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Client Advisory

Pension Protection Act Affects Qualified Defined Contribution and Defined Benefit Plans

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The Pension Protection Act of 2006 (the "Act") was signed into law by President Bush on August 17, 2006. The Act contains many important provisions affecting qualified defined contribution and defined benefit plans. This Advisory focuses on some of these changes.

EGTRRA Permanence

The Act makes permanent certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). This Client Advisory briefly describes some of the more significant provisions of EGTRRA relating to pension plans that have been made permanent by the Act.

The Act makes permanent the following changes made by EGTRRA:

- increased contribution dollar amounts for elective deferral contributions to plans under Code Sections 401(k) and 403(b);
- permitting catch-up contributions by participants age 50 and older;
- increased annual benefit and contribution limits under Section 415 of Internal Revenue Code of 1986, as amended (the "Code");
- increased compensation limit under Section 401(a)(17) of the Code;
- increased deduction limit under Section 404 of the Code for contributions paid to defined contribution plans;
- exclusion of elective deferral contributions for purposes of determining the Section 404 deduction limit;
- application of a 3-year cliff or 6-year graded vesting schedule to matching contributions under a tax-qualified retirement plan;
- reduction of suspension period for elective deferral contributions in the event of hardship withdrawals;
- elimination of the multiple-use test under Section 401(m) of the Code;
- permitting exclusion of amounts attributable to rollover contributions for purposes of determining whether the mandatory cash-out threshold is exceeded;
- permitting rollover of after-tax amounts;
- expansion of the types of plans to which rollovers may be made; and
- modifications to the top-heavy rules.

Plan sponsors should perform a review of their tax-qualified plans to determine if an amendment is necessary to delete any sunset provisions applicable to EGTRRA changes.

Defined Contribution Plans

The following additional provisions of the Act affect defined contribution plans:

- Requirement that employee deferrals invested in publicly traded employer stock be immediately eligible for diversification, and that employer contributions invested in publicly traded employer stock be eligible for diversification after a plan participant has 3 years of service.
- Required distribution of a notice to diversification-eligible participants describing their right to divest employer stock held in their plan accounts no later than 30 days before the diversification rights become effective. (The Department of Labor will issue a model notice.)
- Acceleration of the vesting schedule for profit-sharing contributions (also called "nonelective contributions"). These contributions must vest fully after no more than 3 years of service, or at a rate of at least 20 percent after 2 years of service, increasing 20 percent for each additional year of service until participants are fully vested after 6 years of service.
- Introduction of a new automatic enrollment safe harbor and other automatic enrollment provisions. Plans that comply with the automatic enrollment safe harbor will be treated as automatically passing the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests and will be exempted from the top-heavy plan rules. The Act specifically preempts state laws that would prohibit automatic enrollment and permits a participant to elect to withdraw without penalty contributions made through automatic enrollment within 90 days after the first contribution.
- Requirement that plan sponsors issue participant benefit statements at least quarterly under plans that permit participants to choose their investments, at least once per calendar year under plans that do not involve participant-directed investments and upon request to plan beneficiaries who are not covered by either of the foregoing requirements. The Act describes the information that must be included in the statements.
- Enhancement of the portability of retirement benefits by expanding rollover options to permit direct rollovers to Roth IRAs from qualified plans, tax sheltered annuities, and governmental 457 plans. The Act also permits the rollover of after-tax contributions to annuity contracts and enables non-spouse beneficiaries to roll over distributions into an IRA. In addition, the Act allows qualified plans to accept rollovers from Roth IRAs.
- Expansion of hardship withdrawal provisions to enable plan beneficiaries to take distributions due to hardship.
- Enabling of military reservists who are called or ordered to active military duty after September 11, 2001 and before December 31, 2007 for a term of more than 179 days to take distributions during such duty from employer-sponsored retirement plans without being subject to the 10 percent early withdrawal penalty. Reservists who take such distributions may re-contribute withdrawn amounts during the two-year period after their duty ends.
- Clarification that the maximum deduction a plan sponsor may take for contributions to one or more defined contribution plans applies only for contributions in excess of 6 percent of compensation.
- Requirement that summary plan descriptions be available on the Department of Labor website and on the employer's Intranet, if applicable.
- Allowing the accounts of missing participants under terminating plans to be transferred to the PBGC.
- Increased maximum ERISA bond for plans holding employer securities to the lesser of 10 percent of plan assets or $1,000,000.

Hybrid Plans – Cash Balance and Pension Equity

The term "hybrid plan" typically refers to a defined benefit plan that is designed to replicate a characteristic feature of defined contribution plans – individual participant accounts – while maintaining a characteristic feature of defined benefit plans – the maintenance of investment risk with the employer. Cash balance and pension equity plans are two common forms of hybrid plans. The Act resolves prospectively three major issues currently being contested in the courts with respect to the viability of certain hybrid plan designs, namely:

- ***Age Discrimination***

  The Act provides a safe harbor for hybrid plans against claims of age discrimination based on the manner with which benefits typically accrue under such plans. However, in order to enjoy the Act's safe harbor, hybrid plans must meet certain vesting and interest crediting standards set forth in the Act.

- ***Whipsaw Elimination***

  The Act provides that a hybrid plan may distribute a lump sum payment equal to the electing participant's hypothetical account balance under the plan. Prior court cases had held that under certain circumstances hybrid plans were required to pay an amount that was greater than a participant's hypothetical account balance.

- ***Elimination of Wearaway***

  The Code and ERISA contain an anti-cutback rule that generally prohibits the elimination of benefits that have already accrued under a qualified retirement plan. In order to avoid violating the anti-cutback rule when converting a traditional pension plan to a hybrid plan, some plan sponsors chose to freeze the benefit accruals under the traditional plan. If the frozen benefit was greater than that provided under the hybrid benefit formula, the participant effectively would not see any change in his/her benefit until such time as his/her benefit determined under the hybrid formula exceeded his/her frozen benefit determined under the traditional formula – i.e., until the difference between the old benefit and new benefit was "worn away." The Act prohibits the wearaway of previously accrued benefits following the conversion of a traditional defined benefit plan to a hybrid plan.

Funding Requirements for Single Employer Plans

- ***Determining Funded Status***

  The funded status of a defined benefit pension plan is generally determined by comparing the value of the plan's assets to the present value of the plan's accrued benefit liability. Various assumptions are used by the sponsoring employer and the plan's actuary in determining the plan's funding target for a given plan year. The funding target is equal to the present value of benefits accrued as of the valuation date. The Act provides that certain interest rate assumptions based on corporate bond yields must be used in determining a plan's funding target and directs the Treasury Department to establish a new mortality table for valuing such liability. The Act also provides that an actuarial assumption regarding the probability that participants will elect optional forms of benefit that are more valuable than the plan's normal form of benefit be used in calculating the plan's benefit obligations.

- ***Annual Funding Obligation***

  The minimum required contribution by a sponsoring employer for a given plan year is generally equal to the sum of the plan's target normal cost and shortfall amortization installment less any carryover of the plan's funding standard account or pre-funding balance. Generally, the target normal cost for a plan year is determined by calculating the present value of all benefits that are expected to accrue during that plan year. The shortfall amortization installment is based in part on the ratio of plan assets to the funding target.

  Present law allows employers to avoid having to make a shortfall amortization installment with respect to a plan year in which the plan is 90% funded. The Act eliminates 90% funding and requires that, effective 2008, subject to the transition rules discussed below, a defined benefit pension plan must be 100% funded. If the plan is not 100% funded, then a funding shortfall will exist that generally will be equal to the difference between the plan's assets and funding target for the plan year. The funding shortfall for a given plan year will be amortized in level annual installments for a period of seven years – the first installment due for the plan year in which the shortfall was first incurred.

  The Act provides transition relief for 2008, 2009, and 2010 to soften the initial impact of the new funding requirements. The transition rules provide that in order to avoid a funding shortfall for those years, the plan need only be 92%, 94%, and 96% funded, respectively. However, if the plan incurs a funding shortfall in 2008 or 2009 using the transitional percentages, then the plan may no longer rely on the transition relief provided under the Act. Moreover, the transition relief is not available to plans adopted after 2007 as well as plans that are subject to deficit reduction contributions in 2007.

- ***Funding Waiver***

  The Act allows plan sponsors to seek a funding waiver from the IRS based on financial hardship. In such case, the sponsor may seek to avoid making all or a portion of its required contribution for a given plan year. If a waiver is granted, then the required contribution for that year is adjusted to reflect the waiver and the amount waived is amortized in level annual installments over a five year period.

"At-Risk" Funding Requirements for Single Employer Plans

The Act provides special funding and reporting rules with respect to single employer plans that are "at-risk" from a funding perspective. Under the Act, a plan that is determined to be "at-risk" will be required to make increased minimum required contributions as well as certain disclosures to the PBGC. A plan is considered "at-risk" if: (1) the plan is less than 80% funded, determined without regard to at-risk liabilities and (2) the plan is less than 70% funded, determined with regard to at-risk liabilities. For purposes of the special funding rules, "at-risk" liabilities are determined by assuming that all participants who are eligible to retire within ten years do in fact retire at their earliest date of eligibility and elect the form of benefit with the greatest present value. The Act provides transition relief that reduces the 80% threshold to 65% for 2008, 70% for 2009, and 75% for 2010. Only plans with at least 500 participants, based on all defined benefit plans maintained by the same employer and/or members of the employer's controlled group, can be considered at risk.

Benefit Limitations Fixed to Funded Status of Plan

The Act provides various restrictions on paying certain benefits as well as amending certain benefits depending on a plan's funded status.

- ***Less Than 80% Funded*** – The Act generally prohibits a sponsoring employer from adopting certain amendments that increase plan benefits if the plan is less than 80% funded or would be less than 80% funded taking into account the amendment. Such amendment may be allowed if the employer makes a contribution in addition to its minimum required contribution to fund the increase in the funding shortfall caused by the amendment or increases the plan's funded status to 80% or above. The act also limits the payment of lump sums and other forms of accelerated benefits under a plan that is less than 80% funded.
- ***Less Than 60% Funded*** – In addition to prohibiting certain amendments to a plan to increase benefits, the Act provides that a plan that is less than 60% funded may not make lump sum or other accelerated payments. Moreover, the Act provides for the cessation of benefit accruals under a plan that is less than 60% funded as well as the cessation of certain contingent benefit payments under the plan. However, the Act does allow the payment of contingent benefit payments to the extent the employer makes a contribution in addition to its minimum required contribution that funds the benefits or increases the plan's funded status to 60% or above.
- ***Restrictions on Nonqualified Deferred Compensation*** – The Act restricts the ability of an employer to fund a trust or other arrangement established for the purpose of providing nonqualified deferred compensation to certain current or former executives during any of the following periods: (1) the period within which any qualified defined benefit pension plan sponsored by the employer or a member of its controlled group is considered "at-risk" (See "at-risk" discussion above); (2) the period within which the sponsoring employer or a controlled group member is in bankruptcy; or (3) the twelve month period beginning six months prior to the involuntary or distress termination of any qualified defined benefit pension plan sponsored by the employer or a member of its controlled group. If the employer sets aside assets in violation of the Act's restrictions, then the executives will be subject to immediate taxation on such assets and may face an additional 20% tax, as well as an interest assessment. Furthermore, the employer may not deduct any amount it sets aside on behalf of the executive to "gross-up" the executive's compensation for purposes of covering the aforementioned penalty taxes. Finally, the amount of any "gross-up" payment will be taken into account for purposes of determining the executive's overall tax liability with respect to amounts set aside on his/her behalf in violation of the Act. This provision of the Act is effective for transfers or other asset reservations after August 17, 2006.

Defined Benefit Plan Reporting and Disclosure Provisions

The Act changes the ERISA reporting and disclosure requirements for defined benefit pension plans by increasing the amount of information that plans are required to provide to participants and beneficiaries and to the IRS, the DOL and the PBGC. Specifically, for single-employer defined benefit plans, the Act adds the following new requirements:

- an annual funding notice must be provided to the PBGC, each plan participant and beneficiary and any labor organization that represents participants and beneficiaries (i) identifying the plan and certain information about the plan and the plan sponsor; (ii) disclosing the plan's funding target attainment percentage for the plan year covered by the notice and the two prior plan years; (iii) stating the plan's total assets and the value of the plan assets and liabilities for the plan year covered by the notice and the two prior plan years; (iv) describing the plan's funding status, details about the plan participants, the plan's funding policy and investment allocations, and any amendment or other event that increases or reduces benefits or materially impacts plan liabilities or assets for the year; (v)

summarizing the plan benefits that are guaranteed by the PBGC and the rules governing termination of single-employer plans, including limits on benefit payments; (vi) explaining, if applicable, that each contributing sponsor (and each controlled group member) was required to file a Form 4010 with the PBGC for the plan year; and (vii) stating that a person may obtain a copy of the plan's annual report from the plan sponsor or administrator, from the DOL website or from the plan sponsor's intranet;

- the Form 5500 has been expanded to include an explanation of the actuarial assumptions and methods used to project future retirement benefits and, in certain cases must include the funded percentage of defined benefit plans as of the last day of the previous plan year;
- the Form 5500 must be filed in an electronic format that accommodates internet display and must be posted on the plan sponsor's intranet site (the DOL will also post Forms 5500 on its website);
- each member of a plan sponsor's controlled group must file a Form 4010 with the PBGC if the plan's funding target attainment percentage is less than 80% (eliminating the previous $50 million aggregate unfunded vested benefits filing threshold); and
- a plan administrator that has filed with the PBGC a notice of intent to terminate a plan must provide the same information provided to the PBGC to any affected party within 15 days after receipt of a written request for such information.

In addition to the new requirements listed above, the Act requires the following for multiemployer pension plans:

- an annual funding notice to the PBGC, each plan participant and beneficiary, each contributing employer and each labor organization representing plan participants and beneficiaries (i) including items (i), (iii), (iv) and (vii) listed above for single-employer plans; (ii) disclosing the plan's funded percentage for the plan year covered by the notice and the two prior plan years; (iii) indicating whether the plan was in critical or endangered status under ERISA and, if so, describing any applicable funding improvement or rehabilitation plan and stating how a person may obtain a copy of such plan and related data; and (iv) summarizing the plan benefits that are guaranteed by the PBGC and the rules governing reorganization or insolvency, including limits on benefit payments;
- delivery of an estimate of withdrawal liability to a contributing employer within 180 days after receiving a written request for such an estimate, and delivery of copies of actuarial reports, financial reports and funding extension requests within 30 days after receiving a written request from a contributing employer;
- the Form 5500 has been expanded to include several new data requirements, including the number of employers contributing to the plan, a list of employers that contributed more than 5% of the plan contributions for the year, the number of participants for whom no employer contributions were made for each of the last three years and whether the plan was in critical or endangered status; and
- delivery of a summary plan report (containing information specified in the Act) to each contributing employer within 30 days after the filing of the Form 5500.

The annual funding notices described above generally must be provided within 120 days after the end of the plan year to which the notices relate, except that small plans (those with fewer than 100 participants) may provide these notices when filing their Forms 5500 (which generally are due at the end of the seventh month after the end of the plan year). The DOL is to issue a model funding notice within one year after the Act enactment date.

The new reporting and disclosure requirements generally are effective for plan years beginning after December 31, 2007. The Act also repeals ERISA Section 4011, which generally requires that defined benefit plans subject to variable rate premiums for a plan year must provide a notice for such plan year to participants and beneficiaries describing the plan's funding status and the limits of the PBGC's guaranty of benefits should the plan terminate while underfunded. This repeal applies to plan years beginning after December 31, 2006.

Qualified Optional Survivor Annuity

Section 1004 of the Act amends Section 417(a)(1) of the Code and Section 205(c) of ERISA. The Code and ERISA, as amended, require a tax-qualified retirement plan that is subject to the qualified joint and survivor annuity ("QJSA") and/or the qualified pre-retirement survivor annuity ("QPSA") provisions of the Code and ERISA to include a "qualified optional survivor annuity." Such plan must permit a participant who elects to waive the plan's QJSA or QPSA the ability to elect a joint and survivor annuity with a periodic survivor annuity for the life of the spouse that is equal to the "applicable percentage" of the periodic amount payable during the participant's lifetime.

In general, the "applicable percentage" is 75% for a plan that provides for a QJSA with a survivor annuity that is less than 75% of the amount that was or would have been payable during the participant's life. The "applicable percentage" is 50% for a plan that provides for a QJSA with a survivor annuity that is equal to or greater than 75% of the amount that was or would have been payable during the participant's life.

In connection with the new requirements described above, the Act has also amended the provisions of Code Section 417 and ERISA Section 205 describing the joint and survivor annuity explanation. The Code and ERISA, as amended, require that a joint and survivor annuity explanation provided under a plan include a description of the terms and conditions of the plan's qualified optional survivor annuity.

The requirement to offer a qualified optional survivor annuity is effective for plan years beginning after December 31, 2007.

Notice and Consent Regarding Benefit Distributions

Section 1102 of the Act amends Code Section 417 and ERISA Section 205 to extend the applicable election period for the waiver of the QJSA from 90 days to 180 days prior to the annuity starting date. The Act also extends the time period for providing the special tax notice required under Section 402(f) of the Code, and for consenting under Code Section 411(a)(11) and ERISA Section 203(e) to the distribution of an immediately distributable benefit in excess of $5,000, to 180 days before the date of distribution.

The amendments under Section 1102 are effective after December 31, 2006.

These changes to the Code and ERISA will require sponsors of qualified retirement plans and certain non-qualified plans of deferred compensation to perform a review of their plans to determine whether any plan amendments are needed to comply with the new provisions.

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 your qualified defined contribution and defined benefit plans.

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