

Pension ANALYST

Important Information

Legislation

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Pension Protection Act of 2006 Makes Significant Changes to Single Employer Defined Benefit Plans

This is one of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined benefit plans. This publication focuses on those changes that are effective in 2006 and 2007. Many of the significant changes affecting funding will be effective in 2008. A later publication will discuss the provisions effective in 2008 and beyond. A separate publication will discuss those provisions that apply to governmental and church plans that do not elect to be covered by ERISA (“non-electing church plans”).

WHO'S AFFECTED These developments affect sponsors of and participants in qualified single employer defined benefit plans.

BACKGROUND AND SUMMARY On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The 1000 pages of this new law contain major provisions for comprehensive pension reform and introduce substantial changes to enhance retirement security of American workers and their families.

For defined benefit plans covered by ERISA, PPA revises funding requirements, which will typically increase minimum contributions, impact the measurement of plan assets and liabilities and limit the use of accumulated excess contributions, known as credit balances. PPA also requires enhanced disclosure to participants regarding a plan's funding status. In addition, the new law contains provisions that significantly impact hybrid plans, such as cash balance plans, that were in existence as of June 29, 2005. Prospective conversions of defined benefit plans to hybrid plans are deemed to be non-discriminatory, provided certain requirements are satisfied.

This *Pension Analyst* discusses the PPA provisions that apply immediately (e.g., in 2006, 2007 and retroactively) to single employer defined benefit plans, in an effort to help plan sponsors determine the immediate actions needed to keep their plans in compliance with ERISA and the Internal Revenue Code.

ACTION AND NEXT STEPS The provisions of PPA impact plan funding, design and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and should discuss the new law's impact on their plans with their enrolled actuary. Prudential Retirement's enrolled actuaries are well prepared to respond to your inquiries regarding the effect of the new law on your plan.

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[Next Steps](#)**Provisions Effective Immediately****EGTRRA Provisions Made Permanent**

Many important changes made by the [Economic Growth and Tax Relief Reconciliation Act of 2001](#) (EGTRRA) were scheduled to expire, or sunset after December 31, 2010, unless Congress took action to extend the provisions. Some of the more notable defined benefit plan provisions that PPA has now made permanent include:

- The increased annual compensation limits applied when determining qualified plan contributions.
- The increased limits on the maximum annual benefit limit.
- The revised rules for notification of benefit accrual reductions.
- The simplification of the top-heavy rules, including the definition of key employee.
- The requirement to automatically rollover to an IRA small distributions exceeding \$1,000.
- Multiple rollover rules, including the ability: to make rollovers to and from various types of plans; for a surviving spouse to rollover a death benefit distribution.

EGTRRA permanence is especially welcome news for many plan administrators, who are only just beginning to amend plan documents to fully reflect EGTRRA provisions.

Determination of Average Compensation for Benefit Limits

In general, a participant's annual benefit under a defined benefit plan is limited to the lesser of (1) the participant's highest three years of average compensation, or (2) \$175,000 (for 2006). PPA clarifies that compensation received during years that the individual was not a plan participant may be taken into consideration in determining the three-year average compensation. This provision applies to limitation years beginning after December 31, 2005.

Hybrid Plan Rules

PPA now provides guidance that will enable certain hybrid plans, such as cash balance plans, to satisfy the ERISA, Internal Revenue Code (Code) and Age Discrimination in Employment Act (ADEA) rules prohibiting age discrimination. To satisfy these rules, a participant's accrued benefit must be equal to or greater than that of any similarly situated younger individual (i.e., an individual who is identical in every respect, including period of service, compensation, position, date of hire, work history, but not age) who is or could be a participant in the plan.

PPA also requires a defined benefit plan that is converted into a hybrid plan after June 29, 2005, to protect the accrued benefit of any participant who was a participant immediately before the date the conversion amendment was adopted. The participant's total accrued benefit *cannot be less than* the participant's accrued benefit for years of service before the effective date of the amendment *plus* the participant's accrued benefit for years of service after the effective date of the amendment.

Finally, PPA requires hybrid plans to satisfy specific requirements with respect to vesting, interest crediting and the payment of lump sums.

For hybrid plans in existence on June 29, 2005, the interest rate and vesting requirements apply to plan years beginning after December 31, 2007. However, a plan sponsor may elect to have these requirements apply for any period beginning after June 29, 2005, and before the first day of the plan year beginning after December 31, 2007. A delayed effective date applies to plans maintained pursuant to collective bargaining agreements.

The plan conversion rules apply to plan amendments that are adopted and effective after June 29, 2005. However, a plan sponsor may elect to have these rules apply to plan amendments adopted before June 29, 2005, but effective after that date.

A detailed explanation of the impact of PPA on hybrid plans is discussed in our September 2006 *Pension Analyst*, titled "[Pension Protection Act of 2006 and Other Recent Developments Provide Guidance on Hybrid Plans.](#)"

Extension of 2004 and 2005 Interest Rate Basis for Determining Liabilities

For plan years beginning after December 31, 2003, and before January 1, 2006, the Pension Funding Equity Act of 2004 (PFEA) changed the required interest rate used for determining a plan's current liability. For these years, the required interest rate was a weighted average of monthly composite long term corporate bond rates. The use of this rate had been scheduled to expire for plan years beginning on or after January 1, 2006, and would have been replaced with an interest rate based on 30-year Treasury bonds. However, PPA extends the use of the long term corporate bond rate for the 2006 and 2007 plan years.

Beginning in the 2008 plan year, the method for determining a plan's current liability will be determined on a different basis. This will be discussed in a future *Pension Analyst*.

Funding of Nonqualified Deferred Compensation Arrangements

PPA imposes immediate taxation and a 20% penalty tax on assets set aside or reserved in a trust after August 17, 2006, to pay nonqualified deferred compensation to certain individuals, if that funding occurs during a defined benefit plan's "restricted period."

A "restricted period" is:

- Any period in which the employer is in bankruptcy; or
- The six-month period before or after the date an underfunded plan is terminated in a distress or involuntary termination; or
- For plan years beginning on or after January 1, 2008, any period in which a single employer plan is in "at risk" status.

The provision does not apply to assets set aside before the beginning of a restricted period.

Individuals affected by these rules are the plan sponsor's:

- Chief executive officer;
- Four highest compensated officers (other than the chief executive officer); and
- Individuals subject to section 16(a) of the Securities and Exchange Act of 1934.

A plan sponsor that "grosses up" an executive's compensation (directly or indirectly) to pay the penalty taxes imposed by this new rule cannot take a tax deduction for the gross-up amount. In addition, the gross-up amount must be taken into account for purposes of determining the amount taxable to the individual under Code section 409A.

Disclosure of Plan Termination Information

Effective for plan termination proceedings that begin after August 17, 2006, PPA requires plans to provide to "affected parties" any information provided to the Pension Benefit Guaranty Corporation (PBGC) in connection with the proposed termination. This information must be provided within 15 days after the plan sponsor either:

- Receives a request from an affected party; or
- Provides new information to the PBGC relating to a previous request.

"Affected parties" include:

- Participants;
- Beneficiaries of deceased participants;
- Alternate payees under qualified domestic relations orders;
- Employee organizations that represent any group of participants; and
- The PBGC.

The PBGC may provide guidance on the form and manner in which this information is to be provided, but the law does allow plan sponsors to provide it in written, electronic or other appropriate form. A plan sponsor may charge reasonable fees for providing this information in other than electronic form.

PBGC Limits on Plant Closings

Under PPA, the PBGC treats benefits that are paid as the result of a plant closing or similar unpredictable contingent event occurring after July 26, 2005, as if the plan amendment providing these benefits had been adopted on the date the event occurred. As a result, the five-year phase-in period for the PBGC guarantee of these benefits begins on the date the shutdown or unpredictable event occurred. Previously, the guarantee was phased-in from the date the contingent event plan provision was adopted, which was typically before a shutdown actually occurred, resulting in larger liabilities for the PBGC.

Interest on Refund of PBGC Premiums

Before the enactment of the new law, the PBGC charged interest on underpayments of premiums but did not pay interest on overpayments. PPA now authorizes the PBGC to pay interest on premium overpayments. Interest accruing for periods beginning on August 17, 2006, will be calculated at the same rate and in the same manner as interest charged on premium underpayments.

Employer Bankruptcy

If a plan sponsor enters into bankruptcy or similar proceedings on or after September 16, 2006, and terminates its plan while in bankruptcy, the date the plan sponsor entered into the bankruptcy proceedings will be considered the plan termination date for purposes of determining the:

- PBGC guarantees; and
- Allocation of assets to annuity benefits that were being paid or could have been paid three years before the date of plan termination.

The amount of guaranteed benefits payable by the PBGC is based on plan provisions such as salary, service and the guarantee in effect on the date the employer entered bankruptcy.

The sponsor must notify the plan administrator when the sponsor enters bankruptcy. The plan administrator must notify plan participants and beneficiaries of the bankruptcy and of any benefit limitations if the plan is terminated while underfunded. PPA requires the Department of Labor (DOL) to issue guidelines on the form and content of the participant notice. PPA also permits the DOL to assess a civil penalty of up to \$100 a day for each failure to provide the notice. Each violation with respect to any single participant is a separate violation.

New Deduction Rules

For taxable years beginning in 2006 and 2007, PPA provides that the maximum deductible contribution amount for a single-employer defined benefit plan is 150% of the plan's current liability, minus the value of plan assets.

In addition, a special combined plan contribution deduction limit applies when an employer sponsors both a defined contribution plan and a defined benefit plan covering one or more of the same employees. This limit is the greater of:

- 25% of compensation paid or accrued during the plan years; or
- The contribution necessary to meet the minimum funding requirements, but not less than the amount of the plan's unfunded current liability.

Effective for contributions made for tax years beginning in 2006 and 2007, the combined plan deduction limit does not apply if the defined contribution plan contributions are 6% or less of compensation for beneficiaries under the plan.

Retiree Health Benefits

Previously, an ongoing defined benefit plan could only transfer excess assets to a separate health account within the plan to be used for current retiree health costs. In order to make such a transfer, the plan had to have excess assets equal to at least 125% of the plan's current liability minus the lesser of the market or actuarial value of assets.

For transfers made after August 17, 2006, PPA permits a plan with assets exceeding 120% of the plan's current liability (or funding target) to transfer two but not more than ten years of estimated retiree medical costs to a health account under the plan. The maximum amount that can be transferred is the lesser of the assets in excess of 120% of current liability or the sum of retiree health liabilities. Assets must be reduced by credit balances when determining the amount of excess assets.

For all years for which a transfer has been made, the employer must make contributions sufficient to maintain the plan's 120% funding level (or transfer assets back from the health account to the pension plan).

Interest Rate Assumptions for Lump Sums

A plan must adjust the annual benefit limit (\$175,000 for 2006) if a participant takes a form of payment other than a single life annuity or a Qualified Joint and Survivor Annuity (QJSA). If a single sum payment (or certain other forms of payment) is made, the plan must use an interest rate equal to or the greater of the rate specified in Code section 417(e)(3) or the rate specified in the plan when making this adjustment.

For plan years beginning in 2004 and 2005, PFEA replaced the Code section 417(e)(3) rate to be used for determining maximum benefit limits with a rate of 5.5%.

However, PPA now requires that effective for distributions made in years beginning after December 31, 2005, the interest rate assumption used for purposes of adjusting a lump sum payment to comply with the benefit limitation rules may not be less than the greater of:

- 5.5%;
- The rate that produces a benefit of not more than 105% of the benefit calculated using the minimum value lump sum interest rate; or
- The interest rate specified in the plan.

Sponsors may need to review lump sum payments previously paid in 2006 to determine if overpayments or underpayments have been made and may need to take corrective action. Hopefully, the IRS will provide guidance in this regard, since PPA was enacted in the second half of the calendar year.

Under PFEA, sponsors were also required to amend their plans by the end of the 2006 plan year to reflect these requirements. However, PPA has extended this amendment deadline to the last day of the 2008 plan year.

QDRO Rules Clarified

Effective August 17, 2006, and subject to regulations that the DOL must issue by August 17, 2007, PPA clarifies that the mere fact that a domestic relations order is issued after another domestic relations order or revises another domestic relations order does not cause the order to fail to meet the requirements of a qualified domestic relations order (QDRO). Plan sponsors should be aware of the pending DOL regulations, in case they receive domestic relations orders that may be subject to those rules.

Increased Penalties for Coercive Interference with ERISA Rights

Coercive interference with ERISA rights occurs when a person uses fraud, force or violence (or the threat of force or violence) to restrain, coerce or intimidate any plan participant or beneficiary to interfere with or prevent the exercise of his ERISA rights. A willful act of coercive interference is a criminal offense, subject to fine and/or imprisonment. Effective for violations occurring on or after August 17, 2006, the maximum fine amount is increased from \$10,000 to \$100,000, and the maximum prison term is increased from one year to ten years.

Provisions Effective in 2007

Several important PPA provisions are effective in 2007. Some of these provisions are purely operational in nature, while others will require plan amendments. While formal plan amendments may not be needed until 2009, plan sponsors will need to keep track of when and how each new provision was put into place, to be able to adopt the appropriate amendments.

Extension of Participant Notification Period to 180 Days

Qualified plans must provide certain notices to participants and their spouses before distributions may be made. These notices include: the QJSA notice, which must be provided to a participant and his spouse if the plan is subject to the QJSA rules and an optional form of payment may be elected; the notice to a participant describing available optional forms of payment, including the right to defer distribution, if QJSA notices are not required; and the notice explaining tax and rollover rules. Effective for distributions made on or after January 1, 2007, the time period for providing any or all of these notices is expanded. The notices will have to be provided no more than 180 days and no less than 30 days before the distribution or annuity starting date.

In addition, PPA directs the IRS to issue rules requiring the notice that describes an employee's right to defer distribution to also describe the tax and retirement savings consequences of not deferring a distribution. Until those regulations are issued, plan sponsors must make a "reasonable attempt" to comply with the new rules.

Non-Spouse Beneficiary Rollovers

Effective for distributions made on or after January 1, 2007, non-spouse beneficiaries will be able to directly rollover death benefit distributions to IRAs. These IRAs will be treated as inherited IRAs and later distributions will be subject to the minimum required distribution rules that apply to IRA beneficiaries (rather than those that apply to owners). Indirect 60-day rollovers are not permitted.

Rollover of After-Tax Amounts

PPA expands the rollover options available for the distribution of employee after-tax contributions. Effective for distributions made on or after January 1, 2007, after-tax amounts may be directly rolled over from a qualified plan to any other qualified plan, including a defined benefit plan, or to a section 403(b) arrangement or IRA. The receiving plan must separately account for the nontaxable after-tax amounts and the taxable related earnings, if both amounts are rolled over. Indirect 60-day rollovers are not permitted and after-tax amounts may not be rolled-over from section 403(b) arrangements to qualified plans. While plans must permit these rollover distributions, and may have to be amended to reflect these new rules, plans will not have to accept rollover contributions of these amounts. Plans that choose to accept such contributions will have to be amended to reflect the new provisions.

Pension Plans May Make Limited In-Service Distributions

Generally, defined benefit plans do not allow in-service payments to a participant who has not terminated employment, although plans are permitted to allow payments once a participant reaches his normal retirement date, even if still employed. The IRS had previously proposed phased retirement rules in 2004 that permitted a pension plan to pay participants a portion of their accrued benefit before normal retirement age, provided the participant's work schedule was reduced.

However, effective for plan years beginning on or after January 1, 2007, defined benefit plans will be able to make distributions to active employees who have reached age 62, even if the employee has not reduced his work schedule. Plans are not required to permit in-service distributions. If a plan sponsor chooses to offer in-service distributions, the plan would have to be amended. This amendment would be considered a "discretionary amendment" that would have to be adopted by the last day of the plan year that it is effective.

Benefit Statements

Effective for plan years beginning on or after January 1, 2007 (later, for certain collectively-bargained plans), defined benefit plans must either:

- Provide benefit statements at least once every three years to participants who have a vested accrued benefit and are still employed at the time the statements are provided; or
- Give each participant, at least annually, a notice of the availability of a benefit statement and the manner in which it can be obtained.

The plan administrator must also furnish a statement to a participant or beneficiary, upon written request. However, no more than one statement must be provided upon request during any 12-month period.

The benefit statement must indicate:

- The total benefits accrued;
- The vested accrued benefit or the earliest date on which the accrued benefit will become vested; and
- An explanation of any permitted disparity or floor-offset arrangement that may be applied in determining the accrued benefits.

PPA directs the DOL to provide model statements, satisfying these requirements, by August 17, 2007.

PBGC Premiums for Small Plans

For plan years beginning on or after January 1, 2007, PPA provides that the per participant variable rate premium for a plan sponsored by a “small employer” will be no more than \$5 times the number of participants in the plan at the end of the preceding plan year. A “small employer” is a plan sponsor that has 25 or fewer employees on the first day of the plan year. All employees of all members of a plan sponsor’s controlled group are considered in determining the number of employees.

Next Steps

Prudential Retirement will continue to monitor the IRS, PBGC and DOL’s published guidance regarding these new rules. As guidance is provided, we will make changes to the services that we provide to assist plan sponsors with their plan administration responsibilities.

At this time, service providers who offer plan documents (e.g., IRS pre-approved plans) are looking for additional clarification about plan amendment requirements. In general, PPA provides that required plan amendments may be effective retroactively and will not violate the anti-cutback rule, as long as the plan is operated in compliance with the new provisions as of the appropriate effective dates and the amendments are adopted on or before the last day of the first plan year beginning on or after January 1, 2009. While recent [IRS guidance](#) sets forth adoption deadlines for “interim amendments” (reflecting statutory or regulatory changes) and “discretionary amendments” (reflecting voluntary plan design changes), this guidance also provides an exception to these deadlines when a new law provides a different amendment deadline. IRS representatives have recently indicated that the PPA amendment deadline supercedes the standard interim and discretionary amendments deadlines.

In the interim, plan sponsors must operationally comply with the provisions of PPA, based on the various effective dates. Sponsors should review the contents of this publication to assess the impact of PPA on their plan’s administration, forms and funding. They should also consult with the plan’s enrolled actuary with respect to the impact of PPA on any plan design changes. Sponsors of hybrid plans should examine their plan provisions to determine if design changes may be needed.

If you have any questions about the information discussed in this *Pension Analyst* and how the PPA changes affect your plan design or operation, please contact your plan’s enrolled actuary.

**Summary of Pension Protection Act Provisions
Effective Before January 1, 2008
For ERISA Single Employer Defined Benefit Plans**

Changes Effective Retroactively

- EGTRRA permanence
- Revised calculation of average compensation for benefit limit purposes (limitation years beginning on or after January 1, 2006)
- Hybrid plan conversion rules (conversions made after June 29, 2005)
- Extension of 2004 and 2005 interest rate basis for determining liabilities (plan years beginning on or after January 1, 2006)
- PBGC limits on plant closings (events that occur after July 26, 2005)
- New deduction rules (for tax years beginning in 2006 and 2007)
- Interest rate assumptions for lump sums (distributions made in years beginning after December 31, 2005)

Changes Effective upon Enactment (August 17, 2006)

- Funding on nonqualified deferred compensation arrangements
- Disclosure of plan termination information
- Interest on refund of PBGC premiums
- QDRO rules clarified
- Increased penalties for coercive interference with ERISA rights
- Employer bankruptcy notification rules (for bankruptcy proceedings on or after September 16, 2006)
- Retiree health benefits

Changes Effective in 2007

- Extension of maximum pre-distribution notice period to 180 days
- Ability for non-spouse beneficiaries to make direct rollovers to IRAs
- Expanded ability to make direct rollovers of after-tax amounts
- Ability to make in-service distributions at age 62
- Expanded benefit statement requirements
- PBGC premiums for small plans

Pension Analyst by Prudential Retirement

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