eBenefits Alert: A Year-End Message to Our Friends and Clients

December 1, 2007

The Employee Benefits & Executive Compensation Group at Gray Plant Mooty is grateful for the opportunity to work with you over the past year. We hope this has been a year of fulfillment for you personally and for your organization. Our sincere wish is that this holiday season brings you peace, joy and a prosperous New Year.

In our field of law, the wonder and anticipation of the holidays are always joined by two other year-end phenomena: effective dates and deadlines. This eBenefits Alert discusses the most significant changes in the employee benefits arena that we should be thinking about as 2007 becomes 2008. Links to more detailed discussions are included for some topics. As always, we invite you to call us with your questions.

- ***Vesting.*** Employers using the longest permissible vesting schedule for their retirement plan contributions - either a 7-year graded schedule or a 5-year cliff vesting schedule - must switch to a shorter schedule. At a minimum, employer contributions for plan years beginning on or after January 1, 2007, must become vested under a 6-year graded schedule or 3-year cliff vesting schedule. For additional information on this topic, please click here.
- ***Participant Benefit Statements.*** New requirements for furnishing benefit statements to retirement plan participants became effective in 2007. The rules speak to the content of the statements as well as their timing and frequency. One of the required elements for plans with participant-directed investments is an explanation of the importance of a diversified portfolio. For additional information on this topic, please click here.
- ***ESOP Fidelity Bond.*** Most retirement plan sponsors are required to maintain an ERISA fidelity bond to protect participants from loss due to the dishonesty of someone handling plan assets. Under the law now in effect, the face amount of the bond must be the lesser of $500,000 or 10% of the value of the assets. Effective for plan years beginning on or after January 1, 2008, the bonding requirement for ESOPs and other plans holding employer securities increases to $1,000,000 (or 10% of the value of the assets, if less). The requirement for other retirement plans is unchanged.
- ***Automatic Enrollment.*** More and more employers are adopting automatic contribution arrangements to increase participation in 401(k) plans. Effective for plan years beginning in 2008, a plan may implement a new safe-harbor qualified automatic contribution arrangement, which offers relief from the requirements of annual 401(k) and other nondiscrimination testing. Other forms of automatic enrollment were available prior to 2008 and will still be available in 2008 and beyond. The IRS and DOL have recently issued guidance for implementing these arrangements. The guidance explains the special

notice requirements that apply to these arrangements, and generally requires notice to participants prior to the beginning of the 2008 plan year. If you have an automatic contribution arrangement and are not sure you have met the notice requirement, you should contact us for assistance.

- ***Default Investments.*** On October 24, 2007, the DOL issued final regulations with respect to default investment alternatives. This refers to the fund or funds in which participants' accounts are invested if they fail to provide investment directions. If a Plan sponsor uses a qualified default investment alternative and meets certain other requirements of the regulations, the participant is deemed to have exercised control over his or her assets and the plan fiduciaries will not be liable for losses from such investments. The final regulations include notice requirements and describe the types of funds that may be used as a qualified default investment alternative.
- ***Nonspouse Beneficiaries.*** The Pension Protection Act of 2006 included two changes that respond to the needs of unmarried participants or participants who, for various reasons, decide to name individuals other than their spouse as the beneficiary of their retirement accounts. One change permits a nonspouse beneficiary to defer taxes by rolling death benefits into an IRA. The other change expands the hardship distribution rules to permit in-service withdrawals when the financial hardship affects a primary beneficiary who is neither the spouse nor a dependent of the participant. Employers are not required to offer either of these options in their retirement plans, although legislation has been introduced in Congress that would force plans to allow rollovers by nonspouse beneficiaries. For additional information on nonspouse rollovers, please click here.
- ***Lump Sum Distributions Under Defined Benefit Plans.*** The rules for calculating lump sum distributions from defined benefit plans are changing in 2008. For more information on this change and the decision that may face some plan sponsors, please click here.
- ***Additional Survivor Annuity Option.*** Plans required to provide a qualified joint and survivor annuity as a payment option may have to add an additional form of joint and survivor annuity to the list of choices. For example, if the qualified joint and survivor benefit under your plan is a joint and 50% survivor annuity, you must offer a joint and 75% survivor annuity option, even if your plan already offers a joint and 100% survivor annuity. If the qualified joint and survivor option under the plan has a survivor percentage of 75% or more, the plan must offer a joint and 50% survivor annuity option. You should begin offering the additional option for benefit payments beginning in the 2008 plan year. Conforming amendments may be adopted anytime before the end of the grace period provided by the Pension Protection Act, generally, before the end of the 2009 plan year.
- ***Hurricane Relief.*** The Katrina Emergency Tax Relief Act of 2005 and the Gulf Opportunity Zone Act of 2005 permitted plans to allow distributions to individuals affected by Hurricanes Katrina, Rita or Wilma. The distributions had to be made on or after a specified date (depending on the hurricane) and prior to January 1, 2007. Qualified hurricane distributions could not exceed $100,000. In addition to these distributions, plans were permitted to make adjustments to their loan rules for hurricane victims by increasing loan limits or relaxing the five-year repayment requirement. This legislation still has relevance for employers with workers in the affected areas because plan amendments may still be required. In addition, plans are permitted to allow recontribution of a qualified hurricane distribution during the three-year period beginning on the date the distribution was made. Plans that implemented any of these hurricane relief provisions must be retroactively amended to reflect such provisions by the end of the first plan year that begins on of after January 1, 2007. Thus, December 31, 2007, is the

deadline for calendar year plans.

PPA Vesting Change

Vesting schedules come in two shapes. The more common schedules take a participant from 0% to 100% vesting in a series of steps - often in 20% annual increases. This is sometimes called "graded vesting." "Cliff vesting" schedules, like an express elevator, take participants from 0% to 100% vesting in one jump after the completion of a specified number of years of service. Prior to the Pension Protection Act of 2006 ("PPA"), the longest permissible graded vesting schedule extended for seven years, with 20% vesting after three years and 20% increases for each additional year. The longest cliff vesting schedule before the PPA required five years of service for full vesting (and participants with less than five years of service were 0% vested).

In the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Congress shortened the maximum vesting schedules for employer matching contributions to a 401(k) plan from seven to six years for graded vesting and from five years to three years for cliff vesting. The PPA imposes identical changes for all other employer contributions to qualified defined contribution plans, including profit sharing contributions and ESOP contributions.

If your plan has a seven-year graded vesting schedule or a five-year cliff vesting schedule, the schedule must be shortened to comply with the new requirements. (It is possible to change from one style of vesting schedule to another - for example, from five-year cliff vesting to six-year graded vesting - but in that case participants with at least three years of vesting service may have additional rights that must be observed.) As long as you begin operating under a permitted schedule, you may delay amending the written plan document until 2009. The new law only applies to employer contributions made for plan years beginning in 2007 or later years, unless the employer decides to apply the change to older contributions as well. This flexibility gives you, as the employer, several planning options:

1. Use the shortened vesting schedule only to the extent the law requires (that is, only for post-2006 employer contributions). In this case, your plan must maintain separate accounts and separate vesting schedules for pre-2007 and post-2006 employer contributions.
2. Use the shortened vesting schedule for all employer contributions effective on the first day of the 2007 plan year. Under this alternative, all partially vested participants and some 0% vested participants who are actively employed would see an increase in their vested percentage as of the first day of the 2007 plan year. If any such participants already received a distribution during the 2007 plan year under the old vesting schedule, they would be entitled to a supplemental payment from the plan. For example, a participant with four years of service is 40% vested under the typical seven-year vesting schedule. The PPA rules require that this participant have at least 60% vesting under the maximum six-year vesting schedule. If this participant received a distribution during the 2007 plan year based on 40% of the

account balance, she would be entitled to a larger 2007 payment based on 60% vesting once the vesting schedule is retroactively shortened to six years.

3. Use the shortened vesting schedule for all employer contributions effective on the first day of the 2007 plan year, but only for employees who complete at least one hour of service on or after the first day of the 2007 plan year. Excluding participants who terminated before the 2007 plan year may reduce the number of participants entitled to a supplemental payment from the plan.
4. Initially, apply the shortened vesting schedule only to post-2006 contributions. Most plans have not yet allocated any employer profit sharing or ESOP contributions for the plan year that started in 2007, so distributions made this year under the old vesting schedule would still be accurate and would not require corrective payments. If you wish to avoid the complications of maintaining separate vesting schedules once contributions for 2007 are allocated, you may amend the plan prospectively, as of the end of the 2007 plan year, to extend the shorter vesting schedule to the pre-2007 employer contributions. (This option requires an analysis of the impact of the amendment on various groups of employees to ensure that it does not violate nondiscrimination requirements.)

The PPA change to the vesting requirements does not apply to defined benefit plans. Therefore, cash balance plans and traditional defined benefit pension plans may continue to operate under five-year cliff vesting or seven-year graded vesting schedules. The change applies to ESOPs, because they are defined contribution plans, but the effective date may be delayed if the ESOP had outstanding on September 26, 2005, a loan used to purchase employer stock. If that condition was met, the ESOP is not required to adopt the shorter vesting schedule for plan years beginning before the earlier of (1) the date on which the loan is fully repaid, or (2) the date on which the loan was, as of September 26, 2005, scheduled to be repaid. Defined contribution plans maintained pursuant to collective bargaining agreements may also be subject to a delayed effective date, depending on when the most recent agreement terminates.

Participant Benefit Statements

Most companies with a 401(k) plan, profit sharing plan or ESOP are already providing benefits statements to participants on a quarterly or annual basis, even though, as a matter of legal compliance, benefit statements were required under prior law only upon request of the participant. Under the Pension Protection Act of 2006, starting with the 2007 plan year, statements must be provided at least quarterly and no later than 45 days after the end of the quarter for plans that permit participant direction of investments. For plans that do not permit participant direction, the Department of Labor (DOL) has stated that benefit statements must be provided at least annually and that plan administrators will be treated as acting in good faith compliance if the statements are provided no later than the Form 5500 filing due date (including any extension). Statements for defined contribution plans must include the participant's account balance, the amount invested in each investment fund or in employer stock, and vesting status. Statements for plans that permit participant-directed investment must also include an explanation of the importance of a diversified portfolio

and a direction to the U.S. Department of Labor's website for sources of more investment and diversification information. The DOL website address for this purpose is www.dol.gov/ebsa/investing.html. Model language for the explanation is available in Q&A 6 of the DOL's Field Assistance Bulletin 2006-03, which can be found at www.dol.gov/ebsa/regs/fab_2006-3.html.

Nonspouse Beneficiary Rollovers

Many retirement plan participants have named beneficiaries who are not married to the participant. Upon the death of the participant, these "nonspouse" beneficiaries have been at a disadvantage from a tax perspective. The distribution provisions of the plan may have forced them to take the entire death benefit in a single lump sum payment within the five-year period following the year of the participant's death. Because IRA rollovers have not been available to beneficiaries other than surviving spouses, nonspouse beneficiaries often found themselves in the highest tax brackets, facing large tax bills because they could not spread the taxable death benefit over multiple tax years.

The Pension Protection Act of 2006 allows employers to help with this problem by amending their plans to permit direct rollovers by nonspouse beneficiaries (including certain trusts) into special IRAs called "inherited IRAs." The rollover amount cannot include the portion of the benefit that must be distributed to the beneficiary in the year of the rollover under the minimum required distribution rules.

Inherited IRAs must meet certain requirements. The title of the inherited IRA must indicate that it is held by the individual as beneficiary of the deceased participant. A beneficiary who establishes an inherited IRA may generally control when amounts are withdrawn as taxable income, provided that minimum required distributions are taken each year over the beneficiary's life expectancy. A beneficiary may not contribute additional amounts to an inherited IRA and may not make rollovers from the inherited IRA to other IRAs or retirement accounts.

An employer who wishes to add this provision to its qualified plan, 403(b) arrangement or governmental 457(b) plan may do so immediately because the new opportunity for nonspouse beneficiaries may be applied to any distributions made after December 31, 2006. However, the statute insists that the rollover be paid directly from the plan to the IRA (a "trustee-to-trustee" transfer) so it is too late to salvage a distribution that has already been paid to a nonspouse beneficiary in 2007.

Lump Sum Distributions Under Defined Benefit Plans

Lump sum distributions are computed using the so-called "applicable interest rate." Beginning with the 2008 plan year, the Pension Protection Act changes how the applicable interest rate will be determined.

Currently, the applicable interest rate is an indexed rate based on 30-year Treasury Bonds. Under the new rules, the applicable interest rate will be based on high-grade corporate bonds. The new index will be based on short-term, mid-term or long-term corporate bond yields for the short term, mid-term and long term segments of the time period used for discounting a participant's annuity benefit to its lump sum present value. In addition, the new index will be phased in from 2008 through 2011. During that time, an increasing percentage of the lump sum will be computed applying the new corporate bond index and a declining percentage will be computed using the old index based on 30-year Treasury Bonds.

The net result is that, beginning with your 2008 plan year, lump sums likely will be smaller. Generally, individuals close to retirement will be affected the least; those further away from retirement the most. Even though your plan document may say that lump sums are to be calculated using the 30-year Treasury Bond index, you may still apply the new index , as adjusted by the phase-in rule, for the plan year beginning in 2008. If you follow this course, conforming plan amendments must be adopted by the end of the grace period provided by the Pension Protection Act, which is generally the end of the 2009 plan year. Some plan sponsors, however, may wish to use the old 30-year Treasury Bond index, especially if the plan has a cash balance or similar formula or the plan provides a full lump sum option, i.e., the lump sum form of payment is not just confined to the payment of small benefits, such as lump sums of $1,000 or less. If this is the case, you should consult with us concerning the implications of retaining the old index and the amendments that may be necessary to your plan

This article is provided for general informational purposes only and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult a lawyer concerning any specific legal questions you may have.