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Client**Advisory**

Pension Protection Act of 2006 Impacts ESOPs

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Now that Congress has passed and President Bush has signed into law the Pension Protection Act of 2006 (the "Act"), with its comprehensive reform of the law governing tax-qualified retirement plans, it is appropriate to examine the provisions of the Act that impact employee stock ownership plans ("ESOPs"). Although certain components of the Act will require ESOP plan amendments and modifications in plan operations, none of the provisions represents a cutback in the important tax incentives that exist for ESOPs. This Client Advisory summarizes the ESOP-related components of the Act.

Permanency of EGTRRA Provisions

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") included several changes applicable to ESOPs that were subject to a "sunset" provision under which they would expire at the end of 2010. These included the prohibited allocation provisions of Internal Revenue Code ("Code") Section 409(p) applicable to S corporation ESOPs and the deduction for ESOP dividends reinvested in employer stock in accordance with Code Section 404(k).

The Act provides that both the Code Section 409(p) rules and the Code Section 404(k) deduction for reinvested dividends will remain in the Code on a "permanent" basis – that is, without a 2010 sunset. This is extremely important for S corporation ESOPs, as the Act preserves the anti-abuse provisions of Code Section 409(p) to deal with objections raised by the Treasury Department, members of Congress and their staff before Code Section 409(p) was enacted. The dividend reinvestment provisions will continue to benefit primarily public companies (but also privately held companies) that sponsor stand-alone ESOPs and ESOPs integrated with 401(k) plans.

Diversification Requirements

Under the Act, defined contribution plans that hold publicly traded employer stock are required to provide new diversification rights for amounts invested in employer stock. These plans are required to permit participants and certain beneficiaries to direct that the portion of their accounts invested in employer stock be reinvested in other investment options. The time when the diversification requirements apply depends on the type of contributions (i.e., elective deferrals, employee after-tax contributions, and employer matching contributions) invested in employer stock.

ESOPs that hold employer stock that is not publicly traded generally are not subject to the new diversification requirements. If an ESOP sponsor or a member of the ESOP sponsor's controlled group has issued a class of stock that is publicly traded, that ESOP would be subject to the new requirements even if it does not hold publicly traded stock, unless it satisfies the exemption under the Act for ESOPs that hold publicly traded stock or are under common control with an issuer of publicly traded stock. To be exempt from the new diversification requirements, such an ESOP must be a stand-alone plan (meaning that is not combined with any other defined contribution or defined benefit plan) and cannot hold contributions, and earnings thereon, that are subject to the nondiscrimination tests applicable to employee elective deferrals, employee after-tax contributions and employer matching contributions.

Under the new requirements, plans must permit amounts that are attributable to elective deferrals and employee after-tax contributions that are held in employer stock to be invested in alternative investments by participants or beneficiaries who are permitted to exercise participant rights. With respect to non-elective employer contributions and employer matching contributions that are held in employer stock, each participant who has completed at least three years of vesting service, a beneficiary of such a participant, and a beneficiary of a deceased participant must be permitted to direct the investment of such amounts in other investment options.

A transition rule applies to amounts attributable to employer contributions that are invested in employer stock acquired before the plan year beginning in 2007. For the first three years the new requirements apply to plans holding such contributions, the portions of such amounts subject to diversification are as follows:

Plan Year	**Percentage**
2007	33%
2008	66%
2009	100%

> **EXAMPLE:** If Participant A, who has three years of vesting service, has 150 shares of employer stock contributed as employer matching contributions allocated to his account as of December 31, 2006, 50 shares of employer stock are subject to diversification during the first year, 99 shares may be diversified in the second year, and 150 shares may be diversified in the third year.

The transition rule does not apply to the employer contribution accounts of participants who are age 55 and have completed at least three years of service before the first plan year beginning after December 31, 2005. Such participants must be given the opportunity to diversify all or a portion of their employer contribution accounts held in employer stock during the first plan year beginning after December 31, 2006.

The new diversification requirements require a plan to provide a participant or beneficiary a choice of at least three investment options other than employer stock. These must be diversified and must have materially different risk and return features. Diversification opportunities must be provided at least quarterly and at least as frequently as other investment changes are permitted under the plan. A plan may not provide less favorable treatment, such as a lower rate of employer contributions, to a participant who diversifies his or her employer stock account.

The diversification provisions are effective for plan years beginning after December 31, 2006. Special effective dates apply for plans maintained pursuant to collective bargaining agreements and plans with employer matching and non-elective contributions invested in employer preferred stock as of September 17, 2003.

Vesting

The Act requires more rapid vesting for all employer contributions to defined contribution plans after December 31, 2006. Such contributions generally must be fully vested upon a participant's completion of three years of service or pursuant to a graded schedule under which at least 20 percent of the contributions vest for each year of service beginning with the participant's second year of service, resulting in 100 percent vesting after six years of service.

An ESOP with an outstanding employer securities acquisition loan that was in effect on September 26, 2005 may defer compliance with the new vesting provisions until the earlier of the date the loan is fully repaid or the date the loan was, as of September 26, 2005, scheduled to be fully repaid.

Action Items

EGTRRA Provisions – Examine ESOP documents for references to the 2010 sunset provision and revise them to reflect the "permanency" of Code Sections 409(p) and 404(k), as applicable.

Diversification – Determine whether the ESOP holds publicly traded employer securities or whether any member of the plan sponsor's controlled group has issued publicly traded stock. If either of these situations applies, amend the plan and update the administrative procedures to incorporate the diversification requirements for plan years beginning after December 31, 2006.

If the ESOP does not hold publicly traded securities and no member of the plan sponsor's controlled group has issued publicly traded stock, determine whether the plan is part of another qualified plan or contains elective deferrals, after-tax employee contributions or matching contributions. If any of these factors applies, amend the plan and update the administrative procedures to incorporate the diversification requirements for plan years beginning after December 31, 2006.

Vesting – Determine whether the ESOP has an outstanding acquisition loan that was in place on September 26, 2005. If it does, compliance with the new vesting rules may be delayed. If the ESOP is not leveraged or if it has an outstanding acquisition loan that was established after September 26, 2005, examine the plan's current vesting schedule and amend it as necessary to comply with the new timing requirements.

We Can Help

Please contact one of the following Katten Muchin Rosenman LLP attorneys or your relationship partner if you would like to discuss the impact of the Act on ESOPs:

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