

Legal Alert: Pension Protection Act of 2006 – An Overview

August 8, 2006

After a lengthy and at times fractious legislative process, the Congress has passed and President Bush is expected to sign the [Pension Protection Act of 2006](#). The bill approved by the Senate on August 3, 2006, without amendment, is identical to the bill (H.R. 4) passed by the House on July 28, which incorporates the provisions agreed to by the conference on the separate bills passed earlier by the two chambers. Because of the manner in which this legislation ultimately developed, there are no House, Senate or Conference committee reports on the enacted bill. The staff of the Joint Committee on Taxation published a [technical explanation](#) on August 3 (JCX-38-06).

Within its scope, this bill is as far-reaching as any pension legislation enacted in the last 25 years. It is the culmination of a policy debate over pension reform that began over five years ago. It both reacts to recent developments affecting American businesses – including the economic volatility and corporate distress and failures experienced and continuing in this decade – and pushes forward the trend towards greater individual responsibility for retirement security. It will have fundamental significance for the selection, design, funding, operation, and investments of tax-qualified retirement plans; materially influence the financial accounting consequences of sponsoring retirement plans; and change the terms on which investments and services are offered in the employee plan market. For plans that fail to meet the funding targets, it also has implications for executive compensation.

As a first step in understanding this important legislation, this overview highlights some of the key provisions. In the next several days, we will supplement this overview with more detailed summaries of principal sections of the legislation.

While many of the rules are not effective until 2008, some are effective earlier. In general, plans must comply in operation with these legislative changes as of their respective effective dates. Plan amendments may be adopted on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of governmental plans) without infringing on anti-cutback rules.

Qualified Plan Changes Requiring Immediate Attention

Employer Stock/Diversification. Effective for plan years beginning after 2006, defined contribution plans holding publicly traded employer securities (or nontraded tracking stock for a subsidiary of a publicly traded company) generally must permit participants to diversify balances invested in those securities and must make available at least three materially different investment options. This diversification requirement applies to salary reduction and after-tax contribution accounts upon entry into the plan, and to all other participant accounts after three years of service. With respect to contributions other than salary reduction and after-tax contributions, this requirement is phased in ratably over 2007 to 2009 for securities acquired before 2007 (with a carve-out from the phase-in for certain older participants). There are exceptions and/or an extended effective date for certain ESOPs and collectively bargained plans.

Vesting. The accelerated minimum vesting requirements enacted in 2001 for matching contributions in defined contribution plans are extended to all employer contributions to defined contribution plans after 2006 (with special rules for collectively bargained plans and leveraged ESOPs meeting certain conditions).

EGTRRA Permanence

Many of the salutary benefit provisions enacted on a temporary basis in the Economic Growth and Tax Relief Reconciliation Act of 2001, which were to sunset in 2010, are made permanent. In general, they include:

- Increased contribution and other limits for tax-qualified plans and IRAs, including age 50 catch-up contributions;
- Roth 401(k) and 403(b) programs;
- Enhanced portability;
- Employer deductions for reinvested ESOP dividends; and
- Simplification of, and other improvements in, plan administration.

Funding Defined Benefit Plans

Single-Employer Plans. The Act transforms the funding and related requirements for single-employer plans.

Funding Requirements. The funding requirements for single-employer defined benefit plans are replaced by a new standard tied to and varying by the funded status of the plan. For 2006 and 2007, the current rules continue to apply, but the use of the long-term corporate bond interest rates adopted in 2004 is extended. Starting generally in 2008:

- Employers must make sufficient plan contributions to fund all benefits that accrue in the current year, including increases in prior accrued benefits attributable to current compensation, plus an amount to eliminate funding shortfalls over seven years.
- If the plan is “at-risk,” contribution requirements are accelerated. A plan is at-risk if either:
 - The plan is less than 70% funded on worst-case assumptions (employers cannot count credit balances, participants are generally assumed to take the most expensive benefits at the earliest possible age, and a loading factor applies if the plan was at risk in two out of the last four years); or
 - The plan is less than 80% funded (in 2011 or later; the percentage starts at 65% in 2008 and increases 5% in each of 2009 to 2011) using standard assumptions.

In addition, if a plan is less than 80% funded:

- Employers may not use credit balances or new “prefunding balances.”
- The payment of benefits in lump-sum form and the purchase of annuity contracts from insurance companies are restricted.
- The plan generally may not be amended to increase benefits, create new benefits or change the benefit accrual or vesting schedules.

If the plan is less than 60% funded, both these amendments and even tighter accelerated distribution restrictions apply, plus:

- All benefit accruals must cease until the first plan year the funding reaches the 60% level.
- Benefits cannot be paid on plant shutdown and other “unpredictable contingent events.”
- For purposes of determining plan liabilities, benefits are grouped into three segments based on bands of expected benefit payment dates, and each segment is valued using a corporate bond yield curve intended to reflect current market interest rates averaged over two years. This interest rate method is phased in from 2008 to 2010, with a blending of prior-law rates and new rates during the transition. The value of assets may still be averaged to smooth the effect of market fluctuations, but with less flexibility than in the past.
- Special rules provide transition relief to the airline, automotive and other industries.

PBGC Premiums. The per-participant PBGC premiums are unchanged from the levels set by Congress in 2005. The variable-rate premium, equal to 0.9% of unfunded vested benefits, is determined under new rules based on yield curve segment rates, phased in starting in 2008. The termination premium of \$1,250 per participant for employers that emerge from bankruptcy after “dumping” pension liabilities on the PBGC, enacted on a temporary basis in 2005, is made permanent. The obligation of the PBGC to guarantee benefits provided on plant shutdown and other unpredictable contingent events is restricted.

Deduction Limits. For 2006 and 2007, the defined benefit maximum deductible contribution limits are increased to an amount equal to 1.5 times the plan’s excess of liabilities over assets, and the combined plan limit disregards contributions to a defined contribution plan up to 6% of compensation. For 2008 and later years, different, but in many cases more generous limits take effect, which include ignoring contributions to any single-employer defined benefit plan covered by the PBGC for purposes of the combined plan limit.

Effect on Executive Compensation. The employer may not set aside assets in a rabbi trust or other arrangement to provide nonqualified deferred compensation to its five top executives or other section 16 “insiders” if its qualified defined benefit plan is at-risk, if the employer is in bankruptcy, or during the 12-month period beginning six months before the termination of an underfunded plan.

Multi-employer Plans. Multi-employer plans are subject to different funding requirements. The prior-law minimum funding standards are retained with some refinements, and with a temporary requirement (through 2014) that:

- “Endangered” plans (either less than 80% funded or has/is projected in any of the next six years to have an accumulated funding deficiency) and “seriously endangered” plans (meeting both the foregoing criteria) must propose and adopt a funding improvement plan of contribution increases, benefit reductions or both to increase funding levels over 10 years or 15 years, respectively.
- “Critical” plans (projected to fail the minimum funding standards or become insolvent in three to six years, depending on specified factors) must propose and adopt a 10-year rehabilitation plan, and employers are subjected to a 10% surcharge (5% in the first year) on contributions.

Cash Balance and Other Hybrid Plans

The Act amends ERISA, the Code and the Age Discrimination in Employment Act to provide that a cash balance or other type of hybrid plan will not violate ERISA, fail to qualify for tax-exempt status under the Code, or discriminate on the basis of age if certain requirements are satisfied. Most importantly:

- A participant’s accrued benefit must be at least as great as that of any similarly situated younger individual – an individual who is identical in every respect, including period of service, compensation, position, date of hire, work history, etc., *except* age – who is or could be a participant in the plan.
- The “interest credits” provided under the plan must not be at a rate that exceeds a “market rate of return,” though the plan may provide for a reasonable minimum guaranteed rate of return or for interest crediting at the greater of a fixed or variable rate.
- The Act prohibits the use of “wearaway” provisions previously used in many defined benefit plan conversions. As a result, if a traditional defined benefit plan is converted to a hybrid plan, a participant’s accrued benefit must be the sum of (1) his or her accrued benefit determined prior to the conversion, plus (2) the benefit accrued for years of service after the conversion.
- The Act clarifies that a plan need not project a participant’s benefit forward to normal retirement age using the plan’s interest rate assumptions and then discount it back

using the Code-required interest rate, thus avoiding the “whipsaw” result of certain court decisions concerning hybrid plans. Instead, for purposes of calculating lump sums and certain other optional forms, a plan can treat the present value of a participant’s accrued benefit as being equal to his or her hypothetical account balance.

Largely to avoid influencing past and current litigation concerning hybrid plans, the rules set forth in the Act apply prospectively only. Generally, the new rules apply for periods beginning on or after June 29, 2005, though several different transition rules apply for the various rules.

Other Pension Plan Provisions

- Defined benefit plans must use segmented interest rates (based on expected payment dates) similar to the rates used for funding purposes to convert annuity benefits to lump sums. This new method is effective beginning in 2008, but with a phase-in from 2008 to 2012.
- Defined benefit plans may provide in-service distributions to participants age 62 or older, *i.e.*, phased retirement, starting in plan years beginning in 2007.
- Effective for plan years after 2007 (with an extended effective date for collectively bargained plans), defined benefit and money purchase plans must offer a joint and 75% survivor annuity, as well as an option with a survivor benefit between 50% and 75%.
- Effective for plan years after 2007, single employer defined benefit pension plans must provide an annual funding notice to participants that includes, among other things, information regarding the plan’s funded status, PBGC guarantees and limitations, plan asset allocation, and material plan amendments. This requirement is similar to the current rule for multiemployer pension plans.
- Also effective for plan years after 2007, the Act somewhat expands the information required on the annual Form 5500 for pension plans and requires some of the information on the Form 5500 to be provided to the Department of Labor in a format suitable for posting to an internet website to be created by the government. Employers will also be required to post some of this information on their own intranet websites, if they have them.

Automatic Enrollment

Automatic enrollment procedures are enhanced in important ways. Except as noted, these provisions are effective for plan years beginning after 2007:

- State payroll and withholding laws that limit automatic contributions will be explicitly preempted by ERISA if a plan meets certain participant notification requirements. This provision is effective immediately.
- Plans that notify participants how contributions will be invested and meet certain default investment guidelines will be treated as satisfying ERISA section 404(c) even if a participant does not make an affirmative investment election.
- A 401(k), 403(b) or governmental 457(b) plan that complies with the new ERISA 404(c) requirements and meets other notice requirements may permit a participant to withdraw automatic contributions at any time during a 90-day window period without penalty. A plan meeting these requirements can also make corrective distributions to pass nondiscrimination tests within 6 months of year end, rather than 2 ½ months. Amounts withdrawn or distributed are taxable in the year of receipt.
- Code section 401(k) and 403(b) plans that provide for automatic enrollment and meet certain other requirements are deemed to pass the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests and are exempt from top-heavy requirements. These plans must provide for minimum automatic salary deferrals – between 3% and 6% of compensation – and the employer must make minimum contributions – either a 3% nonelective contribution or a matching contribution equal to 100% of the employee's contributions up to 1% of compensation and 50% of contributions between 1% and 6% of compensation.

Investment Advice for Participants

A new statutory exemption from the ERISA prohibited transaction rules applies to investment advice provided to participants after 2006.

- For employer-sponsored plans subject to ERISA, a fiduciary that is a registered investment advisor, bank, insurance company or registered broker-dealer may provide such advice if either (1) its fee does not vary with the participant's investment choices or (2) its advice is based on a computer model certified by an independent third party, and if certain other safeguards are satisfied.

- A similar exemption is provided for IRAs, with the additional condition that the computer model satisfy guidelines to be published by the Labor Department.

Plan Investments and Services

Effective generally as of the date of enactment:

- Under another new statutory exemption from the ERISA prohibited transaction rules, service providers who are neither fiduciaries nor otherwise related to a plan may engage in sales, exchanges, leases and loans with the plan so long as the plan receives adequate consideration. This provision will provoke a reconsideration of many practices that currently rely on other, more conditional relief.
- Parties that inadvertently engage in prohibited transactions involving securities and commodities are given 14 days from discovery to correct the transaction without a penalty.
- The regulatory rule blocking “plan asset” treatment, and thus fiduciary status, for investment entities in which plan participation is less than 25% will be determined solely on the basis of investment by ERISA-covered plans, and will disregard investment by non-ERISA governmental and foreign plans.
- Other provisions facilitate block trades brokered by a party-in-interest, transactions through regulated electronic communications networks with parties-in-interest, and certain cross-trading and foreign exchange transactions.

Health Care Provisions

- Rules allowing the transfer of excess pension assets in single-employer plans to separate accounts funding retiree medical expenses are liberalized as of the date of enactment (subject to future guidance to be issued by the Treasury Department), and similar rules are provided for collectively bargained arrangements.
- For tax years after 2006, allowable deductions to fund a medical benefit reserve in certain self-funded association health plans are increased.

Insurance Products

- Prior law permitted the tax-free transfer of cash value from a life insurance contract to pay for qualified long-term care insurance provided under the contract or a rider to

the contract. That rule is extended to annuities. In addition, the section 1035 rules for tax-free exchanges are extended to stand-alone, long-term care contracts and combination contracts, and the DAC treatment of combination contracts is clarified. These changes are generally effective for contracts issued after 1996 in taxable years beginning after 2009.

- For corporate-owned life insurance policies issued or materially changed after the date of enactment, the employer will be taxed on the proceeds received (in excess of premiums and other consideration paid) on the death of an insured who is a former employee, unless certain notice and consent requirements are met and either (1) the proceeds are paid to the former employee's heirs, (2) the insured was an active employee within 12 months of death, or (3) at the time the policy was issued, the employee was a director or highly compensated employee. This tax law change models a substantive change in state insurance law recently adopted in a number of jurisdictions.



Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

George H. Bostick	202.383.0127	george.bostick@sablaw.com
Daniel M. Buchner	202.383.0869	daniel.buchner@sablaw.com
Adam B. Cohen	202.383.0167	adam.cohen@sablaw.com
Ian A. Herbert	202.383.0644	ian.herbert@sablaw.com
Alice Murtos	404.853.8410	alice.murtos@sablaw.com
Robert J. Neis	404.853.8270	robert.neis@sablaw.com
W. Mark Smith	202.383.0221	mark.smith@sablaw.com
William J. Walderman	202.383.0243	william.walderman@sablaw.com
Carol A. Weiser	202.383.0728	carol.weiser@sablaw.com