Employee Benefits Law Action Memo

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NEW PENSION LEGISLATION WILL AFFECT MOST RETIREMENT PLANS

President Bush signed the Pension Protection Act of 2006 ("Act") into law on August 17, 2006. Described by the President as "the most sweeping reform of America's pension laws in over thirty years," the Act introduces new requirements that reform the funding rules for defined benefit pension plans and are designed to strengthen the financial stability of such plans. The Act also contains numerous other changes that will affect most retirement plans, including, among other things, a permanent extension of the once-temporary provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), new rules that encourage participation in Internal Revenue Code ("Code") Section 401(k) plans through automatic enrollment features, and provisions that clarify the legal status of cash balance and other "hybrid" plans. Most of the pension reform provisions are effective for plan years beginning in 2008, but some of the Act's provisions contain earlier effective dates. Plan sponsors should analyze the impact of the Act on their employee benefit plans, and take steps to make any modifications to such plans that are required by the Act or are desirable.

A brief description of some of the more important of the Act's provisions is set forth below:

Act Provisions Affecting 401(k) and Other Defined Contribution Plans

- EGTRRA Changes Made Permanent. The EGTRRA provisions that relate to retirement plans and IRAs, which were scheduled to expire at the end of 2010, were permanently extended by the Act. EGTRRA contained numerous favorable benefit provisions, including providing for "catch-up" contributions for participants age 50 and older, increased contribution limits, enhanced portability provisions, and the addition of Roth 401(k) plans.
- 401(k) Plan Automatic Enrollment. The Act introduced provisions designed to facilitate the implementation of automatic enrollment procedures in Code Section 401(k) plans. In general, the new rules provide for (1) an exemption under ERISA from state withholding rules (such rules were sometimes considered to be impediments to automatic enrollment arrangements), (2) fiduciary relief for investment of participant account balances in certain default investments, and (3) the creation of a nondiscrimination "safe harbor" for automatic enrollment plans that meet certain contribution requirements.
- Faster Vesting of Employer Nonelective Contributions. The Act requires plans to apply either a three-year cliff vesting schedule or a two-to-six year phased vesting schedule with respect to all employer contributions (i.e., nonelective employer contributions and matching contributions) to a defined contribution plan. Previously, these accelerated vesting requirements applied only to matching contributions. The provision is generally effective for plan years beginning after 2006.
- Investment Advice. The Act provides for a new prohibited transaction exemption that allows certain qualified investment advisors to provide investment advice to participants provided that either (1) the advice is based on an approved computer model, or (2) the fiduciary advisor charges a fixed fee for the investment services that is not contingent upon the investments elected by the participant.

New Funding Rules For Single Employer Defined Benefit Plans. The Act contains highly technical requirements that overhaul the current funding system for defined benefit plans. Most of these provisions are effective for plan years beginning in 2008, although certain transition rules delay the full phase-in of some provisions until later years. The changes include:

- Funding Target. Under current law, the funding target is generally 90 percent of a plan's total liabilities. The Act increases the funding target to 100%, subject to phase-in rules during 2008-2010. Plans that experience a funding "shortfall" are required to amortize such shortfall over a period of seven years.

- Interest Rate Assumptions. The interest rate used for funding purposes will be based on a three segment yield curve developed from a 24-month average yield of the top three grades of corporate bonds. Plans must value benefit obligations using different interest rates depending upon when the benefit is expected to be paid (alternatively, a single blended interest rate may be used for valuing all benefits). These rules will be phased in starting in 2008, with full compliance required by 2010. During 2006 and 2007, the interest rate requirements used in 2004 and 2005 will continue to apply (i.e., the interest rates will be based on rates for long-term investment-grade corporate bonds).
- "At Risk" Plans. Plans with more than 500 participants that are considered "at risk" (generally, plans that are less than 80% funded, subject to a transition rule) will be subject to increased contribution requirements.
- Benefit Limitations. The Act generally restricts plan sponsors from making plan amendments that increase benefits if the plan is less than 80% funded. These rules also restrict certain underfunded plans from making lump sum payments, and provide that certain severely underfunded plans must be frozen.
- Restrictions on Funding of Nonqualified Deferred Compensation Plans. The Act restricts an employer's ability to transfer assets to a trust or other arrangement to fund a nonqualified deferred compensation plan for certain executives during (1) the time period that a defined benefit plan is considered "at risk," (2) the time period that the employer is in bankruptcy, and (3) the twelve month period beginning six months before the termination of an underfunded plan in an involuntary or distress termination. These rules are effective after August 17, 2006.

Cash Balance and Other "Hybrid" Plans. The Act provides that cash balance plans and other "hybrid" plans are not inherently discriminatory and may be maintained by plan sponsors without violating age discrimination rules provided certain requirements are met. In general, the new rules:

- provide that cash balance and other hybrid plans will not violate age discrimination rules under the Employee Retirement Income Security Act ("ERISA"), the Age Discrimination in Employment Act ("ADEA"), and the Code if a participant's accrued benefit is equal to or greater than that of any similarly situated, younger individual who is or could be a participant and the plan (1) 100% vests participants after three years of service, and (2) provides interest credits that are not less than zero or greater than the market rate of return;
- prohibit the "wearaway" of a participant's benefit in the conversion of a traditional defined benefit plan to a cash balance or other hybrid plan by requiring that a participant's post-conversion benefit must equal the sum of the pre-conversion benefit under the prior plan formula plus the participant's accrued benefit under the new plan; and
- allow cash balance and other hybrid plans to make a single sum distribution equal to a participant's hypothetical account balance or hybrid formula accumulation (some courts previously required a larger distribution in such situations based on the so-called "whipsaw" effect).

Generally, the provisions regarding cash balance and other hybrid plans are effective for periods beginning on or after June 29, 2005, except for the "whipsaw" provisions, which are effective after August 17, 2006. The vesting and interest credit requirements are generally effective for plan years beginning after December 31, 2007. The Act provides that the hybrid plan changes made by the Act should not create any inferences regarding age discrimination rules before the June 29, 2005 effective date.

Other Act Provisions. The Act contains numerous other provisions, including, among others:

- revised funding rules for multiemployer defined benefit plans;
- technical changes to Pension Benefit Guaranty Corporation ("PBGC") premium requirements;
- new deduction limits that generally increase the deductible limit for contributions to single-employer and multiemployer plans, and the combined deduction limit for employers that maintain both defined benefit and defined contribution plans;
- "phased retirement" rules that generally permit in-service distributions from defined benefit plans once a participant reaches age 62, even if the plan's normal retirement age is later;

- new disclosure rules, including the creation of a new annual funding notice for all defined benefit plans and new requirements regarding individual benefit statements;
- provisions establishing participant diversification rights with respect to plans that invest in employer stock;
- rollover rules that permit, among other things, after-tax contributions to be rolled over from a qualified retirement plan to another qualified retirement plan (either a defined contribution or a defined benefit plan) or a tax-sheltered annuity, direct rollovers from retirement plans to Roth IRAs, and rollovers by nonspouse beneficiaries of certain retirement plan distributions;
- provisions relating to spousal pension protections, including, among other things, rules affecting the validity of certain qualified domestic relations orders, and requirements for plans that offer a 50% qualified joint and survivor annuity to offer a joint and survivor benefit option that provides for at least a 75% survivor benefit;
- rules that permit certain plan sponsors to combine a Code Section 401(k) plan with a defined benefit plan; and
- welfare plan changes, that allow, among other things, certain defined benefit plans to transfer excess assets to a separate account to fund retiree health benefits.

Recommended Action By Plan Sponsors. The Act contains a broad spectrum of employee benefit changes that will affect most retirement plans in some manner. Plan sponsors should take steps now to evaluate how such changes will affect their employee benefit plans. Defined contribution plan sponsors may want to consider the automatic safe harbor provisions to determine if such a design is desirable or appropriate, and to evaluate the current terms of their plans to determine if plan amendments are necessary to comply with the Act's new requirements. Plan sponsors of defined benefit plans should begin to determine how the Act's funding changes will affect their contribution requirements. Plan sponsors that maintain cash balance plans should review their plans to determine if any plan design changes are necessary to avoid age discrimination concerns.

This memo is intended to provide a brief description of some of the more important provisions of the Act. Greater detail regarding some of the Act provisions covered in this memo will be provided in future memos.

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