

Legal Alert: Pension Protection Act of 2006 – Defined Benefit Plans

September 7, 2006

Among the most sweeping changes made in the [Pension Protection Act of 2006](#) are the revisions to the rules applying to defined benefit pension plans. These changes, which are summarized here, include:

- Replacement of the minimum funding standards of ERISA and the Internal Revenue Code for single-employer defined benefit plans;
- Restrictions on benefit increases and other provisions tied to a plan's funded status;
- Increases in the maximum deductible contributions to defined benefit plans and to a combination of a defined contribution plan and a defined benefit plan;
- Changes in premiums payable to the Pension Benefit Guaranty Corporation;
- A number of new reporting and disclosure requirements; and
- Additional qualified joint and survivor annuity requirements.

The Act also makes changes to Code section 409A to impose additional restrictions on executive nonqualified deferred compensation of an employer that maintains an underfunded defined benefit plan and certain other defined benefit plan sponsors. Further explanation of the Act is provided in the [technical explanation](#) published by the staff of the Joint Committee on Taxation.

Funding of Single-Employer Defined Benefit Plans

Under ERISA and the Code, contribution requirements for employers maintaining single-employer defined benefit plans have been based on minimum funding standard accounts that are (1) charged with the normal cost for benefits accruing in the current year, supplemental costs for liabilities relating to benefits increased through amendments, and actuarial losses and (2) credited with contributions and credit balances from actuarial gains and contributions in excess of the minimum required contributions. The funding rules established when ERISA was enacted did not mandate the use of particular actuarial assumptions or methods, though subsequent changes in the rules imposed additional requirements, including requirements that the need for a "deficit reduction contribution" would be assessed based on standard interest rate and mortality assumptions used to determine a plan's "current liability," and an additional contribution would be required if the "funded current liability percentage" was less than 90%.

Rules for 2006 and 2007. The minimum funding standards for 2006 and 2007 for single-employer defined benefit plans generally remain unchanged from the prior rules, except for extension of the temporary interest rate “fix” adopted in 2004. Specifically, under current law, the interest rate for determining a plan’s current liability is based on a weighted average of the yields on 30-year Treasury securities within the four years ending before the beginning of the plan. In 2004, with new 30-year T-bills no longer being issued and a significant decline in the average yields on outstanding T-bills, Congress provided that the average yields on long-term, investment-grade corporate bonds be substituted for the T-bill rate on a temporary basis for 2004 and 2005 while Congress and Treasury studied more permanent changes. With the permanent changes under the Act not taking effect until 2008, the use of average yields on long-term, investment-grade corporate bonds over a four-year period in place of the yields on 30-year T-bills over the same period has been extended through the 2007 plan year. [IRS Notice 2006-75](#) sets forth the rates for December 2005 through July 2006.

Funding Rules for Plan Years After 2007. The current funding rules for single-employer defined benefit plans have been replaced for plan years that begin after December 31, 2007. The effective date is delayed for collectively bargained plans and certain other plans that have special grandfather rules. The new rules for single-employer defined benefit plans are set forth in ERISA section 302 and Code section 430.

The new funding rules provide less flexibility than the current rules in a number of ways. For example, all plans must use the first day of the plan year as the valuation date to measure plan liabilities and assets under the new rules; the only exception is for a small plan covering 100 or fewer participants after all plans maintained by an employer or a controlled group of employers are aggregated. More significantly, the new rules mandate the use of specified interest rates and an IRS-prescribed mortality table, require amortization of all “shortfalls” over a seven-year period (rather than periods from 5 to 30 years under the current rules) and permit “smoothing” or averaging of asset values over a maximum of two years, compared to four years under current rules. Overall, the new rules are intended to tighten the funding requirements, though we understand that the required contributions for some underfunded plans that have been subject to the deficit reduction contribution regime may be less under the new rules.

Several terms are useful in understanding the new rules:

- “Target normal cost” means the present value of all benefits expected to accrue (or be earned) under the plan for the year being evaluated, *i.e.*, the current plan year. IRC § 430(b). This cost explicitly includes any increase in the value of a benefit based on past service attributable to compensation in the current year. It is not clear whether the cost also includes an increase in value by reason of a participant’s entitlement to an early retirement subsidy or similar benefit; presumably it does not include any increase in value attributable to an amendment to increase prior benefits, *e.g.*, through an early

retirement enhancement, a change in formula, or a grant of past service, since none of those benefits would be expected to accrue during the current year as of the first day of the year.

- “Funding target” means the present value of all benefits accrued (or earned) as of the beginning of the current plan year, including early retirement benefits, but excluding benefits that accrue during the year. IRC § 430(d)(1). Thus, the value of benefits provided under amendments adopted during the previous year, at least to the extent accrued during that year, will be included in the funding target for the current year.
- “Funding shortfall” means any amount by which the funding target for the year exceeds the value of plan assets reduced by any credit balance(s). IRC § 430(c)(4).

Interest Rates. Uniform “segment” interest rates must be used to determine the present value of benefits for computing a plan’s target normal cost and funding target. The segments are for benefits expected to be payable (1) within the next five years, including the current plan year, (2) within 6-20 years, and (3) after 20 years. IRC § 430(h)(2)(B)-(D). The IRS is to prescribe tables indicating the average yield on corporate bonds maturing in each of the segments for the 24-month period ending with the preceding month. Bonds in the top three quality levels available are to be taken into account. The information the IRS publishes regarding these yields is to be sufficiently detailed to allow actuaries to make projections of cost for the future.

Employers may elect to use the rates published for the month including the valuation date or any of the four preceding months. In addition, employers may elect to use interest rates without 24-month averaging, but once made, this election can be revoked only with IRS approval.

The new interest rates generally apply for plans years beginning after December 31, 2007. A transition rule permits employers to use an aggregate interest rate in 2008 and 2009, based on 1/3 of the rate under the applicable segment and 2/3 of the rate under the current method for 2008, and 2/3 of the applicable segment and 1/3 of the rate under the current method for 2009.

Mortality Table. The Act generally provides for the use of IRS-prescribed mortality tables. IRC § 430(b)(3). It directs the IRS (1) to continue to update mortality tables for determining present value for funding purposes and certain other purposes at least every 10 years, and (2) to develop two additional tables – for individuals becoming disabled before 1995 and after 1994. Employers may request that the IRS approve plan-specific mortality tables for plans that have a sufficient number of participants and credible experience. Unless the IRS determines otherwise, however, plan-specific tables can be used only if all of the plans maintained by the employer and any other member of the employer’s controlled group use plan-

specific tables, and each plan separately has credible experience. Presumably the IRS will prescribe procedures for employers to obtain approval of plan-specific mortality tables.

Other Actuarial Assumptions. The rules mandate that in calculating present value or any other computation under new section 430, both the probability that a participant will elect a lump sum or another optional form and any difference in present value as a result of differences between the plan's actuarial assumptions and the assumptions required under section 430, must be taken into account. IRC § 430(h)(4).

Any other actuarial assumptions or methods needed to calculate a plan's funding target and target normal cost are subject to the same requirements as under current law that they be reasonable and provide the actuary's best estimate of anticipated experience under the plan. Similarly, as under the present rules relating to assumptions for computing current liability, actuarial assumptions used by certain plans to determine the funding target cannot be changed without approval of the IRS.

Asset Valuation. Plan assets are generally to be valued at fair market value as of the valuation date under the new rules, except that IRS and Treasury may issue regulations allowing the use of averaging. IRC § 430(g)(3). The regulations may provide for averaging over a period of no more than two full years preceding the valuation date and may result in a value that is no less than 90% and no more than 110% of the fair market value on the valuation date. Contributions made after the valuation date for a prior plan year are to be treated as assets, but in years after 2008, only the present value of the receivable is taken into account, and the present value is determined using a blend of the segment interest rates for the plan. Also, contributions made during the current plan year for that year, but before the valuation date, must be backed out of the plan assets. This rule should apply only to small plans since all other plans must use the first day of the plan year as the valuation date.

Minimum Required Contributions. If the value of plan assets (*reduced by any credit balances* - see below) is less than the funding target, the minimum contribution due is the sum of (1) the target normal cost, (2) the total of installments to amortize any shortfall, and (3) any waiver amortization charge for a plan that has obtained a funding waiver. If the value of plan assets (less any credit balances) equals or exceeds the funding target, the minimum contribution due is (1) the target normal cost minus (2) the amount by which the assets exceed the funding target. IRC § 430(a).

Contrary to the implication of its name, a shortfall amortization installment can be positive or negative. Several steps are needed to compute these installments. Each year a separate "shortfall base" is determined by subtracting from the funding shortfall the present value (using the segment rates) of the previously determined amounts – *i.e.*, the total shortfall amortization installments and waiver amortization installments determined in prior years to be

due for the current year and all following years. IRC § 430(c). This base is amortized over seven years, *i.e.*, the current plan year and the next six years, to determine the installments due in each of those seven years. As indicated above, the minimum required contribution for a plan year includes the sum of all installments calculated in this manner that are due for that year. If the value of plan assets (less any credit balances) for a plan that has developed a funding shortfall reaches or exceeds the funding target, all shortfall amortization bases are eliminated. If actuarial gains result in a negative shortfall, these negative installments offset other positive shortfall installments but cannot be used to reduce the target normal cost or any funding waiver charge.

In limited instances, a transition rule *may* apply for establishing shortfall amortization bases for 2008 through 2010. It is available only for plans in existence in 2007 and for which no deficit reduction contribution was required for 2007. Under the rule, a plan is not required to establish a shortfall amortization base for a transition year if the plan's assets (less any prefunding balance) are at least equal to a specified percentage of the plan's funding target. The percentage is 92% for 2008, 94% for 2009 and 96% for 2010. A further requirement is that the transition rule can be used in 2009 only if the plan was eligible for it in 2008, and in 2010 only if the plan was eligible for it in both 2008 and 2009.

The rules allowing the IRS to waive the funding requirements if an employer is experiencing temporary business hardship are largely unchanged by the Act. IRC § 412(c). As under current law, the amount waived is amortized over five years. As for shortfall amortization bases, waiver bases can be eliminated if the value of plan assets (reduced by credit balances) equals or exceeds the funding target.

Use of Credit Balances. The new rules provide for two types of credit balances: (1) a new "prefunding balance" and (2) a "funding standard carryover balance" that preserves prior law credit balances. These two types of credit balances may be credited against a minimum required contribution at the employer's election. IRC § 430(f). However, as indicated above, the balances generally reduce plan assets for purposes of determining a plan's funding shortfall and minimum required contributions, and a prefunding balance generally reduces assets for determining whether the transition rule applies when computing shortfall amortization bases. As discussed below, the credit balances may even subject an otherwise well-funded plan to "at-risk status" or a variable rate PBGC premium. Since the new law also permits an employer to waive the use of credit balances, subject to certain conditions, these are particularly important rules.

- A funding standard carryover balance is the positive balance in the plan's minimum funding standard account under Code section 412(b) as of the end of the plan's 2007 plan year.

- If the employer's contributions for a year after the plan's 2007 plan year exceed the minimum required contribution for the year, the excess is credited to the prefunding balance. The total prefunding balance is the sum of such amounts plus interest and minus (1) any amount applied to reduce the minimum required contribution, (2) any prefunding amount waived as described below, and (3) any contributions required to avoid certain benefit limitations, as described below.
- A plan may not use its credit balances for any year if, for the preceding year, the value of assets (less any prefunding balance) is less than 80% of the plan's funding target. Also, a plan generally may not use a prefunding balance if it has a funding standard carryover balance.

As noted above, the credit balances generally reduce plan assets, but there are limited exceptions:

- Prefunding balances reduce plan assets when determining a shortfall amortization base only if the employer has elected to apply a portion of the prefunding balance to reduce the minimum required contribution for the year;
- Neither type of balance reduces plan assets if the employer has a written agreement with PBGC not to apply the balances to reduce minimum required contributions for the year; and
- The plan assets are not reduced by the credit balance(s) if the employer elects to waive the credit balances permanently, except that a prefunding balance may not be waived until any funding standard carryover balance has either been applied or waived.

At-Risk Plans. At-risk plans are subject to additional funding requirements. IRC § 430(i). A plan is at-risk if two conditions apply:

- The plan assets (generally reduced by credit balances) are less than 80% of the plan's funding target, computed using the generally applicable actuarial assumptions as described above; and
- The plan assets (generally reduced by credit balances) are less than 70% of the plan's funding target, computed using at-risk actuarial assumptions.

Under a transition rule, the trigger for the first condition is phased in at 65% for 2008, 70% for 2009 and 75% for 2010. Plans with fewer than 500 participants, aggregating all plans of the employer and the employer's controlled group, are not subject to the at-risk rules.

If the plan is at-risk, the at-risk actuarial assumptions are used to calculate the plan's funding target for purposes of determining the amount of the shortfall, which increases the shortfall and accelerates funding. These actuarial assumptions are as follows:

- Participants eligible to retire in the next 11 years (but not assumed to retire as of the valuation date under the plan's general assumptions) are assumed to retire at the earliest retirement date after the end of the current plan year;
- Those participants are assumed to elect the benefit with the highest present value available as of that earliest retirement date; and
- If the plan has been at-risk for at least two of the last four years, a loading factor of \$700/participant plus 4% of the funding target under the generally applicable assumptions is added.

The at-risk actuarial assumptions, other than the \$700/participant loading factor but including the 4% factor if applicable, are also used to compute the plan's target normal cost for the year. However, the funding target and the target normal cost for an at-risk plan are never less than those amounts computed using the generally applicable assumptions.

Under a permanent transition rule, it is intended that if a plan has been at-risk for fewer than five consecutive plan years, including only 2008 and later years, only a portion of the funding target and the target normal cost adjusted by the at-risk assumptions are taken into account to determine the funded status of the plan and the contributions due. The portion is based on the consecutive number of years the plan is in at-risk status, including the current plan year and beginning with the 2008 plan year:

<u>Consecutive Years</u>	<u>Transition Percentage</u>
1	20
2	40
3	60
4	80

If the transition rule applies, the applicable transition percentage is applied to (1) the excess of the at-risk funding target, minus (2) the generally applicable funding target. The result is added to the generally applicable funding target to determine the funding target under the transition rule. The same calculation applies for the target normal cost.

Restrictions on Benefit Increases, Lump Sums and Other Benefits

The new funding rules restrict the ability to provide certain benefits under a single-employer defined benefit plan if the plan is underfunded by more than a specified percentage. The restrictions include prohibitions on (1) providing shutdown or similar benefits, (2) amending the plan to increase benefits, (3) paying lump sums, and (4) continuing the accrual of benefits. IRC § 436. Certain of the restrictions are triggered when the plan is less than 80% funded, while the other restrictions are not triggered unless the plan is less than 60% funded.

For purposes of these rules, the funded status of the plan is generally based on the ratio of plan assets (reduced by credit balances) to the funding target for the year, as determined under the general rules for funding, not the at-risk rules. However, both the plan assets and the funding target are increased by amounts used to purchase annuities for non-highly compensated employees during the two prior plan years. Also, the assets are not reduced by the prefunding balances if the plan would be at least 100% funded on that basis. Under a transition rule, the threshold funding level for this exception is 92% for 2008, 94% for 2009 and 96% for 2010, though the transition rule only applies in 2009 if the conditions for using it were met in 2008, and it does not apply in 2010 unless those conditions were satisfied in both 2008 and 2009.

Amendments to Increase Benefits. An amendment to increase benefits cannot take effect if the plan is less than 80% funded or it would be less than 80% funded taking into account the amendment. The restriction applies to an amendment to (1) increase benefits, (2) adopt new benefits, or (3) change the rate of benefit accrual or vesting in a manner that would increase plan liabilities; the restriction does not apply to a cost of living adjustment or certain other amendments. The restriction ceases to apply if, in addition to the minimum required contribution, the employer contributes:

- The increase in the funding target attributable to the amendment – if the plan was already less than 80% funded before adoption of the amendment; or
- The amount needed to increase funding to 80% – if the amendment reduced the funded status to less than 80%.

Rather than make the contribution, the employer may provide security in the form of a surety bond, cash or short-term T-bills held by a bank or similar escrow agent or in another form approved by the IRS and acceptable to the plan fiduciaries. Code section 436(f) provides requirements for enforcing the security and releasing the security if the funded status of the plan improves sufficiently.

Prefunding and funding standard carryover balances may not be used to offset the additional contributions. If the plan is collectively bargained, however, those credit balances are

automatically applied to increase the plan's funding so that the limits will not apply, unless the credit balances are insufficient to raise the plan's funding to the necessary level. Once the restriction applies, the plan is treated as having the same level of underfunding for the next year until the actuary certifies the actual funded status, which has the effect of continuing the restriction in place at least until the valuation is prepared. The rules also include other presumptions that are operable based on when the actuarial valuation is completed for a plan that was close to the 80% funded level or that was previously subject to the restriction.

Any new plan is not subject to this restriction on amendments to increase benefits for its first five plan years.

Lump Sum/Accelerated Benefits. A plan that is less than 60% funded, or less than 100% funded if the employer is in bankruptcy, may not pay benefits in a lump sum or other "accelerated form" or purchase an annuity as an irrevocable commitment to provide benefits. The prohibited accelerated benefits include any benefit that exceeds the monthly amount under a single life annuity plus a social security supplement or as is otherwise specified by the IRS. In addition, if a plan is less than 80% funded but at least 60% funded, the maximum amount the plan may pay as an accelerated benefit or use to purchase an annuity is the lesser of (1) 50% of a lump sum benefit, or (2) the lump sum value of the PBGC guaranteed benefit, with payments to a participant, an alternate payee and a beneficiary receiving benefits on the participant's behalf being aggregated. The rules described above regarding the presumptions to be made with respect to a plan's funded status also apply for purposes of this benefit restriction. However, there is not an exception to this limitation on payment of accelerated benefits for new plans, and the rule requiring a release of credit balances (if that would allow the plan to avoid implementing the restriction) applies to all plans, not just collectively bargained plans. Finally, this restriction does not apply if benefit accruals are frozen on and after September 1, 2005. A plan that becomes subject to the restriction may resume making the prohibited benefit payments when the restriction ceases to apply, unless the plan provides otherwise.

Shutdown Benefits. A shutdown or other unpredictable contingent event benefit cannot be provided if a plan is less than 60% funded, or it would be less than 60% funded taking into account the occurrence of the event. The application of the restriction is determined in the year the event occurs, not the year the benefit is payable. The restriction does not apply or ceases to apply if, in addition to the minimum required contribution for the year, the employer contributes:

- The increase in the funding target attributable to the benefit – if the plan was already less than 60% funded; or
- The amount needed to increase funding to 60% – if the payment of the benefit would reduce the funded status to less than 60%.

The same rules described above with respect to restrictions on amendments to increase benefits – *i.e.*, the ability to provide security rather than make a contribution, the use of credit balances and certain presumptions concerning the plan’s funded status and inapplicability to new plans – also apply with respect to the shutdown benefit restriction. An unpredictable contingent event benefit is defined to include a shutdown or similar benefit or any other benefit payable solely by reason of an event other than attainment of age, performance of service, receipt of compensation, death or disability. Thus, this restriction may apply to certain cost-of-living adjustments.

Benefit Accruals. If a plan is less than 60% funded, benefit accruals cease unless the employer contributes an amount sufficient to increase funding to 60% in addition to the minimum required contribution for the year. The same rules regarding providing security (rather than making a contribution), use of credit balances, inapplicability to new plans, and presumptions regarding funding apply as described above for amendments to increase benefits. Unless the plan provides otherwise, a plan that becomes subject to the limit on continued benefit accrual may resume benefit accruals when the restriction no longer applies.

Notice Required. The plan administrator must provide notice to plan participants within 30 days after the plan becomes subject to the restriction on (1) unpredictable contingent events or (2) payment of lump sums or other accelerated benefits. ERISA § 101(j). In addition, the administrator is to provide notice to participants within 30 days of the valuation date, if the plan is less than 60% funded, or one of the presumptions applies so that the plan is deemed less than 60% funded, since that will result in the cessation of benefit accruals.

Amendments Needed. The Act amends Code section 401(a)(29) to incorporate these restrictions. To satisfy this qualification requirement and to ensure that prohibited accruals do not occur, plans will have to be amended to incorporate these restrictions, regardless of the funded status of the plan. Generally, plans must be amended to comply with the Act by the last day of the plan year beginning in 2009. These plan amendments may be given retroactive effect if the plan operates in compliance with the Act in the interim.

Effective Date. These restrictions generally apply to plan years beginning after December 31, 2007. For collectively bargained plans, however, the limits do not apply until the earlier of January 1, 2010, or the date the last bargaining agreement terminates (without regard to extension), if that is later than the general effective date.

Deduction Limits

The Act also revises the limits on maximum deductible contributions under the Code for single-employer defined benefit plans and the combined limits that apply when employees participate in both defined benefit and defined contribution plans.

Defined Benefit Limits. The new deduction limits for single-employer defined benefit plans are effective for years beginning after December 31, 2007, are based on the new funding rules and replace the current rules under Code section 404(a)(1)(A) for these plans. The deduction limit, which continues to be based on the employer's taxable year, is the greater of:

- The minimum required contributions for each plan year ending with or within the taxable year, or
- The amount required for the plan to be 100% funded plus a "cushion" of 50% of the present value of accrued benefits and certain projected amounts. IRC § 404(o).

Specifically, the second limit is the sum for each plan year ending with or within the taxable year of (1)(a) the funding target, (b) the target normal cost, plus (c) the cushion, minus (2) the value of plan assets for the year. The cushion is 50% of the funding target for the year plus either the expected increase in the funding target based on projected increases in final average pay or other increases in compensation, or for a plan that does not increase past service benefits based on future compensation, the average annual increases in benefits over the six prior years. The benefit projections must take into account the limits on benefits under Code section 415, though a plan subject to Title IV of ERISA may anticipate increases in the section 415 limits. A special rule applies for a plan with 100 or fewer participants. Also, as under current law for a plan subject to Title IV of ERISA, if the plan is being terminated, the employer may contribute and deduct the amount needed to make the plan sufficient for plan termination benefit liabilities.

The deduction limit for a defined benefit plan is also increased for 2006 and 2007 to 150% of the current liability under Code section 412(l) (or 140% for a multiemployer plan), rather than 100% of that liability.

Combined DB and DC Limits. The new deduction limits that apply for a combination of defined benefit and defined contribution plans also take effect in increments. In 2006 and 2007, contributions to a defined contribution plan are subject to the limit only to the extent the contributions exceed 6% of compensation, and a corresponding change is made to the excise tax rules for excess contributions. Also, multiemployer plans are not taken into account in applying the limits on combined plans under Code section 404(a)(7). These rules continue to apply in 2008 and later years. In addition, beginning in 2008, the combined plan limit does not apply to a single-employer defined benefit plan subject to Title IV of ERISA. Finally, for a defined benefit plan not subject to Title IV, the employer may contribute the plan's funding shortfall even if that exceeds the 25% of compensation limit.

Changes to PBGC Premiums and Guarantees

Premiums. The PBGC flat rate premium was increased from \$19/participant to \$30/participant for plan years beginning after December 31, 2005 under the Deficit Reduction Act of 2005. The Deficit Reduction Act also provided for indexing the flat rate premium and imposed a termination premium of \$1,250/participant for the year of termination and the next two subsequent years for a plan terminated by the PBGC or certain distress terminations. The Act makes the termination premium permanent and adopts changes in the rules for computing variable rate premiums, but does not affect the flat rate premium structure.

For 2006 and 2007, the interest rate used to value unfunded vested benefits to calculate variable rate premiums continues to be 85% of the rate used to determine current liability under the existing minimum funding standards. Beginning in 2008, the new segment rates are used to calculate the plan's funding target, which is determined in the same manner as for the new minimum funding rules, *e.g.*, using the at-risk assumptions if applicable. Also, as under current law, the portion of the funding target attributable to vested benefits is taken into account to compute the variable rate premium due. The rule that no variable rate premium is due if contributions for the preceding plan year equaled the full funding limit no longer applies.

Limit on Guaranteed Benefits. The Act imposes several new limits on benefits guaranteed by PBGC:

- The guarantee for a plant shutdown or other unpredictable contingent event benefit is phased-in over five years after the event. The definition of the term "unpredictable contingent event benefit" is the same as it is for applying the restrictions on such benefits for underfunded plans as described above. This rule is effective for events that occur after July 26, 2005.
- The guaranteed amount of benefits is frozen when a contributing employer enters bankruptcy or a similar proceeding. The employer must notify the plan administrator of the bankruptcy, and the administrator must notify plan participants. The Department of Labor is to prescribe rules for providing notice and may assess penalties of up to \$100/day/participant for any failure to provide notice. The rules are effective for bankruptcies initiated after September 16, 2006.
- The extended phase-in of guaranteed benefits for certain owners is revised to apply to owners with a 50% or more ownership in a business for terminations initiated by the PBGC or for which a notice of intent to terminate is provided after December 31, 2005.

Other PBGC Changes. The Act also changes or add rules with respect to (1) the allocation of a recovery from a contributing employer under a terminated plan for which the

PBGC is the trustee, (2) premiums for small plans, (3) payment of interest on premium refunds, (4) the transfer of assets to the PBGC for missing participants under a terminated plan not subject to Title IV of ERISA, and (5) the ability of the PBGC to force a plan termination under ERISA section 4042(a)(4) when a plan sponsor ceases to be a member of a controlled group if the plan was fully funded under current law and certain other conditions are met.

Reporting and Disclosure

The Act enhances the level of disclosure and reporting required for defined benefit pension plans in several ways.

Annual Funding Notice. The Act requires single-employer pension plans to provide participants and the PBGC with an annual funding notice similar to that required under current law for multiemployer plans. ERISA § 101(f). The Act also modifies the annual funding notice rules applicable to multiemployer plans.

The annual funding notice must include, among other things:

- The number of participants broken down by retirees, terminated vested participants, and active employees;
- A statement of the plan's funding policy and asset allocation by percentage of total assets;
- Amendments or other events in the current year having a material effect on plan liabilities;
- The plan's funded percentage for the current year and prior two years; and
- The plan's assets and liabilities determined as specified in the notice rules.

The notice must be provided within 120 days after the end of the plan year to which it relates, except that plans covering not more than 100 employees need not provide the notice until the Form 5500 filing is due. The current law requirement of a summary annual report for defined benefit plans is eliminated given that the annual funding notice contains such detailed information.

The PBGC is directed to issue a model annual funding notice within one year of the date of enactment. The annual funding notice rules are applicable for plan years beginning in 2008. The current law rule requiring single-employer plans subject to PBGC variable rate premiums to provide annual funding notices is repealed effective for plans years beginning in 2007.

Form 5500 Reporting. The Act requires certain additional information to be provided in defined benefit plan annual reports on Form 5500. First, with respect to single-employer plans, a plan that has been merged with another plan during the plan year must report the pre-merger funded status of the plans that were merged. Second, multiemployer plans must include additional information including, among other things, (1) the number of contributing employers, (2) employers contributing more than 5% of total contributions, (3) participants with no contributing employer, (4) information on amortization extensions, (5) additional information on the plan's funded status, and (6) the number of employers that withdrew during the plan year and the related withdrawal liability.

Certain basic plan information and actuarial data must be provided to the Department of Labor in an electronic form suitable for display on the internet, and the Department of Labor is directed to establish a website to display such information within 90 days of the filing of the annual report. ERISA § 104(b)(5). The same information is also required to be shown on any intranet website maintained by the plan sponsor, in accordance with regulations to be issued.

Multiemployer plans are required to provide a summary report to each union and employer contributing to the plan within 30 days after the annual report due date. The summary report must include, among other things, (1) the number of contributing employers, (2) employers contributing more than 5% of total contributions, (3) participants with no contributing employer, (4) information on amortization extensions, (5) information on the plan's funded status, and (6) the number of employers that withdrew during the plan year and the related withdrawal liability.

All of the reporting changes relating to the Form 5500 described above are effective for plan years beginning in 2008.

Periodic Benefit Statements. Current law requires a defined benefit pension plan to provide a benefit statement to a participant who makes a written request for it, subject to a limit of one statement every 12 months. The statement must include the participant's total accrued benefit and vested benefit (or the earliest date on which the participant will become vested).

The Act revises the benefit statement rule by requiring a plan to either (1) provide a benefit statement at least once every three years to each active employee with a vested accrued benefit or (2) provide an annual notice to each such active employee regarding the availability of the benefit statement and how to request one. ERISA § 105(a)(2). A participant can also request a benefit statement at any time, subject to a limit of one statement every 12 months. In addition to the information required under current law, the benefit statement must also contain an explanation of any permitted disparity or floor-offset arrangement that may apply. The

Department of Labor is directed to provide one or more model benefit statements by August 17, 2007.

This provision of the Act is effective for plan years beginning in 2007, with a delayed effective date for collectively bargained plans of the earlier of the date the collective bargaining agreement expires (without regard to extensions) or December 31, 2008.

PBGC Reporting. Section 4010 of ERISA currently requires detailed financial and actuarial reporting to the PBGC if aggregate unfunded vested benefits under all plans in an employer's controlled group exceed \$50 million, or certain other conditions are met. The Act replaces the \$50 million threshold with a requirement that section 4010 reporting be made if the funding level (as determined under the new rules) for a plan maintained by an employer or any member of its controlled group is less than 80%. The PBGC must also submit a report to Congress aggregating each year's section 4010 reporting results. This change is effective for plan years beginning in 2008.

Effective for terminations occurring after August 17, 2006, the Act also requires plans to provide to affected parties (including participants), upon request, certain information given to the PBGC in connection with a distress or involuntary termination.

Other Provisions Affecting Defined Benefit Plans

In addition to the funding and reporting rules described above, the Act contains a number of other changes relating to defined benefit plans, including rules regarding phased retirement distributions, survivor annuities and computation of lump sum distributions.

Phased Retirement Distributions. Many employers with aging workforces have struggled with the rules under ERISA and the Code that prevent pension plans from making distributions before age 65 to employees who have not separated from service. In response to this problem, the IRS issued proposed regulations in 2004 permitting participants in a "phased retirement" program to receive distributions from pension plans while continuing to work. However, the proposed regulations required employees to reduce their hours by at least 20% to be eligible to receive a distribution, and the distribution permitted was only a pro rata portion of the total accrued benefit.

Effective for distributions in plan years beginning in 2007, a pension plan will be permitted to allow a distribution to an employee who has attained age 62, even if the employee has not separated from employment. IRC § 401(a)(36). This rule permits distributions of the entire accrued benefit, and it applies even if the employee continues to work full-time. The Code and ERISA are specifically amended to provide that a pension plan permitting such distributions will continue to be considered a pension plan under ERISA and the Code.

Survivor Annuities. Current law requires that pension plans, including money purchase and defined benefit plans, provide that a married participant must (unless the participant elects and the spouse consents) receive his or her benefit in the form of a qualified joint and survivor annuity (a “QJSA”), with an amount payable to the surviving spouse equal to at least 50%, but not more than 100%, of the benefit payable to the participant.

The Act adds a new requirement that, in addition to the QJSA, plans must offer participants the opportunity to elect to receive benefits in the form of a qualified optional survivor annuity (a “QOSA”). IRC § 417(g). A QOSA is intended to offer a different survivor percentage than the QJSA under the plan. Thus, if the QJSA under the plan provides a survivor annuity of 75% or more, the QOSA must provide a 50% survivor annuity, and if the QJSA under the plan provides a survivor annuity of less than 75%, the QOSA must provide a 75% survivor annuity.

Since most plans provide a QJSA with a 50% survivor annuity, most plans will simply need to add a 75% survivor option to comply with the QOSA requirement if they do not already provide such an option. The QJSA explanation will also need to be revised to explain the QOSA.

The QOSA requirement is effective for plan years beginning in 2008, with a delayed effective date for collectively bargained plans of the earlier of the date the collective bargaining agreement expires (without regard to extensions) or December 31, 2009.

QJSA Notice Period. Effective for plan years beginning in 2007, the Act extends the election period after the QJSA explanation is provided during which the participant can elect a distribution from 90 days to 180 days. IRC § 417(a)(6). Under current law, participants occasionally failed to elect a distribution during the 90-day period, sometimes even when a valuable early retirement subsidy was available. The complexity of the retroactive annuity starting date rules led many plans to require a new, later benefit commencement date when the 90-day period was exceeded, rather than permit a retroactive annuity starting date. The extension from 90 days to 180 days should help plans avoid many of the situations in which participants inadvertently exceeded the 90-day period.

Computation of Lump Sum Benefits. Beginning in 2008, the minimum lump sum present value of an annuity benefit must be calculated using the applicable segment interest rates that are to be used for the new funding rules, with the segment based on the number of years in the future the participant’s benefit would have been payable as an annuity. IRC § 417(e)(3). However, the 24-month averaging of the corporate bond yields permitted for purposes of the funding rules is not to be used for determining the rates to compute lump sum distributions. Generally, this is expected to result in a reduction in the amount of lump sum distributions.

The IRS is to prescribe rules allowing employers to designate the month as of which the rates are to be determined, as under the current rules. A transition rule provides for phasing-in the new rates, using the following percentage of the value determined using the new rates, with the remaining portion of the lump sum determined using the 30-year T-bill rates as under current law.

<u>Plan Years Beginning In</u>	<u>Percentage</u>
2008	20
2009	40
2010	60
2011	80

Section 415 Limits. The Act makes several adjustments to the rules limiting the payment of annual benefits under Code section 415(b). The most significant change allows a defined benefit plan to base the maximum annual benefit on the highest compensation earned during any three consecutive years of service, rather than limiting the compensation that may be taken into account to compensation for years in which the individual was an active participant in the plan. The new rule is effective for plan years beginning after December 31, 2005.

ERISA and Plan Investments. The Act includes various changes to ERISA that are intended to expand the ability of plans to utilize certain investments within the limitations of the prohibited transaction rules. These changes are briefly summarized below, and they are discussed in more detail in our Legal Alert entitled [“Pension Protection Act of 2006 – Investments, Insurance, and Services.”](#)

The Act modifies the “plan asset” rules and prohibited transaction provisions in ways that will generally allow:

- Non-publicly traded investment funds, including hedge funds, to accept more ERISA plan funds;
- Non-fiduciary service providers to engage in certain transactions with plans to which they provide services, superseding some existing class exemptions issued by the DOL;
- Plan fiduciaries to effect large block trades on behalf of multiple plans;
- Purchases and sales of securities through certain electronic trading networks and alternative trading systems;

- Certain transactions on foreign exchanges; and
- “Cross-trading” by an investment manager in a wider variety of circumstances than currently permitted under an existing DOL class exemption.

Combination Defined Benefit and 401(k) Plans – “DB/k.” Small employers (*i.e.*, employers that have less than 500 employees) will be permitted to combine a defined benefit plan and a 401(k) plan in a single trust, filing a single Form 5500, effective beginning in 2010. IRC § 414(x). The defined benefit plan must meet certain minimum accrual and vesting requirements, and the 401(k) plan must include an automatic enrollment feature and satisfy minimum matching contribution and vesting requirements.

EPCRS Enhancements. The Act clarifies that the IRS has the authority to establish and implement its Employee Plans Compliance Resolution System (“EPCRS”), including waiving income, excise, or other taxes. The Secretary of the Treasury is directed to continue to update and improve EPCRS, including (1) taking into account the special concerns of small employers, (2) extending the self-correction period for significant compliance failures, (3) expanding the ability to self-correct insignificant errors during audit, and (4) assuring that taxes, penalties, and sanctions under the program are not excessive.

Restrictions on Executive Nonqualified Deferred Compensation Plans

The Act amends Code section 409A to impose additional restrictions, related to underfunding of single-employer defined benefit plans, on nonqualified deferred compensation plans (“NQDC plans”). The new provisions create a “restricted period” during which certain actions that have the effect of setting aside assets for the benefit of “applicable covered employees” participating in NQDC plans produce substantial adverse tax consequences.

The “restricted period” is any period during which a single-employer defined benefit plan of a member of the controlled group is in “at-risk status,” as described above, any period when the plan sponsor is a debtor in bankruptcy, and six months before and six months after the termination of a single-employer defined benefit plan with assets that are not sufficient for benefit liabilities.

Adverse tax consequences apply if:

- (1) During the restricted period, assets are directly or indirectly set aside or reserved in a trust or transferred to a trust for the purpose of paying deferred compensation to applicable covered employees under an NQDC plan (of the sponsor of the relevant single-employer defined benefit plan or of a member of the same controlled group); or

- (2) An NQDC plan of the sponsor or a member of the controlled group specifies that assets will be restricted to providing NQDC plan benefits “in connection with such restricted period (or other similar financial measure determined by the Secretary) with respect to the defined benefit plan,” *or* assets are in fact so restricted.

These rules apply whether or not the assets associated with the NQDC plans are subject to the claims of the relevant employers’ creditors. Thus, the rules apply to rabbi trusts. The Treasury is given authority to determine arrangements in addition to trusts to which these rules will apply.

If (1) or (2) above is violated, the amounts set aside, reserved or restricted are included in the employee’s income as section 83 property that has been transferred in connection with the performance of services. In addition, the 20% penalty tax and interest at the underpayment rate plus 1% under section 409A apply.

The statute provides that the rules described in (1) above do not apply to any assets set aside before the beginning of a restricted period. Thus, a typical rabbi trust that has been funded before a restricted period begins should not be affected by the new rules as long as no additional funding or asset restriction takes place during a restricted period. Note, however, that this leaves the rules of (2) as potentially applicable to arrangements put in place before the beginning of a restricted period. Though the ambit of (2) is not well-defined, it could be read as reaching, for example, irrevocable trust interests that were subject to a risk of forfeiture and then vest, the “springing” funding of unfunded trusts, and (perhaps) revocable rabbi trusts which become irrevocable, if in each of these cases the change in the status of the trust or other arrangement were deemed to be “in connection with” a restriction period (or some other financial event identified by the Treasury and IRS). NQDC plans containing triggers that might not comply with these provisions should be reviewed promptly, since the mere presence of such triggers (as well as their use) might be construed to run afoul of the statute. (Since the use of “financial health” triggers already has tax consequences under prior provisions of section 409A, many plans may have already been reviewed for similar provisions.)

If a NQDC plan, within the meaning of section 409A, violates these restricted period requirements, then the adverse tax consequences fall on the “applicable covered employees.” These are defined as the section 162(m)(3) covered employees (currently the CEO and the four other most highly compensated employees employed at the end of the year) plus any other employees of the controlled group subject to section 16(a) of the Securities Exchange Act of 1934 (“insiders”) and any former employees who fell into either of these groups at the time of termination of employment with the plan sponsor or with a member of the controlled group including the plan sponsor. In order to discourage employers from “grossing up” executives for the additional tax and interest resulting from application of these new rules, interest and the additional 20% tax will be applied to the gross-up payment as if it were part of the deferred

compensation to which it relates, and the employer is allowed no deduction with respect to the gross-up payment.

Effective Date. These new rules are immediately effective for transfers or other reservations of assets after August 17, 2006.



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