

## Overview of the New Pension Protection Act of 2006

*August 28, 2006*

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The long-awaited pension reform bill, the Pension Protection Act of 2006 (the "Act"), was signed into law by President Bush on August 17, 2006 (the "Effective Date"). In addition to revising the rules regarding benefit plan asset investment and prohibited transaction exemptions (discussed in our client memorandum of August 8, 2006, [Pension Protection Act of 2006 – Plan Assets and Prohibited Transaction Matters](#)), the Act provides comprehensive changes to the laws regarding retirement plans of all types (as well as addressing other tax-related matters).

The focus of this memorandum will be those material provisions of the Act concerning retirement plans that we believe are of greatest relevance to our clients -- the funding, distribution and disclosure rules relating to defined benefit pension plans (including union-sponsored multiemployer pension plans), the legality and terms of cash balance pension plans, the diversification and other requirements of defined contribution plans, and certain fiduciary requirements.

Several important provisions of the Act became effective immediately as of the Effective Date. Other provisions will be phased in over time, and some of the more complex funding provisions will not become effective until January 1, 2008. This memorandum summarizes the Act's relevant provisions based upon when those provisions become effective.

### **I. PROVISIONS WITH IMMEDIATE EFFECTIVENESS**

A. *Benefit Formulas under Cash Balance and Other Hybrid Pension Plans.* The Act resolves several issues that have been the subject of multiple lawsuits:

(i) *Age Discrimination.* The Act clarifies that, effective on and after June 29, 2005, the age discrimination standards of ERISA and ADEA are not violated by cash balance plans that define participants' accrued benefits as hypothetical account balances to which the same pay and interest credits are made on behalf of all participants, regardless of age, provided that benefits vest over no more than a three-year period and interest credits provide a rate of return not in excess of the market rate. Plans converting to cash balance or adopted on or after June 29, 2005, that wish to qualify as meeting the ERISA/ADEA age discrimination standards must meet the three-year vesting and market interest rate

requirements beginning as of the date of adoption or conversion. However, for cash balance plans in effect as of June 29, 2005, the Act delays the effective date of the above vesting and interest credit requirements until the first plan year beginning on or after January 1, 2008, although an employer may elect to have them apply during the interim period (see Section III.B).<sup>1</sup>

(ii) *Lump-Sum Distributions.* The Act provides that lump sum distributions from cash balance pension plans made after the Effective Date may be based on the participant's hypothetical account balance as of the distribution date, provided the plan's interest crediting rate does not exceed a market rate of return.<sup>2</sup>

(iii) *Wearaway Provisions.* Of significant interest, effective for conversions of traditional defined benefit pension plans to cash balance pension plans occurring after June 29, 2005, plan sponsors are prohibited from using so-called "wearaway" provisions (pursuant to which certain participants with large pre-conversion accrued benefits might not accrue new benefits under the new cash balance plan formula for some period of time after the conversion). The value of early retirement subsidies associated with pre-conversion accrued benefits also must be preserved upon any lump sum distribution of benefits under the post-conversion plan.

In addition, the Act requires that, within 12 months following the Effective Date, the Department of Treasury issue regulations addressing cash balance plan conversions that occur in connection with corporate mergers and acquisitions.

B. *Increased Deduction Limit for Contributions to Defined Benefit Pension Plans.* Generally, for 2006 and 2007, the funding requirements for defined benefit pension plans as in effect prior to the

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<sup>1</sup> Although the Act does not address whether cash balance benefit provisions in effect prior to June 29, 2005, discriminate on the basis of age, we note that the Seventh Circuit Court of Appeals recently held that the cash balance benefit formula in the IBM cash balance plan in effect prior to such date is not age discriminatory. We believe the decision in the IBM case is likely to influence the outcome of pending lawsuits in other circuit courts.

<sup>2</sup> Under prior law, the view of the IRS and many courts was that pension plan distributions could not be less than the present value of an annuity commencing at the plan's normal retirement age, calculated by projecting a participant's hypothetical account balance forward to normal retirement age, converting it into an annuity, and then discounting it back to the date of distribution and converting it back to a lump sum. Where the rate used for projecting the benefit was greater than the discount rate, the lump sum benefit would be larger than the participant's hypothetical account balance measured at the time of distribution, and many courts required distribution of this larger amount. The Act negates this so-called "whipsaw" effect on plan distributions.

Effective Date will continue to govern an employer's obligation to make contributions to such plans. However, in anticipation of the Act's new funding rules that become effective January 1, 2008, the Act allows employers to deduct contributions to such plans of up to 150% of a plan's unfunded current liability (up from 100% under pre-Act law).

- C. *Valuation of Liabilities in Certain Defined Benefit Pension Plan Terminations.* Where an employer that sponsors a single employer defined benefit pension plan leaves a controlled group as the result of a transaction or series of transactions and thereafter voluntarily terminates such plan, it will be permitted to assess liabilities for purposes of such termination using the same interest rate and mortality assumptions as were used for the ongoing plan (as opposed to the pre-Act requirement of using PBGC plan termination assumptions), but only if (i) the plan was fully funded immediately prior to the transaction, (ii) following the transaction, the employer continues to employ at least 20% of the US employees it employed immediately prior to the transaction, (iii) both before and after the transaction, the employer has investment-grade debt, and (iv) the plan is not terminated for at least two years following the transaction.
- D. *Limitations on Funding of Non-Qualified Plans.* On and after the Effective Date, if an employer sets aside amounts in a trust (including a "rabbi trust") or similar arrangement to pay benefits under a nonqualified deferred compensation plan to its chief executive officer or its four next highest compensated officers (the same group that is the focus of the \$1 million compensation deduction limit under Section 162(m) of the Internal Revenue Code) or to any of its other executive officers who are "Section 16(b) insiders" for SEC reporting purposes (collectively, "Key Employees") either (i) at any time when the employer is in bankruptcy or (ii) during the 12 months prior to the date of any termination of the employer's underfunded defined benefit plan, then the Key Employees will be subject to current taxation, plus a 20% additional tax (plus interest), in respect of such amounts. In addition, any gross-up amounts paid by the employer to such employees to cover such taxes will also be subject to the 20% tax (plus interest), and such gross-up amounts will be nondeductible to the employer.

These same limitations and penalties will also apply during any period in which an employer maintaining any such deferred compensation plan also sponsors an "at-risk" defined benefit pension plan. Please note, however, that the Act makes the at-risk plan rules effective only for plan years beginning after December 31, 2007 (see Section III.F below).

- E. *Company Owned Life Insurance.* For company-owned life insurance contracts issued or materially modified after the Effective Date, an employer will be taxed on any death benefit proceeds it receives in excess of any amounts the employer paid for the insurance contract, unless certain notice and consent requirements are met and the death benefit (A) is paid to the employer with respect to the death of an insured who was (i) an employee at any time during the 12-month period before the insured's death or (ii) a director or highly compensated employee or individual at the time the insurance contract was issued, or (B) is paid to the insured's beneficiaries (other than the employer).

- F. *Use of Excess Pension Assets to Fund Retiree Health Benefits.* Employers who sponsor defined benefit pension plans may transfer excess pension assets to a separate account to fund retiree health benefits estimated to be payable within up to 10 years, so long as the pension plan maintains certain minimum funding levels and retiree health benefit levels for four years after such transfer. Transfers must be made for at least a two-year period. (Pre-Act law only permitted such assets to be transferred to fund the estimated costs of such benefits in one-year increments, limited to the estimated cost of such benefits for each such year.)
- G. *Limitation on Pension Benefit Guaranty Corporation ("PBGC") Guaranteed Liabilities.* The Act provides that the PBGC's guarantee of those plan benefits triggered by unpredictable contingent events (such as a plant shutdown or reduction in workforce) occurring after July 26, 2005, will be phased in over the five years following the date of such event.
- H. *ERISA Fiduciary Provisions--Prohibited Transaction Exemptions.* The Act contains new statutory prohibited transaction exemptions which (i) permit certain "block trades" of securities or other property between a plan and a non-fiduciary party in interest ("block trades" are trades of at least 10,000 shares or that have a market value of at least \$200,000); (ii) allow plan fiduciaries to provide investment advice under certain circumstances to participants or beneficiaries in participant-directed plans (such as 401(k) plans or IRAs); (iii) cover certain securities transactions executed through an electronic communication network, alternative trading system or other similar execution system; and (iv) provide specific relief for certain foreign exchange transactions between a bank or broker-dealer and their respective affiliates and plans. In addition, the Act introduces a correction period for certain prohibited transactions (and the avoidance of the associated excise taxes) in connection with the acquisition, holding or disposition of any security or commodity (other than securities or real property of the plan sponsor).

## II. PROVISIONS EFFECTIVE FOR YEARS BEGINNING AFTER DECEMBER 31, 2006

- A. *Defined Contribution Plans--Automatic Enrollment 401(k) Plans.* The Act includes incentives for plan sponsors to adopt automatic enrollment (or negative election) 401(k) plans by, among other things, eliminating possible conflicts between automatic enrollment and state wage withholding laws and adding protections for plan fiduciaries for the plan's default election features, so long as participants receive advance notice and plan assets are invested in accordance with future Department of Labor regulations. The Act includes additional rules affecting automatic enrollment plans, which are described below in Section III.A and become effective on or after January 1, 2008.
- B. *Defined Contribution Plans--Vesting.* The Act mandates that the more rapid vesting schedules currently applicable to employer matching contributions -- either a 3-year cliff schedule or a 6-year graduated schedule (20% annually, starting after two years) -- will become applicable as well to non-elective employer contributions. These changes are generally effective for

contributions made in 2007 or later, with a delayed effective date for collectively bargained plans and certain employee stock ownership plans (“ESOPs”).

- C. *Defined Contribution Plans--Diversification Requirements.* The Act generally requires defined contribution plans that hold (or are treated as holding) publicly traded employer securities to permit participants to diversify their account balances invested in those securities. All participants must be allowed to diversify the investment of their own elective deferrals and after-tax contributions. Participants with three or more years of service must be permitted to diversify the investment of other contributions, such as matching contributions and non-elective employer contributions. Exceptions to these new rules apply for certain ESOPs, which remain subject to the diversification requirements of present law.

Generally, the Act’s new diversification rules are effective for plan years beginning after December 31, 2006, with a delayed effective date for collectively bargained plans and certain ESOPs. With respect to employer securities that were contributed to the participant’s account prior to 2007 in the form of a matching or non-elective employer contribution, the diversification requirements may be phased in ratably over three years. These transition rules do not apply to participants who have reached age 55 and completed at least three years of service before the first plan year beginning after December 31, 2005.

- D. *Individual Pension Benefit Statement Requirements.* The Act requires that the administrator of every defined benefit and defined contribution plan provide participants and beneficiaries with a “pension benefit statement” containing, among other things, a schedule of total accrued benefits and nonforfeitable pension benefits (or the date on which such benefits would become nonforfeitable), and other information about the participants’ rights under the respective plan, in a manner intended to be understood by the average participant. The statement must be provided at least annually.
- E. *Fiduciary Bonding Requirements.* The Act exempts certain registered broker-dealers from the ERISA bonding requirements.

### **III. PROVISIONS EFFECTIVE FOR YEARS BEGINNING AFTER DECEMBER 31, 2007**

- A. *Defined Contribution Plans--Automatic Enrollment 401(k) Plans.* The Act includes additional incentives for employers to adopt automatic enrollment 401(k) plans in years beginning on or after January 1, 2008 by offering optional nondiscrimination safe harbor rules for elective deferrals and matching contributions and making it easier for employers to correct erroneous contributions. “Qualified automatic enrollment plans” could dramatically increase enrollments in 401(k) plans because employees would be required to affirmatively opt out of participation. However, employers considering adopting such qualified automatic enrollment features should recognize that these features also require that the employer make certain minimum matching or non-elective contributions on behalf of all participants, which would be subject to accelerated vesting provisions.

- B. *Cash Balance Plans--Vesting Schedule.* Section I.A discusses rules that became effective with respect to certain cash balance plans as of June 29, 2005, noting a delayed effective date for certain of those rules for cash balance plans in effect prior to June 29, 2005. Effective for plan years beginning after December 31, 2007, a vesting schedule not exceeding three years and an interest rate not in excess of the market rate must be adopted by plan sponsors of cash balance plans that were in existence on June 29, 2005, for those plans to be deemed compliant with the age discrimination requirements of ERISA and ADEA. As noted in Section I.A above, plan sponsors of such plans can elect to make the vesting schedule and market interest rates applicable at any time between June 29, 2005 and December 31, 2007.
- C. *Single-Employer Defined Benefit Pension Plans--New Minimum Funding Calculation.* The Act repeals the current laws with respect to plan funding, including the requirement that a "funding standard account" be maintained, and replaces the current funding rules in their entirety with a new set of rules, which generally require higher minimum funding levels. Beginning in 2008, the minimum required annual contribution will depend on a plan's "target liability," which is an amount to be based on a comparison of the value of the plan's assets with the plan's "funding target" and its "target normal cost." The "funding target" is the present value of all benefits accrued or earned as of the first day of the applicable plan year. The "target normal cost" is the present value of benefits expected to accrue or be earned during such plan year, including increases in previously earned benefits due to increases in pay. The minimum required contribution for any year will be the target normal cost plus the annual amortization of any shortfall between the value of the plan's assets and the target liability. Plan assets will continue to be valued at fair market value. Asset values may be averaged over no more than a 24-month period (as opposed to the pre-Act five-year period), but the result must be within 90% to 110% of the fair market value of the assets on the measuring date.
- D. *Single-Employer Defined Benefit Pension Plans--New Actuarial Assumptions.* Effective January 1, 2008, pension plan liabilities will be required to be calculated using actuarial assumptions, including interest rates and mortality tables, specified in regulations to be provided by the IRS. Interest rates, which will be phased in over three years beginning in 2008, will be based on a 24-month average of investment-grade corporate bonds, with the yield curve divided into three segments (short-term, medium-term and long-term), to take into account expected contribution dates. These changes will have a significant effect on the determination of the funded status of pension plans under the new funding calculations described in Section III.C above.
- E. *Single-Employer Defined Benefit Pension Plans--New Amortization Schedule.* Generally, after 2007, if a defined benefit pension plan is less than 100% funded based on the calculation described in Section III.C above, the plan sponsor will have only seven years to amortize any underfunding, beginning in the year of such underfunding. However, the Act provides transition relief for plans established before 2007 and for plans that that may be underfunded but not required to make deficit reduction contributions in 2007, by phasing in the full funding requirement such that a plan need be only 92% funded in 2008, 94% funded in 2009, and 96% funded in 2010. The

amortization periods for currently existing underfundings will not change. This provision could seriously impact the cash flow of companies that maintain underfunded plans.

- F. *Single-Employer Defined Benefit Pension Plans--Determination and Funding of "At-Risk" Plans.* For plan years beginning on or after January 1, 2008, a defined benefit plan determined to be "at-risk" will be required to use special assumptions. A plan will be considered "at-risk" if, generally, the value of the plan's assets for the preceding plan year was less than (i) 80% of the plan's funding target without regard to the special at-risk assumptions and (ii) 70% of the plan's funding target using the at-risk assumptions. In lieu of 80%, a transition rule substitutes 65% for 2008, 70% for 2009, and 75% for 2010. If a plan is deemed to be at-risk, minimum funding requirements are increased by requiring that, when calculating the plan's "target normal cost," the plan sponsor assume that all employees who will be eligible to retire during the next 10 years will retire at the earliest possible retirement date and will choose the most valuable form of retirement benefit. The target normal cost is further increased by 4% plus an additional \$700 per participant if the plan was at-risk in at least two of the prior five years. The increased contributions for at-risk plans are phased in over five years (20% per year).
- G. *Single-Employer Defined Benefit Pension Plans--Benefit Limitations of "At Risk" Plans.* After December 31, 2007, if a defined benefit plan's funding level drops below 80%, (i) amendments increasing benefits will not be allowed unless the plan sponsor immediately funds the entire cost of the increase and (ii) lump sum distributions will be restricted to no more than 50% of a participant's accrued benefit (or the portion guaranteed by the PBGC, if lower). In addition, the plan sponsor will not be permitted to use the plan's credit balances to offset required minimum contributions. If funding falls below 60% for any plan year, (x) future benefit accruals will have to be frozen until the funding level again reaches 60% and (y) no lump sum benefits or plan shutdown benefits will be available. Participants and beneficiaries must receive notice if the plan becomes subject to any of these restrictions.
- H. *Single Employer Defined Benefit Pension Plans--Bankruptcy Limitations.* Special rules will apply if a defined benefit pension plan sponsor is in bankruptcy. First, unless the plan is at least 100% funded, the plan may not be amended to increase benefits or otherwise increase liabilities by changing the accrual or vesting of benefits. Second, unless benefit accruals have been frozen, the plan cannot make any "prohibited payments." Prohibited payments include any payment in excess of the monthly amount paid under a single life annuity or any payment used to purchase a commercial annuity.
- I. *Multiemployer (Union-Sponsored) Pension Plans--In General.* Amortization periods for most charges to multiemployer pension plans are reduced to 15 years, and the maximum deductible limit for contributions to such plans is increased to 140% of the current liability. Limitations on benefit increases, a shortened amortization schedule, and new funding requirements may be imposed if a multiemployer plan is less than 80% funded (an "endangered" plan) or less than 65% funded (a "critical" plan). Also (and perhaps most important), joint and several liability for

required contributions to multiemployer plans is extended to all members of the plan sponsor's "controlled group" (i.e., all members of a plan sponsor's consolidated tax group).

- J. *Disclosure Requirements--Single-Employer and Multiemployer Defined Benefit Pension Plans.* The Act imposes additional disclosure obligations upon sponsors of both single-employer and multiemployer defined benefit pension plans. For instance, all defined benefit pension plans must:

(i) provide an annual notice to the PBGC and all participants that includes, among other information, (x) whether the plan's funding "target attainment percentage" for that year and the two prior years is at least 100% (and, if not, the actual percentage) (and, for multiemployer plans, whether the plan is "endangered" or "critical" for such year, and if so, a summary of any funding improvement/rehabilitation plan adopted during such year), (y) the total assets and liabilities of the plan for that year and the two prior years, and (z) an explanation of any amendment or known event having a material effect on plan liabilities or assets and a projection of its effects; and

(ii) include in their Form 5500 Annual Reports a statement of the plan's actuarial assumptions and, in any case where liabilities to participants come from more than one pension plan maintained in the same controlled group, the funded percentage of each such pension plan (including the plan for which the Form 5500 Annual Report is filed). In addition, each multiemployer pension plan must include in its Form 5500 Annual Report, as well as in a report to be provided to each participating employer in such plan, among other information, (x) the number of employers obligated to contribute to the plan and (y) the number of employers that withdrew from the plan during the year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against such withdrawn employers.

These disclosure requirements should be of interest to potential acquirors of companies that sponsor or are obligated to make contributions to defined benefit pension plans, as these notices and reports will be extremely helpful in any due diligence review process.

- K. *Fiduciary Bonding Requirements.* For plan years beginning after December 31, 2007, the Act raises the maximum bond required for plans holding employer securities from \$500,000 to \$1 million.



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