

## **NEWSFLASH - PENSION PROTECTION ACT OF 2006**

**October 18, 2006**

On August 17, 2006, President George W. Bush signed the Pension Protection Act of 2006 (PPA)<sup>1</sup> into law. In addition to strengthening traditional defined benefit pension plans through new funding and reporting requirements, the PPA amends many rules relating to defined contribution plans, including ESOPs.

### **Employer Securities Diversification Rules**

One of the most important changes the PPA will have on ESOPs relate to new diversification rules. The new rules apply to ESOPs of publicly traded companies that are integrated or combined with 401(k) plans. If the employer's securities are not publicly traded or the ESOP is a stand-alone plan, the diversification rules will not apply. For ESOPs not subject to the new diversification rules, current diversification rules will continue to apply.<sup>2</sup>

The diversification rules permit participants to diversify their elective contributions at all times and employer matching contributions after three years of service, regardless of age, and plans must provide at least three investment options, in addition to employer securities.<sup>3</sup> Plan sponsors must notify participants of their diversification rights and of "the importance of diversifying investment retirement account assets."<sup>4</sup>

For plans that are subject to the diversification rules, the plan may transition diversification for most participants over a three-year period commencing with plan years that begin after December 31, 2006. However, no transition is available to participants who were age 55 and had three years of service at the beginning of the first plan year after December 31, 2005. Plans must permit these participants to diversify their accounts in accordance with the new rules during the first plan year to occur after December 31, 2006.<sup>5</sup>

### **Vesting**

ERISA already requires accelerated vesting for employer matching contributions made to defined contribution plans.<sup>6</sup> For plan years beginning after December 31, 2006, the three-year cliff and six-year graded vesting schedules that are required for matching contributions will apply to all employer contributions.<sup>7</sup>

There is an exemption, however, from these new vesting requirements for ESOPs that had exempt loans (loans incurred by an ESOP to finance the purchase of employer securities) outstanding as of September 26, 2005. The new vesting rules will not apply to ESOPs with outstanding exempt loans until those loans are fully repaid or until the date on which those loans were scheduled to be repaid as of September 26, 2005.<sup>8</sup>

### **EGTRRA Sunset Provisions**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included certain "sunset" provisions that were scheduled to expire at the end of 2010. The PPA repealed these sunset provisions.<sup>9</sup> As a result, the PPA makes permanent the deduction for ESOP dividends that are reinvested in employer securities.<sup>10</sup> In addition, the "anti-abuse" rules for S corporation ESOPs, set forth in Section 409(p) of the Internal Revenue Code, are also permanent.

### **Bonding**

ERISA requires that every fiduciary and every person who handles funds of a plan maintain a bond in an amount equal to at least ten percent of plan assets, but no greater than \$500,000.<sup>11</sup> Effective for plan years beginning after December 31, 2007, the PPA increases the fidelity bond requirement for plans that hold employer securities to a maximum bond of \$1 million.<sup>12</sup>

### **Conclusion**

The PPA changes the ERISA landscape in many ways beyond pension protection. In addition to provisions discussed herein, there are several other provisions of the PPA that will affect ESOP and KSOP administration, including new reporting and disclosure rules, participant investment advice rules, automatic enrollment rules, distribution rules, and additional fiduciary protections.

The new diversification rules that apply to public companies with employer securities in their plans do not apply to ESOPs sponsored by private companies or to stand-alone ESOPs sponsored by public companies. Probably the most important change that will affect ESOPs sponsored by private companies are the new accelerated vesting rules, the impact of which will be eased by the "grandfathering" provisions available for existing leveraged ESOPs.

### **Additional Information:**

For additional information on the Pension Protection Act of 2006, please see the following Morgan Lewis LawFlashes available under Publications at [www.morganlewis.com](http://www.morganlewis.com):

- Sweeping Pension Reform Bill Passed
- Pension Protection Act of 2006 Includes Numerous Charitable Provisions
- Multiemployer Plan Issues in the Pension Bill
- Fiduciary Duty Provisions Affecting Providers: Pension Protection Act of 2006
- Pension Protection Act Rules for Defined Contribution Plans
- Pension Protection Act of 2006 New Funding and Related Requirements for Defined Benefit Plans

If you have any questions about how the PPA will affect your ESOP, please feel free to contact your Morgan Lewis attorney or any of the following individuals:

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<sup>1</sup> H.R. 4, Pension Protection Act of 2006 (H.R. 4).

<sup>2</sup> I.R.C. § 401(a)(28)(B). ESOP participants who have reached age 55 and have at least ten years of service must be allowed to diversify their plan assets.

<sup>3</sup> J.C.T. Rep., Act §. 901.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> I.R.C. § 411.

<sup>7</sup> J.C.T. Rep., Act §. 904.

<sup>8</sup> *Id.*

<sup>9</sup> J.C.T. Rep., Act §. 811.

<sup>10</sup> I.R.C. § 662.

<sup>11</sup> 29 U.S.C. § 1112.

<sup>12</sup> H.R. 4, §. 622.