BENEFITS REVIEW

Special Editon: Pension Protection Act of 2006

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IN THIS ISSUE

A Note To Our Readers

On August 3, 2006, Congress sent much-anticipated pension reform legislation to President Bush for signature. President Bush signed the Pension Protection Act of 2006 (the "PPA") on August 17, 2006. Some have called the PPA the most sweeping piece of pension legislation since the enactment of the Employee Retirement Income Security Act in 1974.

This edition of the Benefits Review newsletter is devoted exclusively to summarizing the major changes made by the PPA. Because of the length of the PPA (almost 1,000 pages), not all changes are discussed in this newsletter. In addition, even for those changes that are described, many of the more technical aspects of the new rules have been omitted.

While some changes made by the PPA will be effective as soon as the act is signed, and a fair number of changes will take effect in 2007, the majority of the changes do not take effect until 2008. If a particular provision takes effect prior to 2008, we have attempted to note that in the summary.

In the weeks and months ahead, we will alert our employee benefit clients to any specific actions that are required as the result of the passage of the PPA. In the meantime, if you have any questions regarding the information contained in this newsletter, please do not hesitate to call any member of the Ford & Harrison Employee Benefits Group. •

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Funding of Nonqualified Deferred Compensation Plans

Effective as of the date the PPA is signed, assets side aside by an employer to fund nonqualified deferred compensation payable to specified officers may become taxable to those officers, if the assets are set aside while the employer sponsors an "at risk" defined benefit plan, while the employer is in bankruptcy, or during the six months before and after the employer terminates an underfunded defined benefit plan. The affected officers include current or former chief executive officers, and the four highest paid former or current officers. If any taxes owed by the officers as a result of such funding are paid instead by the employer, additional interest and excise taxes will be owed. •

New Rules Affecting Defined Contribution Plans

Transfer to PBGC of accounts payable to missing participants. Once final regulations are issued, employers who terminate a defined contribution plan will have the option of transferring the accounts of missing participants to the PBGC for safekeeping and future payment. Employers may be required to provide information regarding benefits payable to missing participants even if the benefit itself is not transferred to the PBGC.

Ability to diversify out of investment in employer securities. Beginning in 2007, participants must be given the right to diversify out of investments in employer securities. The right to diversify is phased in over three years for securities held as of December 31, 2006, but applies immediately to participants who were over age 55 or had completed more than three years of service as of December 31, 2005. The rules require that all participants must be allowed to diversify employee contributions, and that participants with at least three years of service must be allowed to diversify employer contributions. Participants must be provided with 30-day advance notice of their right to diversify out of investment in employer securities, effective for plan years beginning in 2007. For plans holding employer securities, the maximum amount of the required ERISA bond has increased to $1,000,000, effective for years beginning after 2008.

Providing account statements. Generally effective beginning in 2007, participants who are allowed to direct the investment of their plan accounts must be provided with quarterly account statements, and those who do not have that right must receive a statement at least once a year.

Investment advice. Beginning in 2007, employers can arrange to have an investment adviser provide investment advice to plan participants, without violating the prohibited transaction rules of ERISA. The advice must be provided under an arrangement where either the fees paid for the advice are the same regardless of the investments made or where the advice is provided based on a certified computer program. Various disclosure, authorization, and recordkeeping rules apply.

Immunity from liability for participant-directed investments. ERISA Section 404(c) currently provides that employers and other fiduciaries of the plan are not liable for investment losses resulting from a participant's investment decisions, if certain requirements are met. The PPA provides that this protection is not available during so-called blackout periods unless the employer or other fiduciary has met all of his other fiduciary responsibilities in authorizing and implementing the blackout period. The PPA also extends the protections of ERISA Section 404(c) to investments made by the sponsor when it changes the investment options available under the plan, if advance notice of the changes are provided to participants and certain other requirements are satisfied. For years beginning after 2006, default investments will also receive these same protections if an annual notice is provided to participants regarding their right to invest the assets in their account.

Accelerated vesting rules. All employer contributions to a defined contribution plan must now be fully vested after three years of service, or vest in 20% increments over a six-year period, effective for years beginning after 2006 for employees completing at least one hour of service after 2006. •

EGTRRA Changes Made Permanent

All of the pension changes made by the Economic Growth and Tax Relief Reconciliation Act have been made permanent. This includes the increases in deductible IRA contributions, the provision for deemed IRA's, the increases in the Code Section 415 contribution limits, the increases in compensation limits, the increases in elective deferral limits, the changes in the top heavy rules, the provision for Roth contributions, and the relaxation of the plan rollover rules. The expiration of the Saver's Credit after 2006 has also been repealed. Finally, the changes made by EGTRRA affecting qualified tuition reimbursement plans have also been permanently extended. •

Rollover Rules and IRAs

The PPA includes various changes affecting rollovers to or from retirement plans and regarding IRAs, as follows:

- After-tax amounts may now be rolled over to a 403(b) annuity plan that agrees to separately account for those amounts, effective for years beginning in 2007.

- Amounts distributed from qualified plans, 403(b) plans, and eligible governmental 457 plans may now be rolled over to a Roth IRA.

- Distributions to non-spouse designated beneficiaries that are made in a direct trustee-to-trustee transfer now qualify for rollover treatment, effective for distributions made after 2006.

- Between 2007 and 2009, individuals who received matching contributions of 50% or more under a 401(k) plan that were invested in employer securities can make deductible contributions to an IRA equal to three times the normal deduction limit if the employer files for bankruptcy and is subject to indictment for business transactions related to the bankruptcy, if the individual was a participant in the plan six months prior to the bankruptcy filing.

- The income amounts used to determine limits on contributions to IRAs and Roth IRAs, and to determine eligibility for the Saver's Credit, will now be adjusted for inflation beginning after 2006.

- For 2006 and 2007 only, charitable distributions not in excess of $100,000 can be made from the IRA of an individual who has attained age 70-1/2 without being treated as income to the IRA owner.

- Reservists called to active duty for more than 179 days after September 11, 2001 and before December 31, 2007, can withdraw amounts from an IRA (and elective deferrals made to an employer plan) without paying the 10% early payment penalty tax, and can repay those amounts to an IRA within the two-year period ending on the day after the day the active duty period ends. Refunds or credits for overpayment of taxes related to prior withdrawals can be claimed at any time prior to the close of the one-year period beginning on the day after the day the PPA is signed into law.

- Starting in 2007, taxpayers may direct the IRS to directly deposit tax refunds into an IRA maintained by the taxpayer. •

Employer-Owned Life Insurance Policies

Amounts paid to employers under an employer-owned life insurance policy will be excluded from the employer's income only up to the amount paid by the employer for the policy, unless (i) the policy covered a person employed by the employer within the 12 months preceding his or her death, (ii) the policy covered a person who was a director or highly compensated employee of the employer on the date the policy was issued, or (iii) the proceeds are paid to persons related to the insured or are used by the related persons to purchase an equity interest in the employer. In all cases, the employer must notify the insured of the fact of the insurance and obtain consent to being insured. The employer will now have to provide information regarding any such policies to the IRS on an annual basis. These rules apply to policies issued or materially modified after the date the PPA is signed. •

New 401(k) Rules

For years beginning after 2007, 401(k) plans that contain an "automatic" contribution feature will automatically satisfy the ADP and ACP discrimination tests if the automatic contribution percentage is a specified percentage, employer matching contributions equal to 100% of the first 1% and 50% of the next 5% deferred are made for nonhighly compensated employees (or a nonelective contribution equal to 3% of compensation is made), employer contributions are fully vested after two years of service and are subject to distribution restrictions, and a notice regarding the arrangement is provided to employees each year. Employers can give employees the opportunity to revoke the automatic election within the 90-day period of the date it first went into effect. State laws that would prohibit or restrict automatic contributions are preempted by ERISA effective immediately upon signing of the PPA, provided the required annual notice is distributed.

Additionally, plans with an "eligible" automatic enrollment feature will be permitted to make ADP and ACP refunds up to six months after the end of the year without being subject to the 10% excise tax. The 2-1/2 month deadline continues to apply for plans without automatic enrollment. Refunds made within the 2-1/2 or 6-month deadlines are taxable in the year of distribution, and gap period earnings do not have to be distributed. •

Changes in Distribution Rules

The PPA made several changes to current law rules regarding distributions from retirement plans. For example, hardship distributions from 401(k) and 403(b) plans, and unforeseen financial emergency distributions from nonqualified deferred compensation plans, will now include events that create a hardship for a beneficiary of the participant (and not just for persons who are the spouse or dependent of the participant). Also, under current law, certain types of retirement plans (particularly money purchase and defined benefit plans) are generally prohibited from making distributions to participants until retirement. Under the PPA, all retirement plans are now permitted to make distributions to participants once they reach age 62, even if they are still employed, effective for distributions made after 2006. As another example, beginning in years after 2007, plans subject to the joint and survivor annuity rules (generally money purchase and defined benefit plans) must now offer participants who waive the qualified annuity form of payment the ability to elect to receive payment in an optional joint and survivor annuity of either 50% or 75. •

Distribution and Tax Notices

For years beginning after 2006, the tax notice provided to participants must describe the consequences of a participant's decision to elect an immediate distribution, if the participant has the right to defer receipt of their benefit. Also, the tax, consent, and distribution notices may now be provided within the 180-day (rather than 90-day) period prior to the payment date, effective for years beginning after 2006. •

Governmental Plans

A variety of provisions in the PPA affect various types of governmental entities and plans. For example, the rules regarding the purchase of permissive service credit has been expanded to permit purchase of additional credits for years credit has already been given, effective back to the date the permissive service rules were originally enacted. Plans maintained by Indian tribal governments are generally treated as governmental plans, effective for years beginning on or after the date the PPA is signed. Governmental plans are treated as satisfying the minimum required distribution requirements if they operate in good faith with those rules. Public safety employees will not be required to pay the 10% early payment penalty tax on distributions made after age 50 and separation from service, effective for distributions made after the date the act is signed. Retired public safety employees will be permitted to have health or long-term care insurance premiums (up to $3,000 per year) deducted from pension payments and excluded from income if the premiums are paid directly to the insurer, effective for distributions made in 2007. All governmental plans (not just state and local plans) are now exempt from nondiscrimination testing, effective for years beginning after the date the PPA is signed. •

Cash Balance and Pension Equity Plans

The PPA includes provisions authorizing so-called "hybrid" plans (cash balance and pension equity plans), and providing that such plans do not discriminate on the basis of age if certain rules (primarily related to required interest rate credits) are followed. These rules are effective for years beginning after 2007, but employers can elect to apply them to any period after June 29, 2005. The rules specifically permit the accrued benefit to be equal to the hypothetical account balance, eliminating the "whip saw" problem that can occur when the plan's interest credits differ from the statutory interest rate used to make present value calculations. In addition, the PPA provides that it is permissible to convert a traditional defined benefit plan to a hybrid plan after June 29, 2005, if the pre-conversion accrued benefit is preserved (no "wear-away" is allowed) and the participant's account is credited with the value of any early retirement or retirement-type subsidy if and when the participant satisfies the age and service requirements required for the subsidy. All hybrid plans must provide for 100% vesting after the participant has completed at least three years of service, beginning no later than the 2008 plan year. The PPA does not address the status of hybrid plans existing prior to 2005, merely stating that no inferences are to be made as to the status of those plans based on the changes included in the PPA. •

Funding Rules for Single-Employer Defined Benefit Plans

One of the primary drivers for pension reform was the need to address and help eliminate the underfunded status of many defined benefit plans, which pose a risk to the retirement security of individuals and to the financial solvency of the Pension Benefit Guaranty Corporation ("PBGC"), the federal agency that insures benefits payable from these plans.

Generally effective for plan years beginning in 2008, the new funding rules provide a uniform set of rules for calculating an employer's required annual contributions to its defined benefit plans. Calculations are based on the plan's funding target, which is the present value of all benefits accrued under the plan. If the plan's assets are less than the funding target, the plan has a funding shortfall that will be amortized over a period of seven years. If the plan receives a funding waiver for any year, the plan has a waiver amortization charge that must also be amortized over a five-year period. For each year, employers must generally contribute amounts sufficient to fund the benefits expected to be accrued during that year, plus a portion of any funding shortfall, plus a portion of any prior funding waivers. As part of transitional relief, some plans will not have to recognize a funding shortfall if plan assets equal or exceed 92% (for 2008), 94% (for 2009) and 96% (for 2010) of the funding target.

All calculations must be performed as of the plan's valuation date, which, except for plans with 100 or fewer participants, must now be the first day of the plan year. When valuing a plan's assets, employers may generally use an average value determined over a 24-month period in order to lessen the impact of market upturns and downturns. Interest rates used to calculate present values will generally be based on average corporate bond yields, and different rates must be used for valuing benefits payable in the next five years, versus those payable in years 6 to 20 and, those payable 21 years or more in the future. (For 2006 and 2007, interest rates will continue to be based on investment grade bonds as was the case for 2004 and 2005.) Mortality assumptions will be those prescribed by the Secretary of the Treasury, although sufficiently large plans may apply to use assumptions reflecting the actual experience of the plan.

Special funding rules apply to "at risk" plans, i.e., a plan with assets that are less than 80% of the plan's funding target. At risk plans must calculate benefits assuming persons eligible to retire in the next 10 years will retire at the earliest retirement date available and at the age that would result in the highest value of benefits, and may also be required to make an additional contribution if they have been at risk for at least two of the prior four years. Plans with 500 or fewer participants are not subject to the "at risk" funding rules.

The deadline for the minimum required contribution continues to be 8-1/2 months after the end of the year, and quarterly installments continue to be required for plans that had a funding shortfall in the prior year.

A variety of changes have been made to the funding rules in order to prevent underfunded plans from increasing their unfunded liabilities. For example, plans that are less than 60% funded generally may not pay "contingent event benefits" such as benefits payable due to a plant shutdown, unless an additional contribution is made to the plan. Plans that are less than 80% funded generally cannot adopt amendments that would increase the benefits payable under the plan unless additional contributions are made to the plan. Plans that are less than 60% funded generally cannot pay participants benefits that are more valuable than the amount payable as a single life annuity. All benefit accruals under a plan must generally cease if the plan becomes less than 60% funded. Actuarial certifications of improved funding must be made before these limits and restrictions can be lifted. Also, participants must be notified if any of these restrictions impact the plan.

Special rules apply to defined benefit plans maintained by commercial passenger airlines, and to plans maintained by businesses that provide catering services to those airlines, that were frozen as of July 26, 2005. These plans can elect to follow the new funding rules but amortize funding shortfalls over a period of 10 years, or to follow special funding rules. An election to use the special funding rules must be made by December 31, 2006 or December 31, 2007, depending on the first year to which the rules will be applied, and will apply to all future years. An election to use a 10-year amortization schedule must be made by December 31, 2007.

Cont'd on pg. 7

Changes in Deduction Limits

The deduction limit for employer contributions to single-employer defined benefit plans has been increased to facilitate better funding for those plans. The amount deductible for any year is the greater of (i) the minimum required contribution for the year or (ii) the sum of the funding target, the target normal cost, and a cushion amount (generally 50% of the funding target), less the value of the plan's assets. For 2006 and 2007, the deduction limit is 150% of current liability, less plan assets. For terminating plans, the deductible amount is not less than the amount that must be contributed in order to make the plan sufficient for benefit liabilities. Plans covered by the PBGC are disregarded in determining whether the combined deduction limit for defined benefit and defined contribution plans applies. Finally, the combined limit applies to defined contribution plans only if contributions to those plans exceed 6% of compensation. This latter rule applies for years beginning after 2005. •

Funding Rules for Multiemployer Defined Benefit Plans

The PPA establishes special funding improvement rules for multiemployer plans that have a ratio of assets to vested benefit liabilities (i.e., funding ratio) of less than 80%. These plans are placed into three categories based on the severity of their under-funding: "endangered plans" with funding ratios of between 70 and 79 percent; "seriously endangered plans" with funding ratios between 65 and 69 percent; and "critical plans" with funding ratios of less than 65 percent. Any plan which falls into one of these categories must establish a funding improvement or rehabilitation plan, the purpose of which is to improve to 80% funding over a 10 to 15 year period. Also, a plan that falls into one of these three categories may not increase pension benefits and may not accept a new collective bargaining agreement ("CBA") that would decrease contributions, waive contributions for a time, or exclude younger and new employees from participation.

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Funding Rules . . . Single-Employer, Cont'd from pg. 6

Changes were made to the PBGC plan termination rules as well, some of which will likely strengthen the PBGC's solvency, but others of which would seem to have the opposite effect. For example, the new rules provide that in some circumstances, the PBGC's liability to pay benefits will be based on a date that precedes the actual termination date of the plan. On the other hand, the variable rate premium for employers with 25 or fewer employees has been capped at $5 per participant, the PBGC must now pay interest when it refunds premium overpayments, and existing limits on benefits payable to owners have been increased and now apply only to "majority" owners.

Finally, a variety of new disclosure obligations have been added that will impact employers sponsoring defined benefits plans. All employers must now provide an annual funding notice to the PBGC, to participants and beneficiaries, and to labor organizations representing those participants, within 120 days after the end of the year. A similar notice, required only of plans that paid a variable rate premium to the PBGC, has been eliminated for years beginning in 2007. The Form 5500 for the plan will now be required to contain additional information regarding the funding status of the plan, but the summary annual report will no longer be required. The 5500s will need to be remitted to the Department of Labor in a format that can be displayed on the internet, and employers must also post a copy of the 5500 on their own websites. Annual benefit statements must now be provided to plan participants. Terminating plans and plan's funded at less than 80% are subject to new disclosure rules.

Special note: Defined benefit plans that permit lump sum payments must ensure that the present value of any lump sums do not exceed the limits of Code Section 415(b). The PPA has changed the interest rate that is used to perform this calculation, effective for distributions made in years beginning after December 31, 2005. It is possible that lump sum benefits paid during 2006 may have exceeded the 415(b) limit using the rates previously in effect. Look for more guidance on this issue. •

Funding Rules . . . Multiemployer, Cont'd from pg. 7

The PPA requires that the Treasury Department approve any requests by a plan to extend its amortization period for 5 or more years, and provides that one condition of approval is that the plan must adopt a funding improvement plan. There is no exception for plans, like the Central States Pension Plan, that already had received IRS approval to avoid a funding deficiency. Actuaries must annually certify whether the plan is complying with its funding improvement plan. Failure to meet funding improvement plan benchmarks for 3 consecutive years will result in the imposition of the funding deficiency penalties absent a "special circumstances" waiver by the IRS. Special circumstances include large and unanticipated market fluctuations that decrease plan assets by 10% or more, the loss of a substantial contributing employer or other unforeseeable, sudden events.

Beginning in 2008, employers in a critical plan will be subject to mandatory contribution surcharges of 5% in the first year and 10% in all succeeding years until a new CBA is accepted by the plan. These surcharges are in addition to existing contributions under a CBA. When an employer is negotiating a new CBA, the plan must provide the bargaining parties with at least two schedules of contribution increases or benefit reductions or both that will satisfy the funding improvement plan. If the parties are unable to reach an agreement on the schedules, a default schedule will apply. In crafting a schedule, so-called "adjustable" benefits (such as post retirement death benefits, 60-month guarantees, and disability benefits not in pay status) may now be permissibly reduced without violating the anti-cutback rule.

Various changes were made to the withdrawal liability rules. The trucking industry plan rule, which reduces withdrawal liability claims for plans that derive at least 85 percent of their contributions from employers engaged primarily in the trucking industry, was not altered even though the plans sought the repeal of this provision. One of the positive changes for employers was a slight modification of the "pay now, dispute later in arbitration" rule that generally applies to all withdrawal liability claims. Under the PPA, where a pension fund's claim for withdrawal liability is based, in whole or part, on an allegation that the employer engaged in a transaction (such as a sale of assets or stock or a corporate restructuring) to evade or avoid withdrawal liability, a special rule governs interim payment liability for transactions that occurred after 1998. Under the special rule, a small employer (under 500 employees and under 250 participants) will not have to pay first if the transaction occurred at least 2 years before the withdrawal liability demand. A 5-year time frame applies for all other employers. Qualifying employers will be able to avoid making interim payments for 12 months to allow a court or arbitrator to determine whether a principal purpose of the transaction was to evade withdrawal liability. After one year, the employer will have to post a bond equal to the installments due if the court or arbitrator has not rendered a decision.

A new form of partial withdrawal liability has been created under the PPA. Under prior law, when an employer closed a facility or terminal and transferred work to a third party, a partial withdrawal did not occur. Now, when that work is transferred to a nonunion company that is owned and controlled by the participating employer, a partial withdrawal will occur.

The PPA updates and clarifies ERISA Section 4225, which governs the calculation of liability for a withdrawing employer that is liquidating its business. The schedule in subsection (a) that reduces the withdrawal liability claim to a portion of the liquidation value of the company has been updated for inflation. More importantly, language has been added clarifying that subsection (a) applies to both solvent and insolvent employers. Subsection (b), which reduces by 50 percent the withdrawal liability claim for insolvent employers undergoing liquidation, has been retained, but these employers can now elect whether to use subsection (a) or subsection (b) to calculate withdrawal liability.

The PPA added language to ERISA Section 510, prohibiting multiemployer plans from retaliating against an employer that exercises its rights under ERISA, including the right to petition Congress to change the multiemployer plan laws. Plan audits of employers or other retaliatory conduct stemming from an employer exercising its rights are now subject to penalties.

There are also some extremely valuable new disclosure rules that apply to all multiemployer pension plans in 2008. Employers will now be able to obtain plan actuarial reports, investment advisory reports, copies of IRS determination rulings, information about the total number and names of employers in the plan, and critical funding information, among other items. •

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