned with fiduciaries running off with stock certificates in closely-held companies. (Hard to pay your bills while on the lam with those illiquid stock certificates!).

6. Permits in-service distributions from pension plans after age 62 – For ESOPs that have included a money purchase pension feature (MPP), in-service distributions prior to normal retirement age have been impermissible under ERISA. Under the new law, beginning in 2007, in-service distributions may be made from a MPP so long as the participant has attained at least age 62. This may be useful to MPP ESOPs, particularly in connection with the implementation of diversification elections where some of the funds to be distributed would have come from the MPP account.