

# CLIENT ALERT

## PENSION PROTECTION ACT 2006: HOW IT AFFECTS YOUR ESOP

Written by:

Mychelle Holloway, CPC

By now I am sure you have heard about the new Pension Protection Act of 2006 (H.R. 4) (the "Act") and your first question may be "How does it apply to our ESOP?". The Act primarily addresses issues related to defined benefit (or pension) plans. However, some of the new rules apply to defined contribution plans including profit sharing and 401(k) plans. The purpose of this article is to provide an overview of the new rules under the Act – specifically as they apply to ESOPs.

### **EGGTRA NOW PERMANENT**

Those of you who have recently (or not so recently) amended your ESOP to comply with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will be relieved to learn that amendments made to your ESOP in order

to comply with EGTRRA were not made in vain. The provisions of EGTRRA were scheduled to expire in 2010 but are now permanent.

One of the major changes brought about by EGTRRA was a dramatic increase in the contribution limits as they apply to defined contribution plans. Prior to EGTRRA, contributions to an individual's account were limited to the lesser of 25% of compensation or \$35,000. After EGTRRA, the limit was increased to the lesser of 100% of compensation or \$40,000 (indexed for inflation). For 2006, the compensation limit is the lesser of 100% of compensation or \$44,000.

In addition to the increase in contribution limits, EGTRRA also included the prohibited allocation rules of Code Section 409(p) applicable to S corporations and the dividends deduction for ESOP dividends reinvested in employer stock under Code Section 404(k). These

EGTRRA provisions also are made permanent by the Act.

### **VESTING RULES**

The Act changes the maximum allowable vesting period applicable to employer contributions made after 2006 to ESOPs. Under the new rules, employer contributions must fully vest under either a three year cliff-vesting schedule or a six year graded vesting schedule (where at least 20% of the contributions vest each year after the first year). If your ESOP has a seven year graded or five year cliff vesting schedule, you may have to amend your ESOP to comply with the new vesting rules for employer contributions made after 2006. You should note that a leveraged ESOP with an outstanding loan in place on September 26, 2005 may defer compliance with the new vesting rules until the loan is fully repaid.

# Pension Protection Act 2006

## QUALIFIED PLAN DISTRIBUTIONS

Beginning January 1, 2008, qualified plan distributions can be rolled over directly to a Roth IRA without first rolling the distribution over into a traditional IRA. However, the adjusted gross income limits applicable to rollovers from traditional IRAs to Roth IRAs will apply. (An individual is not permitted to roll over funds to a Roth IRA if his or her modified adjusted gross income exceeds \$100,000 annually.) In addition, beginning January 1, 2007, non-spouse beneficiaries receiving distributions from qualified plans are now permitted to roll over those distributions to IRAs. (Prior to the Act, only spousal beneficiaries were permitted to roll over qualified plan distributions to an IRA.)

After December 31, 2006, the distribution notice and consent requirements are changed to increase the 90-day notice period to 180 days.

## REPORTING REQUIREMENTS

Effective for plan years beginning after 2006, for the first time annual individual account statements are required for all defined contribution plans. (Some defined contribution plans are already required to trans-

mit quarterly statements to plan participants.). Before the Act, annual statements were generally required to be provided upon a plan participant's request. Now, annual statements must be transmitted to all qualified plan participants, including ESOP participants. For your convenience, the DOL is developing model statements and guidance on the content of, and permissible distribution methods of the required annual statements.

## DIVERSIFICATION

The Act brings many changes to the diversification rules as they apply to plan assets invested in employer stock, but mostly for publicly traded employer securities. Under the Act, for ESOPs holding publicly traded employer stock, a participant must be permitted at all times to diversify his or her employee elective contributions invested in employer securities. In addition, participants must be permitted to diversify employer contributions invested in employer securities after three years of vesting service. There also are certain notice requirements applicable to the new diversification rules.

Generally, the Act exempts from the new diversification requirements an

ESOP holding publicly traded employer stock so long as: i) the ESOP is a "stand alone" plan (meaning it is not combined with any other defined contribution plan); and ii) the ESOP does not hold contributions and earnings that are subject to the nondiscrimination tests applicable to employee elective deferrals, employee after-tax contributions or employer matching contributions.

## BONDING REQUIREMENTS

The Act increases the maximum bond amount from \$500,000 to \$1,000,000 for plans holding employer securities. This increase goes into effect for plan years beginning after 2007.

## PLAN AMENDMENTS & COMPLIANCE

Plan amendments required as a result of the Act must be made before the end of the first plan year beginning on or after January 1, 2009. However, interim operational compliance with the new rules is required as specified above.

Should you have any questions regarding the Act and its impact on your ESOP, please call either Michelle Holloway (757) 442-6651 or Mark Kossow (215) 508-1500.

# Department of Labor Audits – What to Do and What Not to Do

Written by:

Steven R. Fischer

The Employee Benefits Security Administration (EBSA), the branch of the Department of Labor (DOL) responsible for the supervision of ESOPs has publicly announced a “national audit project” relating to ESOPs. While you might think that this announcement was accompanied by the theme music from “Jaws”, there should be no reason to fear the increased audit activity by EBSA, provided that you take a few simple precautions. So, what exactly is a DOL audit and what is EBSA looking for? What triggers an audit? What should you do if your ESOP is audited? And, perhaps most importantly, what should you not do?

A DOL audit is an examination of some – or all – of your ESOP plan and trust documents, trustee records, transaction documents, valuation materials, the plan’s annual CPA audits, distribution records and administrative files. The purpose of an audit is to determine whether your ESOP has been operating properly. The following is a short list of the operational areas that receive the greatest attention:

- Were all purchases and sales of shares

by the ESOP accompanied by reasonable valuations, and were annual updates properly performed

- Did plan fiduciaries engage in self-dealing or otherwise have conflicts of interest?
- Were share allocations, forfeitures and ESOP loan interest payments properly calculated?
- Have benefit payments been properly calculated and paid and have diversification elections been properly handled?
- Have ineligible participants received allocations of stock?
- If the internal ESOP loan has been refinanced, did the trustees properly document the new agreement?

An audit begins with a letter from either an EBSA investigator (who may be an attorney) or other agency employee, requesting copies of specific ESOP documents. The title of the auditor does not provide any insight into the nature or extent of the audit. While audits occasionally begin with a narrow focus (reflected in the types of document requested or a particular time period), initial audit letters are typically broad-based and reach back four years or more. The time period for providing the requested documents to EBSA is almost certainly too short to gather and copy the requested materials unless you are amazingly

well organized (or have nothing else to do all day), but reasonable extensions of the response deadline are invariably granted – provided that you ask nicely.

While an audit can be triggered by a communication to EBSA from a plan participant or beneficiary, or an apparent anomaly on a Form 5500, most audits are unrelated to any specific ESOP event. EBSA is organized into regional offices, and some regions (Boston, Cincinnati, Chicago and San Francisco come to mind) have been more active than others. There have been persistent rumors that EBSA “targets” ESOPs that were installed by or received initial valuations from certain unsavory groups of professional advisors, but that may be an urban legend. If anything, our clients have experienced less than the average amount of audit activity. You almost certainly will never know if your audit had a specific “trigger.”

So, how should you respond to an audit? The first thing to remember is that a prompt, courteous response to the DOL is always the best policy. Don’t wait until the day your response is due to call and ask for an extension, and don’t ever let your frustration show. Many EBSA audi-

# Department of Labor Audits – What to Do and What Not to Do

tors have limited experience with ESOPs and they are all overburdened. The design and operation of your ESOP may involve issues that they have never seen before. Don't appear defensive and resist the temptation to explain the entire history of your ESOP – you may create more issues than you resolve. Your goal should be to seek basic guidance from plan counsel and your ESOP recordkeeper, gather the requested materials (seeking clarifications about the request where needed), organize your responses and deliver the documents to the auditor with little fanfare and no editorial or unnecessary explanatory statements.

Regardless of how comfortable you are with the history of your ESOP in operation, you should never turn over ESOP records without carefully reviewing the materials first. The process of responding to an audit may alert you to operational issues. If you discover that a problem exists, do not attempt to “fix it” by creating new documents or re-dating or re-executing old ones (you would be amazed at some of the things that

we – and the DOL – have seen). If you have concerns, your recordkeeper and ESOP counsel can help you craft your response – there are often simple and acceptable solutions and strategies to address perceived issues and problems. While most voluntary correction programs are not available once the ESOP is under audit, there are regulatory approaches that you can take to lessen the impact of operational defects that you discover and address before the auditor does.

After you have responded, you may hear nothing for many months. Resist the temptation to “try to move the audit along”. Ultimately, the auditor may request additional information, may seek a meeting with you, or he or she may provide you with a letter either closing the audit (hopefully with no required corrections) or describing areas of concern or alleged violations. If you receive a letter detailing alleged ERISA or Code violations, you should immediately involve ESOP counsel – do not attempt to reach a binding resolution with EBSA on your own. The fines and penalties associated with

even minor technical matters can quickly spiral out of control unless addressed in a sophisticated manner, and by regulation EBSA is required to report to the IRS any finding that a “prohibited transaction” has occurred. IRS penalties may be significantly greater than those imposed by the DOL.

In the end, most ESOP audits do not result in major problems. But as in medicine, an ounce of prevention is worth a pound of cure. Taking care to operate your ESOP according to the rules is always the best approach. Your ESOP advisors can also discuss with you ways of performing relatively inexpensive “check-ups” to make sure that you remain in compliance.

If you have any questions regarding DOL audits, please contact Steven Fischer at (215) 508-1500 ext. 224 or [sfischer@sfeglaw.com](mailto:sfischer@sfeglaw.com).

Visit Us On  
The Web!  
[www.sfeglaw.com](http://www.sfeglaw.com)



10 Shurs Lane  
Suite 102  
Philadelphia, PA 19127  
P (215) 508-1500  
F (215)508-2500

The Foundry Corporate Office Center  
235 Promenade Street, Suite 497  
Providence, RI 02908  
P (401) 632-0480  
F (401)632-0483

6 South Street  
Suite 201  
Morristown, NJ 07960  
P (973) 540-9292  
F (973)540-9595