Client Advisory

KELLEY DRYE

EMPLOYEE BENEFITS PRACTICE GROUP SEPTEMBER 2006

Pension Protection Act of 2006

On August 17, 2006, the President signed into law the Pension Protection Act of 2006 ("PPA"). This comprehensive pension reform legislation fundamentally changes the funding rules for defined benefit pension plans and makes significant changes to laws governing defined contribution plans, cash balance plans, and non-qualified deferred compensation arrangements, among other employee benefit matters. The PPA requires plans to comply with the new laws beginning in 2007, 2008, and beyond; plan amendments generally do not have to be adopted until 2009.

Several governmental agencies, including the Department of Labor and the PBGC, are scheduled to issue additional regulations and guidance on many sections of the PPA in the next year. We will update this memorandum as necessary as these additional materials are made available.

This client alert summarizes some of the PPA's key provisions. Please contact us if you would like to discuss how the PPA impacts your company's retirement plans and what actions are necessary to ensure that your plans continue to comply with applicable laws.

Defined Contribution Plans

Notable items in the PPA that affect defined contribution plans include:

- Clarification that automatic enrollment features in a 401(k) plan override state laws that preclude the withholding of wages without employee consent, provided the employee is given notice of the right to not participate in the plan. While rules regarding how automatic enrollment contributions are to be invested are still to be published by the Department of Labor, the PPA's state law preemption provision is effective as of August 17, 2006. An automatic enrollment plan may use a new optional safe harbor to satisfy current ADP and ACP testing for plan years beginning in 2008.
- Employer contributions made in plan years beginning after 2006 must now vest on either a 3-year cliff vesting schedule or on a 6-year graded vesting schedule (these accelerated vesting schedules already apply to matching contributions made under 401(k) plans).
- Effective January 1, 2007, plans that automatically invest employer contributions in publicly traded employer securities must allow participants diversification rights (with qualifying investment alternatives), generally after three years of service with the employer.
- Subject to certain additional requirements, plan fiduciaries may now give plan participants investment advice without engaging in a prohibited transaction (the plan sponsor must still fulfill its fiduciary

responsibilities under ERISA with respect to the selection and review of financial advisors).

- Plans are now allowed to correct certain qualifying prohibited transactions involving non-employer securities, within a 14-day period, without incurring a penalty.

Defined Benefit Plans

The PPA makes several substantive changes to the rules governing defined benefit plans, including the following:

- **Distributions**: New rules affecting distributions from defined benefit plans include:
    - For plan years beginning on or after January 1, 2007, in-service distributions may be made to employees age 62 and over.
    - With respect to survivor annuities required to be provided under a plan, a plan offering a 75% or greater survivor annuity must include a 50% survivor annuity option, and a plan offering less than a 75% survivor annuity must include a 75% survivor annuity option in addition to its current annuity options. This change is effective for plan years that begin on or after January 1, 2008.
    - Beginning in 2008, the 90-day period for providing participants with the required explanation of the qualified joint and survivor annuity rules, is extended to 180 days. In addition, future regulations will require benefit notices to include a description of the consequences of failing to defer receipt of a benefit.
- **Restrictions on Lump Sums**: The following new restrictions will apply to lump sum payments from defined benefit plans:
    - Lump sum payments must be calculated using new interest rate assumptions (likely to lower lump sum benefit amounts) that will be phased-in over 5 years beginning in 2008.
    - Beginning in 2008, the availability of lump sum payments from under-funded plans will be severely restricted. Generally, a plan that is less than 80% funded can pay only 50% of a participant's benefit in a lump sum with the balance paid as an annuity. In addition, no benefits can be paid as a lump sum if any of the following applies: (i) a plan is less than 80% funded for two years in a row, (ii) the employer is bankrupt and the plan is not 100% funded, or (iii) the plan is less than 60% funded.
- **Cash Balance Plans**: Pursuant to the PPA, employers may convert defined benefit plans to cash balance or similar plans, but the employer must ensure that participants' accrued benefits are preserved. In addition, cash balance plans will now be deemed not to be age discriminatory if the following requirements are met:
    - The plan provides for 3 year vesting or better;
    - The plan credits interest on accounts at a rate not less than zero and not more than a market rate of return; and
    - The plan treats a participant's hypothetical account balance as the

present value of the participant's accrued benefit, thus eliminating the "whipsaw effect" that formerly could result in the value of a lump sum benefit that was different from the value of the hypothetical account balance.

- **Funding Rules**: The PPA has substantially changed the funding rules for both single and multiemployer defined benefit plans by replacing the minimum funding requirements in the Internal Revenue Code and under ERISA effective for plan years beginning in 2008. Some of the notable changes to the new minimum funding requirements are:
  - Full plan funding must be achieved over 7 years with employers making a shortfall contribution each year.
  - An employer's ability to use credit balances to offset required contributions is restricted.
  - An "at-risk" plan (based on funding status) as defined in the PPA will be subject to additional required contributions.
  - Plan amendments that have the effect of increasing plan liabilities by increasing benefits, establishing new benefits, changing the rate of benefit accrual, or changing vesting provisions are restricted if the amendment would result in the plan being less than 80% funded.
  - Plans that have a funded status of 80% or less may be subject to restrictions on benefit accruals and benefit increases.
  - In some cases, plans that have a 60% or less funded status must be frozen.
  - Employers contributing to a multi-employer plan may be subject to an additional 10% surcharge on required contributions depending on the funded status of the plan.

EGTRRA Permanency

Many of the qualified plan changes that were introduced by EGTRRA in 2001 are made permanent by the PPA. Some of these now permanent provisions include:

- Increased benefit and contribution limits.
- Defined contribution catch-up contributions for participants over 50.
- Tax deductions for reinvested ESOP dividends.
- Repeal of the ADP/ACP multiple use test.
- Favorable tax treatment of certain tuition programs.

Additional Notice Requirements for Qualified Plans

New notice requirements pertaining to both defined benefit and defined contribution plans, include the following as applicable:

- Participants in individual account plans that may invest in employer stock, must be given notice of their eligibility to diversify employer stock in their accounts for plan years beginning on or after January 1, 2007.
- The timing of currently required participant benefit notices has been revised effective January 1, 2007.
- The current Summary Annual Report ("SAR") requirement is replaced by a new annual plan notice requirement.

This notice, which must be provided to all plan participants as well as the PBGC, will require more extensive information than is required under current SAR rules. While not yet clear, it appears that the current SAR exception available to small plans will no longer be available.

- Effective for plan years beginning on or after January 1, 2008, employers are required to post basic plan information on their intranet websites if the employer uses the intranet site to disseminate employee benefit information to its employees.

The Department of Labor is expected to publish additional guidance on these new notice requirements, including model language, in the next year.

Non-Qualified Deferred Compensation Plans

- The PPA amends Section 409A of the Internal Revenue Code to also prohibit an employer's setting aside monies for non-qualified deferred compensation benefits when:
  - That employer's defined benefit plan is "at-risk" (based on its funding status) as defined in the PPA; or
  - The employer is in bankruptcy and the defined benefit plan is not 100% funded.
- If an employer is terminating an insufficiently funded defined benefit plan, funds cannot be set aside for any non-qualified plan sponsored by the employer during the 12 month period that begins 6 months prior to the defined benefit plan termination.
- If funds are set aside in violation of the above rules, certain participants in the non-qualified plan will be assessed a 20% excise tax on the segregated amounts at the time of vesting, and if an employer provides any funds to pay this excise tax, these funds will also be included in calculating the excise tax and the employer will be denied a tax deduction for such payment. Note that these restrictions apply to any funds set aside, including funds in a rabbi trust. This provision of the PPA applies to asset transfers made after August 17, 2006.

Corporate-Owned Life Insurance

- The PPA imposes further limits on the tax advantages of corporate-owned life insurance. These new rules are generally effective for insurance contracts issued after August 17, 2006.

Welfare Plan Provisions

The PPA impacts welfare plans by:

- Expanding current law relating to the transfer of excess defined benefit assets to fund retiree medical accounts under both single-employer and multiemployer plans to permit an employer whose defined benefit plans are at least 120% funded, to transfer pension plan assets to fund up to 10 years of estimated future retiree medical expenses (so long as the employer maintains the plan's 120% funded status). This rule is applies to transfers of assets made after August 17, 2006.
- Annuity contracts may now contain a long-term care feature, the cash value of which need not be included in gross income with respect to taxable years

beginning in 2010 (provided new reporting requirements related to the annuity contracts are met).

Roth IRAs

- Effective January 1, 2008, qualified plan participants' and non-spouse beneficiaries' plan accounts may now be directly rolled over into a Roth IRA without first transferring the assets to a traditional IRA.
- The ability to include a Roth feature in a 401(k) or 403(b) plan is now permanent.

Bonding

- The bonding requirement for plan sponsors and fiduciaries of plans holding employer securities is increased to $1 million (currently $500,000) effective for plan years beginning in 2008.

Pension Benefit Guaranty Corporation

- In an effort to shore-up the PBGC and ensure that it has enough assets to meet its obligations, several new rules with respect to calculating variable-rate premiums and termination premiums will be enacted gradually over the coming years. The PPA also expands the PBGC Missing Participant Program to include terminating defined contribution plans and other plans that are not insured by the PBGC. Underfunded pension plans must also meet new filing requirements for plan years beginning on or after January 1, 2008

For more information please contact:

David E. Barry
(212) 808-7618
dbarry@kelleydrye.com

Alan J. Laska
(212) 808-7624
alaska@kelleydrye.com

Pamela D. Kaplan
(212) 808-7980
pkaplan@kelleydrye.com

Victoria E. Anderson
(212) 808-7621
vanderson@kelleydrye.com

Richard S. Chargar
(203) 351-8028
rchargar@kelleydrye.com

Christine E. Quier-Sheth
(203) 351-8031
csheth@kelleydrye.com

Victoria H. Zerjav
(203) 351-8050
vzerjav@kelleydrye.com