

President Signs Pension Protection Act of 2006

On August 17, 2006, President Bush signed the Pension Protection Act of 2006, H.R. 4 (the “Act”), which was overwhelmingly approved by the House of Representatives and the Senate. The Act is one of the most far-reaching revisions of pension laws in the last 30 years. The Act revises single-employer and multiemployer pension funding rules for defined benefit plans, changes many cash balance and defined contribution plan rules, and liberalizes the investment advice rules. The Act also makes permanent the EGTRRA provisions that were scheduled to expire after 2010. Many provisions of the Act are effective upon enactment, which is August 17, 2006. This Legal Alert discusses the key provisions of the Act.

Reform of Minimum Funding Requirements for Defined Benefit Plans

The Act completely replaces the current minimum funding requirements of the Code and ERISA. Most of the new requirements will be effective as of the plan year beginning in 2008. (The current minimum funding rules will remain in effect for plan years beginning in 2006 and 2007.) However, the Act contains numerous transition rules and special effective dates.

- **Basic Funding Requirement** – The basic minimum funding requirement for a single-employer defined benefit plan for a plan year is equal to the (1) “target normal cost,” (2) the “shortfall amortization charge,” plus (3) the “waiver amortization charge.”
 - The “target normal cost” for a plan year is the present value of all the benefits that are expected to accrue or be earned during the plan year, including increased benefits due to increases in compensation.
 - The “shortfall amortization charge” applies only to plans that are underfunded. It is a charge that amortizes over seven years the difference between plan assets and liabilities. If the plan meets its funding target prior to the end of the seven years, then the shortfall charge would not apply. The charge is phased in for the 2008 through 2010 plan years. For example, if a plan meets at least 92% of its funding target for 2008, the shortfall charge would not apply.
 - The “waiver amortization charge” is a charge that amortizes over five years the amount of any funding waiver that is granted by the Service. (Funding waivers may be requested by an employer that cannot satisfy the minimum funding standard without temporary substantial business hardship.)
- **Value of Plan Assets** – In determining the value of plan assets for the minimum funding requirements, the employer can average the value of plan assets up to 24 months, provided the average is within 90% to 110% of the fair market value of plan assets as of the valuation date.
- **Value of Plan Liabilities** – In determining the value of plan liabilities for the minimum funding requirements, the Act provides for different interest rates to be used for benefits payable within 5 years, 5 to 15 years, and over 15 years. The three interest rates (referred to as “segments”) are derived by the Service using a two-year weighted average of corporate bond rates with corresponding maturities. A plan may elect to use a single interest rate determined by the Service rather than using segments. The use of segments is phased in over three years beginning in 2008. The Act also requires the Service to publish new separate mortality tables for healthy and disabled participants. Larger pension plans may file a request with the Service to use their own mortality table for all plans in the same controlled group, subject to certain restrictions.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

- **At-Risk Plans** – If a plan is considered “at-risk” (e.g., less than 80% funded) for a year, based on the value of the preceding plan year’s assets, the plan is subject to accelerated funding requirements. Plans with 500 or fewer participants are exempt from this requirement.
- **Contribution Deadlines** – The due date for the payment of minimum required contributions is generally 8½ months after the close of the plan year. The payment must be increased with interest to reflect the span of time between the valuation date (generally the first day of the plan year) and the date payment is actually made. If the plan has a funding shortfall for the preceding plan year, quarterly contributions are required. If a plan sponsor does not make timely contributions and the amount of the contributions exceeds \$1 million, then a lien is imposed on all the property of the sponsor and the members of its controlled group.
- **Benefit Restrictions** – The Act expands the restrictions on plan amendments, accruals and distribution options if a plan is severely underfunded (in most cases less than a 60% or 80% level) or if the employer is in bankruptcy.

Other Pension-Related Changes

- **Section 409A Amendments** – Currently, Code section 409A provides if assets are set aside in a trust or similar arrangement that is located outside the United States, these assets are considered taxable to plan participants. Assets set aside (whether or not outside the United States) also become taxable if the plan provides that upon a change in the employer’s financial health, assets will be restricted to payment of the nonqualified deferred compensation. Section 116 of the Act amends Code section 409A to provide that if assets are set aside or reserved in a trust or other arrangement for the payment of nonqualified deferred compensation at a time when the employer’s defined benefit plan is “at-risk,” the employer is in bankruptcy or for a 12-month period that begins 6 months prior to a distress termination of the defined benefit plan, then the amount of the assets set aside or reserved are considered immediately taxable to certain covered participants in the nonqualified deferred compensation plan. These amounts are also subject to the 20% excise tax and additional interest under Code section 409A. This includes assets set aside regardless of the location of the assets and also includes assets set aside in a rabbi trust. Covered participants that are affected by this change are any current or former employees who are or were one of the top-five officers for purposes of Code section 162(m) and any Section 16 officer. Further, if an employer provides for the payment of a covered participant’s taxes that occur as a result of this provision, the amount of the taxes paid by the employer are included in determining the penalty and additional interest under Code section 409A and the employer is denied an income tax deduction for the payments. This provision is effective upon enactment of the Act.
- **Lump Sum Calculations** – The Act replaces the current mortality table and interest rates used to calculate minimum lump sums under Code section 417(e) beginning for plan years starting in 2008. The new mortality table is the one described above for valuing plan liabilities for funding purposes, except that a plan sponsor may not elect to use an alternate table (as is allowed under the new funding rules). The new interest rates are the three segment rates described above for funding purposes, determined without the two year weighted average rule. The new interest rates are phased in over a 5-year period beginning in the 2008 plan year, but the new mortality table applies starting in 2008 with no phase-in.
- **Variable Rate PBGC Premiums** – In an effort to shore up the PBGC, the Act repeals the current full funding exception effective for plan years beginning in 2008. This means that both underfunded and fully funded pension plans will be required to pay both the flat-rate premium of \$30 per participant per year and the variable rate premium of \$9 per \$1,000 of unfunded vested benefits (as determined under the new minimum funding rules).

Reporting and Disclosure Changes

- **Defined Benefit Plan Funding Notices** – Section 501 of the Act amends ERISA to provide that the administrator of a defined benefit plan (*regardless of the plan’s funding status*) is required to provide a plan funding notice each plan year to the PBGC and to each participant and beneficiary for plan years beginning after 2007. The plan

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

funding notice is required to include identifying information about the plan and the plan sponsor, the funded percentage of the plan during the current year and the last two years, the total assets and liabilities of the plan for the current and two preceding years, the number and types of participants in the plan, the plan's funding policy, an explanation of any material plan amendment made during the year, and an explanation regarding the amount of benefits subject to the PBGC guaranty and limitations thereon. The notice must be provided not later than 120 days after the end of each plan year. The DOL is instructed to publish regulations and a model notice implementing this requirement.

- **Electronic Display of Annual Reports** – Section 504 of the Act amends Section 104(b) of ERISA to require that basic plan information and actuarial information included in the Form 5500 be filed with the DOL in an electronic format that accommodates display on the Internet. The DOL is then required to post the filings on an Internet website. The plan sponsor is also required to post the same information on its own website, if one is maintained for the purpose of communicating with employees. This requirement applies to plan years beginning after 2007. Although this appears to be targeted at defined benefit plans, the requirement is not limited to defined benefit plans, and applies to any ERISA plan that is required to file a Form 5500. (Although not all ERISA plans will have actuarial information, they will have basic plan information included in a Form 5500.) The DOL is required to publish regulations that implement this requirement.
- **Notice of Diversification Rights** – An individual account plan is required to distribute a notice to participants at least 30 days before the date that a participant is eligible to diversify his or her investments out of employer securities. (The diversification right is discussed later in this Alert.) This notice requirement applies to plan years beginning after 2006.
- **Benefit Statements** – The Act requires benefit statements to be provided once per quarter for a participant-directed individual account plan, annually for all other individual account plans, and once every 3 years for a defined benefit plan. The Act also establishes minimum requirements for the wording of benefit statements, and requires the DOL to issue model statements. This requirement applies to plan years beginning after 2006. It appears that these statements can be provided through electronic means, if the employer satisfies the DOL regulations regarding transmission of benefit plan information through electronic means.

Fiduciary Rules and Investment Advice

- **Investment Advice** – Section 601 of the Act amends ERISA and the Code to provide a prohibited transaction exemption for certain investment advice that is provided to a participant in an individual account plan. (This provision does not cover advice given to a plan fiduciary.) The advice must be provided by a “fiduciary advisor” pursuant to an “eligible investment advice arrangement” (as defined below). The arrangement must also be approved by an independent fiduciary and certain disclosures to participants must be made. A plan sponsor is treated as having met its fiduciary duties under Part 4 of ERISA, if the above requirements are satisfied. This provision applies to advice provided after December 31, 2006.
 - **Fiduciary Advisor** – A fiduciary advisor includes a registered investment advisor under the Investment Advisors Act of 1940, the trust department of a bank, an insurance company, and a broker or dealer under the Securities Act of 1934.
 - **Eligible Investment Advice Arrangement** – This is an arrangement which either provides that any fees received by the fiduciary advisor from the participant do not vary depending on the investment option selected by participants or the advisor uses a computer model that meets certain requirements. If the advisor uses the computer model, no other advice, including personal advice, can be provided in addition to what the computer model provides. The computer model requirement is based on DOL Advisory Opinion 2001-09A to Sun America, but unlike the DOL Opinion the new rule requires taking into account all investment options available under the plan, including employer stock. Some have speculated that the

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

Sun America opinion is no longer valid after the passage of the Act, but statements made by certain Senators during the passage of the Act suggest otherwise.

- **Default Investment Safe Harbor** – Section 624 of the Act amends ERISA section 404(c) to provide for a safe harbor for default investments chosen by the plan sponsor. The Act instructs the DOL to issue regulations regarding the designation of default investments, and requires the plan to issue an annual notice to participants in order to satisfy the new safe harbor. This provision applies to any situation where a participant has not provided an election, even if not related to the automatic enrollment provisions discussed later in this Alert. This provision applies to plan years beginning after December 31, 2006.
- **Investment Option Mapping** – Section 621 of the Act provides that the ERISA section 404(c) safe harbor rules apply to a qualified change in investment options, as long as certain requirements are satisfied, including participant notice. A participant is also required to have made a previous election for the rule to apply. Therefore, it is questionable whether this new rule applies to mapping one default fund to another default fund. This new provision applies to mapping of investment options to existing and new options and is effective for plan years beginning after December 31, 2007.
- **Plan Asset Definition Modified** – Section 611(f) of the Act significantly loosens the plan asset definition effective as of enactment. As modified, plan assets will continue to be defined by DOL regulations, except that an entity shall not be treated as holding plan assets if less than 25% of the total value of each equity class in the entity is held by benefit plan investors. The term, “benefit plan investors,” has been narrowed to mean only (1) plans subject to ERISA, (2) IRAs and other arrangements subject to the Code’s excise tax on prohibited transactions (Code section 4975), and (3) entities whose assets include plan assets by reason of a plan’s investment in the entity. Such an investment entity shall be deemed to hold plan assets only to the extent of the percentage of the entity that is owned by benefit plan investors.
- **Block Trades** – The Act provides a new prohibited transaction exemption for block trades to be allocated among at least two client accounts of a fiduciary. A block trade is any trade of 10,000 shares or more or a market value of \$200,000 or more. This exemption is effective upon enactment of the Act.
- **Bonding Relief** – The Act removes the bonding requirement for any broker or dealer registered under Section 15(b) of the 1934 Securities Act, if the broker/dealer is subject to the bonding requirements of a self-regulatory organization. This exemption is effective for plan years beginning after the enactment of the Act.
- **Electronic Communication Network Trades** – The Act provides for a prohibited transaction exemption for purchases and sales of securities executed through certain electronic communication networks. This provision is effective upon enactment of the Act.
- **Service Provider Transactions** – The Act provides for a new prohibited transaction exemption for certain transactions between a plan and a service provider party in interest (other than a fiduciary), if the plan pays no more (or receives no less) than adequate consideration. Transactions covered by this new exemption include sales, exchanges, leases, loans and asset transfers. This provision is effective upon enactment of the Act.
- **Correction Period for Securities Transactions** – Section 612 of the Act provides a new prohibited transaction exemption for the acquisition, holding and disposition of any security or commodity (which would be a prohibited transaction), if the transaction is corrected within 14 days of when the fiduciary knew or should have known of the violation. This exemption does not apply to transactions involving employer securities. This exemption applies to any transaction which the fiduciary discovers after the date of the enactment of the Act.

Cash Balance and Similar Plans

- **Prospective Clarification Regarding Age Discrimination** – The Act supports cash balance plans prospectively by providing that a plan is not age discriminatory if a participant’s account balance, determined as of any date

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

under the plan, is at least as great as that of any similarly situated, younger participant. However, satisfaction of this rule is conditioned on interest credits not being greater than a market rate of return (although certain reasonable minimums are permitted), and interest credits cannot result in negative earnings. In addition, full vesting must occur no later than when a participant has 3 years of service. These provisions apply to periods beginning on or after June 29, 2005, except that the vesting and the interest credit requirements do not apply to plans in existence on June 29, 2005 until plan years beginning in 2008, unless the sponsor elects to apply them earlier.

- **No “Wear-Away” Permitted in Conversions** – The Act prohibits a “wear-away” of accrued benefits if a defined benefit plan converts to a cash balance (or similar) plan after June 29, 2005. After the conversion a participant’s accrued benefit must not be less than the participant’s accrued benefit was before the conversion (including early retirement subsidies that became payable), plus the participant’s accrued benefit earned after the conversion.
- **Whipsaw Eliminated** – The Act eliminates the whipsaw issue that has plagued cash balance plans by allowing the present value of a participant’s accrued benefit to equal the balance in a hypothetical account or as an accumulated percentage of final average compensation. However, this is conditioned upon satisfying the interest crediting rules discussed above. This provision is effective for distributions made after the enactment of the Act.
- **Existing Plans** – Changes made by the Act do not create an inference with respect to the status of plans prior to June 29, 2005. This provides much less relief on age discrimination suits for earlier periods than plan sponsors had hoped to obtain.

EGTRRA Permanency

EGTRRA made a number of changes affecting retirement plans and individual retirement accounts. These provisions were scheduled to expire after December 31, 2010, with the exception of the Saver’s Credit, which was due to expire after 2006. The Act removes these expiration dates, making virtually all retirement plan-related EGTRRA changes permanent. These changes include the following –

- Increased benefit and contribution limits.
- Deferrals disregarded from deduction limits.
- Permitting 401(k) account Roth designations.
- Enhanced rollover opportunities.
- Catch-up contributions if age 50 or over.
- Repeal of 457 plan coordination requirements.
- Tax deduction for ESOP reinvested dividends.
- Repeal of the ADP / ACP multiple use test.

401(k) Operations and Investment Revisions

- **Employer Security Diversification** – Section 901 of the Act provides that a defined contribution plan must allow participants to diversify the investment of elective deferrals and employer contributions out of employer stock. However, plans may require a participant to complete 3 years of service before allowing the investment of employer contributions to be diversified out of employer stock. This requirement only applies to plans with publicly traded employer stock (as defined by the Act) and does not apply to an ESOP that does not have any elective deferral contributions or matching contributions. This requirement is effective January 1, 2007, with a three-year, phased-in transition rule for existing plans. An employer is also required to distribute annual diversification notices to participants as discussed earlier in this Alert. It is unclear how this requirement would apply to a frozen employer stock fund, *i.e.*, a fund that does not accept any new contributions.
- **New Automatic Enrollment Safe Harbor** – Effective for plan years beginning after December 31, 2007, Section 902 of the Act provides for a new automatic enrollment safe harbor. In order to meet the safe harbor, a plan must have an automatic enrollment percentage that is more than a certain percentage based on the employee’s year of participation (at least 3%, but no more than 10%), with the enrollment percentage automatically increasing as the employee’s years of participation increase. The plan also must provide a matching contribution of 100% on

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

deferrals up to the first 1% of compensation and 50% on deferrals up to the next 5%, or a 3% nonelective contribution. Matching and nonelective contributions must be fully vested after two years. Plans that satisfy the requirements would be deemed to satisfy the ADP test and would not be subject to the top-heavy rules. (Certain additional rules must be followed to satisfy the ACP test.) Effective as of the date of enactment, the Act also amends ERISA to preempt any state laws (e.g., wage withholding laws) that would prohibit or restrict a plan sponsor from adding an automatic enrollment feature, but only if the employer meets the notice requirements of the Act. Current employees who have made an election, even if it was an election not to participate whether affirmative or default, do not have to be included, but the employer could include these employees if it desired. This new provision provides a safe harbor for those employers who desire to follow the safe harbor rules, but employers are still free to adopt a non-safe harbor automatic enrollment provision.

Portability, Distribution and Contribution Revisions

- **Faster Vesting** – Section 904 of the Act applies the faster vesting rules of EGTRRA for matching contributions (3-year cliff or 6-year graded) to *all contributions to a defined contribution plan*. This applies to contributions made for plan years beginning after December 31, 2006.
- **Nonspousal IRA Rollovers** – Beginning in 2007, nonspouse beneficiaries who inherit amounts from qualified plans, 403(b) annuities or IRAs can roll over these amounts to another plan or IRA and delay immediate taxation.
- **Roth IRA Direct Rollovers** – Effective for distributions after December 31, 2007, retirement plan distributions may be rolled directly into a Roth IRA, subject to the regular Roth IRA conversion rules (including eligibility limits based on adjusted gross income). The taxable portion of the distribution would be taxed at the time of the rollover.
- **Hardships and Unforeseen Financial Emergencies** – Section 826 of the Act instructs the Service to modify (within 180 days after enactment) the 401(k) and 403(b) hardship regulations to provide, if the plan so elects, for a hardship distribution to a participant's beneficiary (even if the beneficiary is not a spouse or dependent). This same modification also applies to an unforeseen financial emergency under Code section 409A.
- **Penalty Free Withdrawals for Qualified Reservists** – The 10% penalty for early withdrawals would not apply to a plan distribution to an individual who is called for active duty for more than 179 days between September 11, 2001 and December 31, 2007.
- **Phased Retirement** – Section 905 of the Act adds new phased retirement rules for pension plans. This provision allows distributions to be made to employees who have attained age 62 and still employed. This modification is effective for distribution in plan years beginning after December 31, 2006.
- **QDROs** – Section 1001 of the Act instructs the DOL to issue regulations which are to clarify that a domestic relations order will not fail to be a QDRO solely because of the time it is issued (e.g., 5 years after a divorce is final) and because it is issued after or revises another QDRO.

Health and Welfare Revisions

- **Transfer of Excess Pension Assets** – Current law permits a defined benefit plan to transfer excess plan assets to a retiree medical account subject to certain requirements and limitations, including that the transfer cannot exceed the cost of the retiree medical benefits for the current year. The Act expands these transfer rules to allow transferring excess pension assets to fund certain estimated future retiree medical costs.
- **Association Health Plans** – The Act amends Code section 419A to allow tax deductions to fund a reserve (subject to certain dollar limitations) for medical benefits (other than retiree medical benefits) for future years provided through certain bona fide associations. This provision is effective for taxable years ending after December 31, 2006.

Administrative and Miscellaneous Revisions

- **EPCRS** – Section 1101 of the Act provides that the Service has full authority to establish and implement the Employee Plans Compliance Resolution System (“EPCRS”) and any other employee plans correction policies, including the authority to waive income, excise and other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature and severity of the failure. It also instructs the Service to take into account special concerns faced by small employers.
- **Notice Rules** – Effective for years after December 31, 2006, the maximum 90-day advance notice periods for rollover notices, the Code section 411(a)(11) consent rules and the QJSA rules are extended to 180 days (the minimum notice period of 30 days remains unchanged).
- **Form 5500s for Small Plans** – The Act instructs the Service and the DOL to issue regulations providing for a simplified Form 5500 for plans with less than 25 participants for plan years beginning after December 31, 2006.
- **Corporate-Owned Life Insurance Changes** – Section 863 of the Act applies to any life insurance policy owned by an employer, including split dollar life insurance, and provides that the policy’s death benefits are taxable to the employer to the extent the proceeds exceed the premiums paid on the policy. However, if the employer gives notice and obtains written consent from the insured regarding the purchase of the policy, the employer files an information return with the Service regarding the policies, and either the insured satisfies certain status rules or the proceeds are paid to the insured’s heirs, then the death benefits received will remain fully non-taxable. This provision applies to any new policies issued after the date of enactment and any grandfathered policy where certain material changes have occurred to the policy after the date of enactment.

Plan Amendments

The Act requires plan amendments relating to the Act to be made by the last day of the first plan year beginning on or after January 1, 2009.

If you would like additional information about the Act, please contact:

Office	Name	Phone	Email
Atlanta	Bill Vesely	404-815-6383	BVesely@KilpatrickStockton.com
Atlanta	Sarah N. Lowe	404-815-6517	SLowe@KilpatrickStockton.com
Raleigh	Craig B. Wheaton	919-420-1721	CWheaton@KilpatrickStockton.com
Raleigh	Lois W. Colbert	919-420-1722	LColbert@KilpatrickStockton.com
Washington, DC	Steve J. Sacher	202-508-5840	SSacher@KilpatrickStockton.com
Washington, DC	Mark D. Wincek	202-508-5801	MWincek@KilpatrickStockton.com
Washington, DC	Mark L. Stember	202-508-5802	MStember@KilpatrickStockton.com

The information contained in this Legal Alert is not intended as legal advice or as an opinion on specific facts. For more information about these issues, please contact the author(s) of this Legal Alert or your existing firm contact. The invitation to contact the author is not to be construed as a solicitation for legal work. Any new attorney/client relationship will be confirmed in writing. You can also contact us through our web site at www.KilpatrickStockton.com.

Copyright ©2006 Kilpatrick Stockton LLP. This *Legal Alert* is protected by copyright laws and treaties. You may make a single copy for personal use. You may make copies for others, but not for commercial purposes. If you give a copy to anyone else, it must be in its original, unmodified form, and must include all attributions of authorship, copyright notices and republication notices. Except as described above, it is unlawful to copy, republish, redistribute and/or alter this newsletter without prior written consent of the copyright owner. For reprint and redistribution requests, please email KSLEGAL@KilpatrickStockton.com.