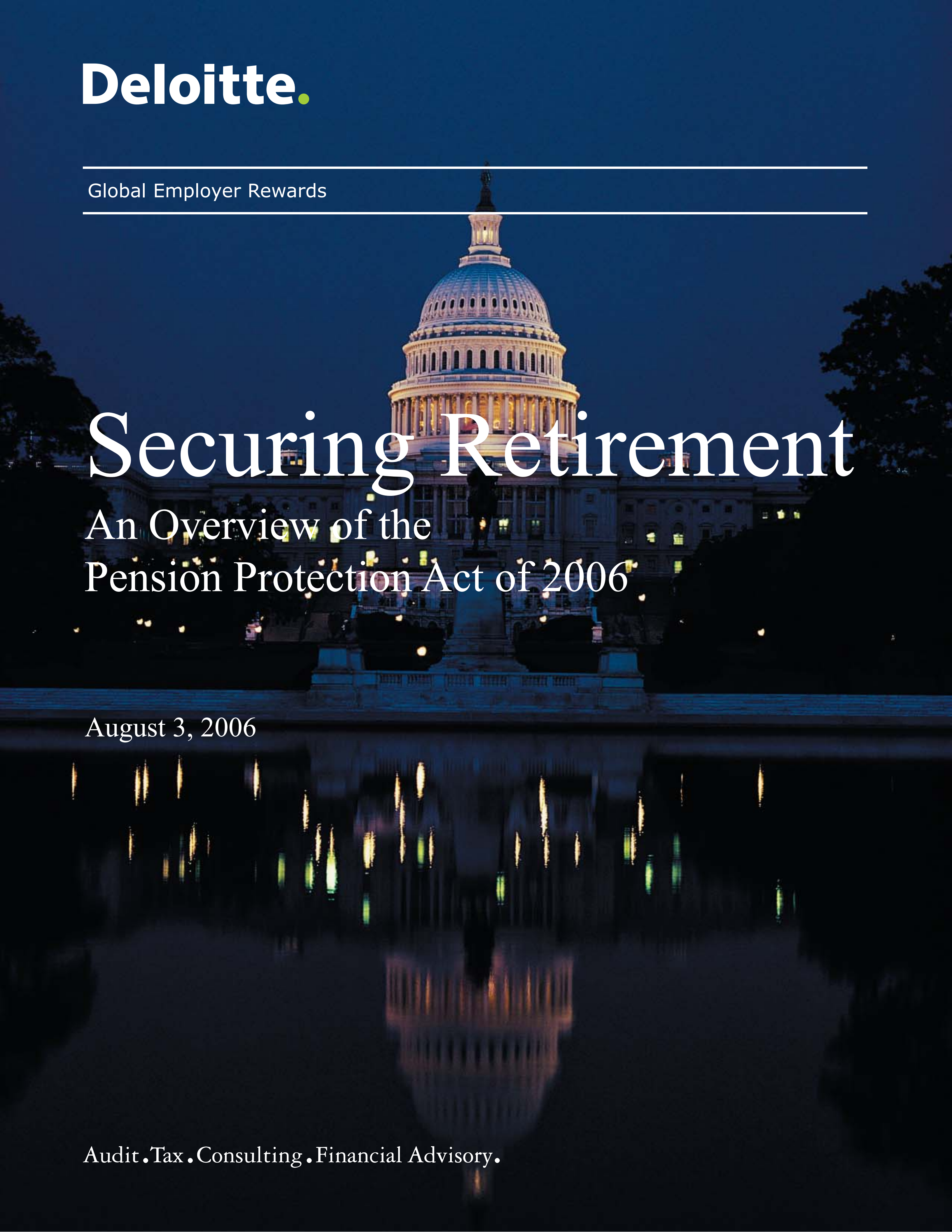

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# Securing Retirement

## An Overview of the Pension Protection Act of 2006

August 3, 2006

Audit . Tax . Consulting . Financial Advisory.

# Contents

# Introduction

In the early part of this decade, two circumstances -- declining stock market values and an artificially low interest rate used for discounting pension obligations -- combined to spark a crisis among sponsors of defined benefit plans. The nation's retirement system had already been rocked by the collapses of corporate giants such as WorldCom and Enron, in which thousands of employees lost retirement savings in their defined contribution plans. Those events focused congressional attention on retirement security. Tightening economic factors also created growing pension liabilities and contribution obligations for sponsors of defined benefit plans. The resulting hardships faced by sponsors of traditional defined benefit plans prompted many to re-evaluate continuing these plans.

Economic factors have since eased and corporate failures have receded from the headlines, but the effect on the U.S. retirement system lingers. At the end of 2004, the Pension Benefit Guaranty Corporation (PBGC) reported claims in excess of $11 billion dollars, covering over 391,000 participants. The bulk of these stem from a few large plan terminations that took place in 2002, 2003, and 2004. In many of these cases, the terminating plan was underfunded and the PBGC assumed responsibility for payment of benefits. The terminations called into question the PBGC's long-term solvency. Since the end of 2004, more large pension plans have terminated and still others threaten termination.

The chain of events has had a stinging effect on American workers: those saving for their future must deal with greater uncertainty about their long-term financial security and a growing awareness that more and more of the responsibility for providing for their future rests with themselves and not their employers.

## The Pension Protection Act of 2006

To remedy these problems, Congress has approved the Pension Protection Act of 2006 (the Act), a comprehensive reform package that models, to some degree, aspects of a proposal for improving pension funding rules put forth by the Bush administration in early 2005.

In brief, the Act will simplify and transform rules governing the funding of defined benefit plans, accelerate funding obligations of employers, prospectively clarify the rules for cash balance plans, make permanent the revisions enacted in 2001 that were set to expire in 2010, strengthen diversification rights and investment education provisions for plan participants, and encourage automatic enrollment in defined contribution 401(k) plans. From another vantage point, these changes will have dramatic effects on the cash flow, reported earnings, and benefit payments of businesses sponsoring plans -- issues of great concern to CEOs, CFOs, and HR directors.

This publication, *Securing Retirement: An Overview of the Pension Protection Act of 2006*, provides a concise guide to navigating the significant pension issues addressed by the Act as well as health care related provisions that may affect employee or retiree benefits. It does not address unrelated provisions of the Act including those that deal with charitable giving and tariffs. Written with corporate leaders and plan administrators in mind, the chapters provide insights on:

- The Act’s new funding rules for defined benefit plans;
- The employee’s view (addressing how quickly or flexibly benefits may be received, and concerns of current and future retirees);
- Retirement plan design and operation (including rules for hybrid plan designs and “automatic enrollment” 401(k) plans);
- Temporary pension-related provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) that will now become permanent; and
- Health care provisions.

Overall, the changes discussed here will likely cause many employers and plan sponsors to review their existing plans for compliance or to consider evaluating other plan designs. Many employers will see an increase in their funding obligations. Moreover, the Act reflects the trend away from traditional defined benefit plans toward 401(k) plans and hybrid designs. Thus, the Act includes rules governing automatic enrollment in these plans. The Act’s provisions on hybrid plans and automatic enrollment remove much of the legal uncertainty surrounding these plans.

Finally, the importance of making permanent the pension-related provisions of EGTRRA cannot be overstated. EGTRRA increased contribution limits for a range of retirement accounts and significantly simplified their portability, plan design, and administration rules. The loss of these provisions would have had a profound impact on plan sponsors and participants.

The Act is unlikely to be the last word on congressional pension reforms, but it certainly marks the culmination of a reform initiative that started at the beginning of this decade. It sets into place a retirement plan system that for years to come will reflect the current administration and its strong support of individual responsibility as America saves for its future.

# Chapter 1: The Employer's Funding Obligation

The Act completely replaces the prior rules governing the funding of single-employer defined benefit pension plans with a new standard keyed solely to the plan's funded status. The general principle is that a plan's required contribution equals the present value of benefits earned by participants during the current year plus the amount needed to amortize any funding shortfall over no longer than seven years. In the case of severely underfunded (at-risk) plans, special rules increase the funding obligation. These rules are generally effective in 2008. The Act also extends -- for 2006 and 2007 -- the funding relief previously enacted in 2004.

## Determining Funded Status

A plan's funded status is determined by comparing the value of plan assets to the present value of the plan's benefit obligations as of the valuation date. Plans with more than 100 participants must use the first day of the plan year as their valuation date. Smaller plans may select a different date, which then can be changed only with IRS consent.

### Measuring Benefit Obligations

The present value of the plan's benefit obligations is determined on the basis of actuarial assumptions that are reasonable both individually and in the aggregate and represent the actuary's best estimate of anticipated experience under the plan. The interest and mortality assumptions used to value benefits are set by the Act. Other assumptions, such as the ages at which participants will retire, are selected by the employer and the plan's actuary.

Under the Act, plans are required to value benefit obligations using different interest rate assumptions depending on when the benefit is expected to be paid. For purposes of determining the appropriate interest rate, benefits are grouped into three segments: (1) benefits expected to be payable within five years, (2) benefits expected to be payable after five years but within 20 years, and (3) benefits expected to be payable after 20 years. The segment rates are based on a corporate bond yield curve, intended to reflect current market-determined interest rates averaged over two years. Alternatively, plan sponsors may elect to use a single blended interest rate, still based on the yield curve, for valuing all benefits. That election may be revoked only with IRS consent. The Treasury Department will publish the interest rate assumptions monthly.

Beginning in 2008, the corporate bond yield curve method will be phased in, with full implementation beginning in 2010. During the transition period, the new rates will be blended with those calculated under the current method.

| Observations |
|---|
| A decision to use the blended rate may, depending upon the plan's demographics, have a substantial impact on contribution requirements for the short term. Because it is irrevocable, it should only be made after careful analysis. |

The Act directs the Treasury Department to (1) establish a new mortality table for valuing benefits, (2) update it every 10 years, and (3) establish a separate mortality table for disabled participants. Very large plans may request permission to use mortality tables based on their own experience.

In addition, the Act requires that actuarial assumptions used to value benefits include an explicit assumption regarding the probability that participants will elect optional forms of benefit that are more valuable than the plan's normal form of benefit.

## Measuring Plan Assets

In general, plan assets are valued at fair market value as of the valuation date. The Act allows averaging to reduce the effect of market fluctuations, but with less flexibility than existing law allows. The Act reduces the longest permissible averaging period from five years to two years and requires that the value lie between 90 percent and 110 percent of fair market value on the valuation date. By using a shorter period and narrower corridor than currently permitted, plan sponsors will experience greater volatility in plan assets and in their funding obligation.

While some employers are required to make quarterly contributions, minimum funding contributions may be made up to 8-1/2 months after the end of the year. Employers have broad discretion to attribute contributions to particular plan years, as long as the contributions for each year are at least equal to the minimum required contribution. In general, a contribution intended to satisfy the minimum funding standards for a particular year is excluded from the value of assets for that year, whether it is made before or after the valuation date. Contributions made after the valuation date cannot be included in the value of plan assets, unless they are made on account of an earlier plan year.

## Comparing Plan Assets to Benefit Obligations

Once the values of the plan assets and benefit obligations have been determined, the two are compared. The ratio of assets to liabilities determines whether the plan is classified as fully funded, overfunded, underfunded, or at risk. A plan's funded status directly affects the amount of the required contribution.

# The Plan Sponsor's Annual Funding Obligation

An employer's minimum required contribution for a plan year equals the plan's target normal cost and shortfall amortization installment (and, where applicable, the funding waiver adjustments), modified for any carryover of funding standard account or prefunding balances.

## Target Normal Cost

The target normal cost is the present value of all benefits that are expected to accrue or to be earned under the plan during the plan year. This includes prior-year benefit accruals that increase because of compensation increases in the current year. Cost is calculated using the actuarial assumptions mandated by the Act, as described above.

## Shortfall Amortization Installments

If the ratio of plan assets to benefit obligations is less than 100 percent, a funding shortfall exists. The funding shortfall attributable to a plan year is amortized in level annual installments over seven years, beginning in the year of the funding shortfall. If in any year during the amortization period the plan’s underfunding increases to more than the present value of the remaining installments, including those attributable to any funding waivers, then the excess constitutes a new shortfall amortization base, which must be separately amortized over a seven-year period.

When the value of plan assets is at least equal to the value of benefit obligations, there is no funding shortfall and no more shortfall amortization installments are required.

The Act provides transition relief for 2008, 2009, and 2010. Avoiding a funding shortfall for those years requires a ratio of only 92 percent, 94 percent, or 96 percent, respectively. If there is a funding shortfall in 2008 or 2009 after applying the reduced percentage, no further use of the transition rule is allowed. In addition, the transition rule is not available for plans established after 2007 or for plans that were underfunded and subject to the requirement to make additional deficit reduction contributions in 2007.

| Observations |
| --- |
| Whether a plan is 91 percent or 92 percent funded for 2008 will make a big difference. Under the transition rule, if the plan reaches the 92 percent level, it will be treated as if it had no shortfall. By contrast, a plan that is only 91 percent funded will require shortfall amortization contributions, beginning in 2008, based on the difference between 100 percent of the value of liabilities and the value of plan assets. |

## Funding Waivers and Waiver Amortization Installments

As under existing law, the Act allows plan sponsors in financial hardship to request permission from the IRS to forgo making all or a portion of a required contribution. If a funding waiver is granted, the minimum required contribution for the plan year is reduced by the amount of the waiver. The amount waived for a plan year must be amortized in level annual installments over five years, beginning with the year after the waiver was granted.

## Credit for Carryover and Prefunding Balances

Plans that have made contributions in excess of the required minimum funding in prior years have unused funding standard account credit balances that, under prior law, could be used to offset contributions that they would otherwise have been required to make. These balances are preserved under the new rules, but they may be used to reduce an employer's minimum required contribution only for years in which the ratio of the value of plan assets to benefit obligations is at least 80 percent.

A prefunding balance arises when contributions for a particular year exceed the minimum required contribution under these rules. These balances are available to reduce required contributions if the ratio of plan assets to benefit obligations is at least 80 percent and there is no remaining pre-Act funding standard account credit balance.

# Special Rules for At-Risk Single-Employer Plans

A plan is at risk if its funded percentage for the preceding year is (1) less than 80 percent, determined *without* regard to the at-risk rule, and (2) less than 70 percent, determined *with* regard to the at-risk rules. A transition rule reduces the 80 percent threshold to 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010.

At-risk plans raise special concerns, because their termination may result in lost benefits for participants and increased liabilities for the financially strapped Pension Benefit Guaranty Corporation. To minimize these possibilities, the Act includes a number of special rules that increase the minimum required contribution for at-risk plans and impose additional PBGC reporting requirements on sponsors of plans that are less than 80 percent funded.

## Determining the Increased Funding Requirement

The Act increases required contributions to at-risk plans by increasing the target normal cost and the present value of accrued benefit obligations. This result is reached by assuming that all employees who become eligible to elect benefit commencement during the next 10 years will retire at the earliest possible date and elect the form of benefit with the highest present value. If the plan also was at risk in at least two of the prior five years, the target normal cost is further increased by 4 percent (based on the cost calculated using the assumptions applying to plans that are not at risk), and the value of plan liabilities used to calculate funding shortfalls is also increased by 4 percent (again based on the value calculated without the special at-risk assumptions) plus a loading factor of $700 per participant  The objective is to induce additional funding that will bring the plan out of "at-risk" status more rapidly than the ordinary amortization of funding shortfalls.

Under the Act, the full at-risk contribution is not required for the first plan year the plan is at risk. The increase in the contribution is phased in over five years. In the first year a plan is at risk, the minimum contribution is equal to the amount required for a plan that is not at risk, plus 20 percent of the difference between that amount and the amount required by the at-risk calculation.

# Timing of Contributions

As under existing law, the Act requires minimum required contributions to be made no later than eight-and-a-half months after the end of the plan year. If the plan had a funding shortfall for the preceding year, the employer is required to make quarterly contributions. The amount of each quarterly installment is 25 percent of the lesser of (1) 90 percent of the minimum required contribution for the current plan year or (2) 100 percent of the minimum required contribution for the preceding plan year. For calendar-year plans, the installments are due on April 15, July 15, October 15, and January 15 of the following year. The due dates for fiscal-year plans are the corresponding dates in the plan year. Special rules apply to plans holding large amounts of illiquid assets.

The sanctions for late or missed quarterly contributions include interest penalties, notification of participants and, possibly, liens in favor of the plan, enforceable by the PBGC.

# Liberalization of Deduction Limitations

The Act's elimination of the existing funding rules makes the existing deduction limitation obsolete. Beginning in 2008, the new deductible limit is (1) the target normal cost for the year, plus (2) the amount necessary to fully fund plan liabilities as of the beginning of the year, assuming that the at-risk standards apply, plus (3) 50 percent of the unfunded liability as of the beginning of the year, plus (4) an additional cushion based on anticipated benefit increases in future years, all minus the value of the plan's assets for the year. In no event can the deduction limit be less than the plan's minimum required contribution.

To facilitate faster funding before the new rules become effective, the deduction limit for 2006 and 2007 is increased from 100 percent to 150 percent of the plan's unfunded current liability, as calculated under pre-Act law.

# Other Changes for Single-Employer Plans

## Funding Notice Requirement

The Act requires PBGC-insured plans to distribute an annual funding notice to participants, with copies to the PBGC and any union that represents employees covered by the plan. This notice must disclose information about the plan's funded status, the allocation of its assets, and other matters. It is due no later than 120 days after the end of the plan year. For plans with 100 or fewer participants, the deadline is the same as for the Form 5500 annual report. The new notice is first required for plan years beginning in 2008. The Secretary of Labor is directed to publish a model notice within one year.

# Changes for Multiemployer Plans

Under the Act, multiemployer plans will be subject to funding requirements that are separate from those for single-employer plans.

The Act preserves the pre-Act minimum funding standards for multiemployer plans, with minor revisions. More significantly, it creates a temporary set of rules, effective through 2014, for shoring up the funded status of multiemployer plans whose funding places them in "endangered" or "critical" status.

Under the Act, most funding standard account bases established after 2007 are subject to a uniform 15-year amortization schedule. (Current amortization periods can be as long as 30 years.) Current rules will continue to apply to amortization bases established before 2008. There are a few exceptions to 15-year amortization. In certain cases, with IRS approval, amortization periods may be increased to as long as 25 years. There are no significant changes to the principles governing actuarial methods and assumptions. For example, the use of yield curve interest rates is not mandatory. A requirement that actuarial assumptions be reasonable individually, as well as in the aggregate, has been added but will have little practical effect.

## Special Rules for 'Endangered' or 'Critical' Status Plans

The Act provides temporary rules, effective through 2014, to improve the funding condition of seriously underfunded multiemployer plans.

In general, a multiemployer plan is considered to be in "endangered" status if it is less than 80 percent funded or has (or is projected to have within the next six years) an accumulated funding deficiency. If both of those conditions are present, the plan is in "seriously endangered" status. Its condition is "critical" if it is projected to fail to satisfy the minimum funding standards or to become insolvent within a period of three to six years (depending upon its current funding level and other factors).

The Act requires an endangered (or seriously endangered) plan to adopt and implement a funding improvement plan, including contribution increases and benefit reductions, designed to increase its funding percentage over 10 years (15 years for seriously endangered plans). The funding improvement plan is intended to result in the elimination of one-third of the underfunding in an endangered plan or one-fifth of the underfunding in a seriously endangered plan.

A multiemployer plan in "critical" status must adopt a rehabilitation plan that sets forth actions to enable the plan to emerge from critical status by the end of a 10-year period. The Act imposes a 10 percent surcharge on each employer's contribution during the "critical" status period (5 percent in the initial year).

Each year during the funding improvement or rehabilitation period, the plan's actuary must certify whether the plan's funding is progressing according to schedule, and penalties may be imposed for actions that impede attainment of the funding goals. If, for example, an employer fails to timely make the contributions required by its plan, it is subject to an excise tax equal to the delinquent contribution.

A plan operating under a funding improvement or rehabilitation plan in 2014, when these requirements otherwise sunset, will continue to operate under the applicable plan until it attains its goals or the 10- or 15-year period expires.

# Chapter 2: The Employee's View

As discussed in Chapter 1, the new funding rules likely will accelerate the funding obligations of employers sponsoring defined benefit pension plans. The other part of the plan's funding equation, of course, is how quickly or in what form plan benefits may be paid to retirees.

As part of its efforts to increase the solvency of defined benefit plans, the Act addresses the competing interests of current retirees on the one hand, and future retirees and plan sponsors on the other. It gradually adjusts the interest rates used to convert accrued benefits into a lump sum in order to bring them into line with long-term market rates and reduce the implicit subsidy that results from the current conversion methodology. It also places restrictions on new pension benefits and certain types of executive compensation that may be provided by sponsors of severely underfunded plans.

## New Assumptions for Calculating Lump-Sum Distributions

The Act changes the assumptions for calculating lump-sum distributions from defined benefit pension plans. A defined benefit pension plan may offer a lump-sum distribution as an optional form of benefit as long as it is actuarially equivalent to the life annuity benefit payable to the participant. Actuarial equivalence is calculated based on the interest rate and mortality assumptions specified by law.

### Changes to Interest Rate Assumptions

The Act requires plans to convert accrued benefits to lump-sum equivalents using rates based on the corporate bond yield curve. Similar to the funding rules, segment rates apply in making this calculation. Thus, the interest rate will depend on when the benefit would have become payable if the participant had delayed distribution until the plan's normal retirement age. However, unlike the funding rules, the rate is based on yields during a one-month (rather than a 24-month) period preceding the distribution date.

The corporate bond yield curve rates will generally be higher than the 30-year Treasury rate that applies under prior law. In a present-value calculation, higher interest rate assumptions generate lower lump-sum amounts. Although this by itself might encourage individuals to elect a lump sum before the new rates apply, the Act includes a phase-in period that will mitigate the impact of these increased rates. Beginning in 2008, a participant's lump sum will be determined based on a mixture of the corporate bond yield curve and the 30-year Treasury rate, with full implementation of the corporate bond yield curve in 2012, as the following chart illustrates:

| Phase-In of New Interest Rate Assumptions | | |
|---|---|---|
| **Calendar Year** | **Interest Rate Components** | **Method** |
| 2006 | 100% 30-Year Treasury | 30-Year Treasury |
| 2007 | 100% 30-Year Treasury | 30-Year Treasury |
| 2008 | 20% Corp Bond Yield Curve + 80% 30-Year Treasury | Mixed Rate |
| 2009 | 40% Corp Bond Yield Curve + 60% 30-Year Treasury | Mixed Rate |
| 2010 | 60% Corp Bond Yield Curve + 40% 30-Year Treasury | Mixed Rate |
| 2011 | 80% Corp Bond Yield Curve + 20% 30-Year Treasury | Mixed Rate |
| 2012 and after | 100% Corp Bond Yield Curve | Yield Curve Method |

| Observations |
|---|
| As individuals near the date at which they would like to receive a lump-sum distribution, potential changes in the interest rate assumption become important. A higher rate will produce a lower lump-sum distribution. By itself, the Act will cause rates to increase from year to year during the phase-in period. These changes could result in an approximately 2-3 percent reduction in the amount of a lump-sum distribution if all other factors remain constant. Individuals contemplating lump-sum distributions should consider these changes in making their decisions. |

## Mortality Table

Under the Act, the mortality assumptions used to value lump-sum distributions will be determined by reference to the mortality table published by Treasury for funding purposes. The impact of these changes on lump-sum amounts is much smaller than the effect of the interest rate modifications.

# Benefit Limitations

Current law limits the annual benefits that can be paid from a defined benefit pension plan to the lesser of (1) 100 percent of the participant’s average compensation for the participant’s highest consecutive three years, or (2) an indexed dollar amount ($175,000 for 2006). The maximum benefits are expressed as a straight-life annuity. If benefits are paid at different commencement dates or in different forms, such as a lump sum, adjustment factors, including interest rates, are applied to the benefit in testing whether it complies with these limits. The interest rate assumption used for this conversion was temporarily set at 5.5 percent for plan years 2004 and 2005, but was set to revert to prior levels in 2006. Beginning in 2006, the Act provides that the interest rate cannot be less than the greatest of 5.5 percent, the rate providing a benefit of no more than 105 percent of the benefit that would be provided if the interest rate used to calculate lump-sum distributions were used, or the rate specified in the plan.

| Observations |
|---|
| The higher the interest rate used to test lump-sum distributions, the more likely it is that a given lump sum will exceed the limits, even if the participant's annuity benefit was within them. For highly compensated employees whose plan benefits are paid from both the qualified retirement plan and a companion nonqualified supplemental retirement plan (SERP), the practical effect will be to shift the obligation for the benefit payment to the nonqualified SERP. |

# Limitations on Benefits Based on Plan's Funded Status

The Act imposes a variety of new benefit limitations on single-employer plans whose funded status falls below specified levels. Poorly funded plans may be subject to restrictions on benefit accrual, benefit increases, or accelerated payment of benefits, depending upon the degree of underfunding. The following chart summarizes the various restrictions that begin to apply at various levels of underfunding:

| Plan Restrictions Based on Funded Status | |
|---|---|
| **Less than 80 Percent of Benefit Obligations Funded** | **Less than 60 Percent of Benefit Obligations Funded** |
| • No amendment that increases benefits<br>• Limited accelerated forms of distribution | • No amendment that increases benefits<br>• No accelerated forms of distribution<br>• No additional benefit accruals<br>• No shutdown benefits |

In addition, the Act contains rules that restrict the funding of executive compensation if the plan is at risk.

## Benefit Limitations for Plans Less Than 80 Percent Funded

The Act generally prohibits an employer from amending an underfunded plan to increase benefits, establish completely new benefits, change the rate of benefit accrual, or change the rate at which benefits become vested. These prohibitions apply if the plan is less than 80 percent funded, or would be less than 80 percent funded as a result of the amendment. Amendments are permitted, however, if the plan sponsor, over and above its other funding obligations, contributes an amount equal to the increase in the funding shortfall attributable to the amendment or brings the plan's funding up to the 80 percent level.

In years in which plans are less than 80 percent funded but more than 60 percent funded, the Act limits the payment of benefits in lump-sum form. The maximum permissible lump sum is the lesser of (1) 50 percent of the value of the participant's accrued benefit or (2) the actuarial equivalent of the maximum pension guaranteed by the PBGC with respect to the participant. The balance of the benefit must be paid as an annuity. The same restriction applies to the purchase of an insurance company annuity to provide benefits. If the plan is less than 80 percent funded for two years in a row, all lump-sum payments and annuity purchases are banned. These restrictions do not apply, however, to plans under which no participant has accrued any benefits during the period beginning on September 1, 2005, and ending with the plan year of the distribution.

## Benefit Limitations for Plans Less Than 60 Percent Funded

In the case of plans that are less than 60 percent funded, the amendment restrictions described above remain in effect, no accelerated form of distributions can be made, and two additional restrictions apply.

First, all benefit accruals must cease until the first plan year in which funding is brought up to the 60 percent level.

Second, benefits payable on account of an "unpredictable contingent event" cannot be paid to any participant if the plan is less than 60 percent funded (or would become less than 60 percent funded after the benefits were paid). This restriction applies to any benefit payable (1) solely by reason of a plant shutdown or (2) upon an event other than the attainment of a specified age, performance of any service, receipt or derivation of any compensation, or upon death or disability. These payments are permitted, however, if the plan sponsor makes a contribution, in addition to its minimum contribution, to fund them or to increase the plan's funded status to at least 60 percent.

## Measuring Funding Status for Purposes of Benefit Limitation

For purposes of these rules, the funded status is the ratio of assets (minus carryover and prefunding balances) to the present value of the benefit obligation, adding to both the numerator and the denominator the aggregate amount of annuity purchases for nonhighly compensated employees in the prior two years.

## Presumptions of Underfunding

In general, a plan's funded status for a year is presumed to be equal to the funded status from the prior year, until the actuary certifies the funded status for the current year. If the actuary does not certify by the first day of the fourth month of the plan year, the plan's funded status for the current plan year is presumed to be the same as in the prior year if the plan was subject to a restriction in the preceding year. If the plan was not subject to a restriction in the preceding year and the funded status was less than 10 percentage points above a threshold that would require the imposition of restrictions (i.e., 80 percent or 60 percent), the current-year funded status is deemed to be 10 percentage points less than for the prior year unless the actuary certifies otherwise by the first day of the fourth month of the plan year. For example, if the plan was 85 percent funded in the prior year, then, absent a certification, the current-year funded status is presumed to be 75 percent, with the result that restrictions on benefit increases and lump-sum distributions will apply during that year.

If the plan's actuary fails to certify its funded status by the first day of the tenth month of the plan year, it is presumed to be less than 60 percent funded. As a result, the restrictions that are triggered for plans that are less than 60 percent funded will apply during the entire plan year, retroactive to the first day of the year.

## Restrictions on Executive Deferred Compensation

The Act restricts an employer's ability to set aside assets in a trust or other arrangement to fund nonqualified deferred compensation for the company's top five executive officers during (1) the period that the employer's defined benefit pension plan is considered at risk, (2) the period that the employer is in bankruptcy, and (3) the 12-month period beginning six months before the termination of an underfunded plan. If amounts are set aside in violation of these rules, or subject to provisions that they will be set aside in these circumstances, the executive will be taxed on amounts set aside. The tax will not apply to assets set aside before the restriction period. Any tax gross-up payment provided by the employer to defray an individual's tax liability under this provision is treated as deferred compensation subject to a 20 percent additional tax. The Act also disallows an employer deduction for these gross-up amounts. These provisions apply to transfers after the date of enactment.

| Observations |
| --- |
| The Act's restrictions on setting aside assets in trust encompasses so-called Rabbi trusts, which are designed to hold assets for executive compensation but are subject to the claims of the employer's creditors and thus are generally considered unfunded for tax and ERISA purposes. Traditionally, the tax consequences of funding a Rabbi trust were no different from a mere unsecured promise to pay. The restrictions in the Act would treat Rabbi trusts differently from other unsecured executive deferred compensation obligations. |

# Chapter 3: Plan Design & Operation

The Act makes changes that will help facilitate the adoption of certain plan designs, and will affect the way plans are operated. On a prospective basis, the Act clarifies the rules governing cash balance and other hybrid defined benefit plans -- something that will help facilitate the adoption of these types of plans. In addition, the Act facilitates early retirement by changing the rules regarding in-service distributions from pension plans.

The Act encourages the adoption of automatic enrollment 401(k) plans by preempting state laws that might affect them and providing additional nondiscrimination safe harbor protections. The Act also makes changes that will affect the operation of defined contribution plans by:

- Limiting an employer's ability to mandate a plan's investment in employer stock;
- Making it easier for sponsors to provide investment advice to plan participants;
- Lessening restrictions on plan investments and certain prohibited transactions; and
- Permitting certain small employers to create linked 401(k) and defined benefit plans.

## Cash Balance and Other Hybrid Defined Benefit Plans

The Act resolves, but only prospectively, three of the major controversies surrounding cash balance and other hybrid pension plan designs:

- **Age Discrimination --** Hybrid plans are protected against challenges under age discrimination rules found in the Internal Revenue Code, the Employee Retirement Income Security Act of 1974 (ERISA), and the Age Discrimination in Employment Act (ADEA), so long as their vesting schedules and interest crediting rates meet specified standards.
- **Conversion from Traditional to Hybrid Formulas --** The Act prohibits wearaway of previously accrued benefits following the conversion of a traditional defined benefit plan into a hybrid plan.
- **Calculation of Lump-Sum Distributions --** When a participant in a hybrid plan elects a lump-sum distribution, the plan may distribute just the participant's hypothetical account balance. Under prior law, as interpreted by most courts, a so-called whipsaw effect sometimes required a larger distribution.

A hybrid plan is a defined benefit plan that simulates the hallmark feature of a defined contribution plan -- individual employee accounts -- while leaving investment risk and reward with the employer. The most common form of hybrid plan is a cash balance plan: A participant's benefit is defined as the balance of a hypothetical account, which is credited with annual contributions (usually a percentage of pay) and earnings at a rate specified in the plan. Unlike a defined contribution plan, a cash balance plan does not allocate its actual investment earnings to participants' accounts. Returns above or below the specified rate redound to the benefit or detriment of the employer.

A simple example of a cash balance formula is a pay credit of 5 percent of compensation per year, with earnings credited at the 30-year Treasury bond rate. A participant who earned $50,000 in 2006 would have $2,500 credited to his or her hypothetical account, and that amount would accrue interest thereafter until benefits commenced. Although benefits under a cash balance formula are generally paid in the form of a lump sum, the amount may be paid as an actuarially equivalent annuity or in any other form provided by the plan.

The other popular hybrid formula is the pension equity plan, under which a participant's lump-sum benefit at any time equals a percentage of his or her final pay multiplied by the number of years of credited service. For example, the formula might be 15 percent times years of credited service times average salary for the final five years of service, so that a participant who retired after 20 years would be entitled to a benefit with a lump-sum value of three times his or her final five-year average pay.

A key economic difference between a traditional and a hybrid formula lies in the pattern of benefit accumulation. In a traditional plan, benefits accrued in the early years of participation are worth relatively little, because they represent a commitment to pay a fixed annuity beginning at the plan's normal retirement age. The further in the future payment is to commence, the lower the present value of the benefit. Thus, the bulk of the value of a traditional pension is backloaded and accumulates in the later years of service.

Under a hybrid plan, the present value of the benefit that a participant earns in a particular year is unrelated to the time remaining until retirement. Therefore, benefits accumulate at a steadier rate than under a traditional formula. A corollary is that, if a hybrid and a traditional plan provide equal benefits at normal retirement age, a participant who leaves before retirement will do better under the hybrid plan. For this reason, many companies believe that hybrid plans are more attractive to a mobile work force than traditional pensions.

The hybrid design also has advantages for employers. Funding requirements are less dependent on interest rate assumptions and, thus, are less volatile. In addition, benefits are more easily communicated to employees.

| **Observations** |
| --- |
| During the mid-to-late 1990s, cash balance plans were widely thought to be the future of the defined benefit plan, and conversions from traditional to hybrid formulas were common. This trend was halted by litigation, largely centering on allegations that the reduction in benefits for older workers was tantamount to age discrimination. Apprehension about adopting these plans has increased as a result of some unfavorable court decisions and an IRS moratorium on the issuance of determination letters for hybrid plans. Although the Act contains limitations on conversions and other new restrictions, its overall impact on hybrid plans should be positive, as it will eliminate the controversy that surrounds adoption of such plans today. |

## Age Discrimination and Plan Conversions

The Act more clearly defines the concept of age discrimination in defined benefit plans, negating the argument advanced in a number of lawsuits that giving equal credits to the hypothetical accounts of participants of different ages is discriminatory. The theory was that a dollar credited to an older participant was worth less than a dollar credited to a younger participant, because the older participant had fewer years until retirement and his or her credit therefore translated into a smaller annuity at retirement age. Some courts had agreed with that view. The Act treats benefits of equal present value as nondiscriminatory, regardless of the ages of the participants. It does, however, require hybrid plans to adopt a three-year vesting schedule. In addition, the interest crediting rate may not exceed a market rate of return as defined by Treasury regulations.

The Act imposes restrictions on converting a traditional plan into a hybrid plan. First, each participant's benefits after the conversion must equal the sum of the pre-conversion benefit under the prior plan formula and the post-conversion benefit under the hybrid formula. Under the wearaway technique used in many past conversions, participants with substantial pre-conversion benefits might accrue no new benefits for a period after the switch to a hybrid plan formula.

In addition, a special conversion rule preserves the value of early retirement subsidies associated with benefits accrued under the prior formula. If at retirement the participant has met the eligibility conditions for the subsidy (e.g., no actuarial reduction for early commencement of benefits for participants who retire at or after age 55 with at least 20 years of service) and elects a lump-sum distribution, the value of the subsidy must be included, even if the plan would not normally take it into account.

| Observations |
|---|
| The new accelerated vesting rule will ensure that more shorter-service workers benefit from these plans. Employer costs will increase modestly as a result. The new limitation on interest crediting rates may inhibit certain plan designs that credit accounts with actual investment returns, sometimes even letting participants select the investments. Additionally, the new conversion rule requiring the inclusion of early retirement plan subsidies could substantially increase the cost of conversions.<br><br>The Treasury Department is directed to develop regulations dealing with conversions that occur following corporate mergers and acquisitions, presumably providing more lenient rules to accommodate special circumstances. The deadline for adoption of the regulations in final form is 12 months after the date of enactment. |

## The Whipsaw Effect

By providing that the distribution of a participant's hypothetical cash balance account is sufficient to satisfy his or her benefit entitlement, the Act resolves, for distributions after the date of enactment, an issue that has plagued many cash balance plans and spawned a number of lawsuits.

In a cash balance plan, a participant's benefit is communicated as a hypothetical account balance. Many plan sponsors assumed that a participant who elected a lump-sum distribution was entitled only to that balance. Under prior law, however, a number of courts had concluded that the distribution could not be less than the present value of the participant's projected annuity at the plan's normal retirement age. To make this calculation, the account balance had to be projected using the plan's interest crediting formula, converted into an actuarially equivalent annuity, and then discounted back to the date of distribution using the statutorily mandated factors for converting accrued benefits into lump sums.

Whenever the projection rate was higher than the discount rate, this process resulted in a lump-sum benefit *larger* than the hypothetical account balance. For example, an account balance of $45,000 with a plan that credited interest at 8 percent would result in a required distribution of $59,524 (the future value of $209,743 discounted at the 30-year Treasury bill rate of 6.5 percent). The Act eliminates this outcome. For distributions after the date of enactment, no distribution in excess of a participant's hypothetical account balance is required. The provision does not resolve disputes about past distributions, about which there is continuing litigation.

| **Observations** |
|---|
| Paradoxically, the whipsaw calculation penalized high interest crediting rates, a feature that participants would consider beneficial. The higher the plan's interest crediting rate, the greater the increase in lump-sum distributions over account balances. This artificial inducement to use low interest rates has now been removed. Note, however, that the Act does not encourage boundless generosity, as a plan may not credit account balances with more than a market rate of return. |

## Effective Dates

In general, the provisions concerning hybrid plans are effective for periods ending on or after June 29, 2005, except for the whipsaw amendment, which is effective for distributions made after enactment, and the requirements related to vesting and interest credits, which are effective for years beginning after December 31, 2007. Plan conversions that took place on or after June 29, 2005, will have to comply with the new rules.

# Phased Retirement

The Act provides that defined benefit pension plans can provide for in-service distributions to participants who are age 62 or older. This is intended to enable older workers to become part-time employees and receive pension benefits to maintain their current earnings level. Under current law, in-service distributions from pension plans cannot be made to participants who have not reached the plan's normal retirement age (65 in the majority of plans).

| **Observations** |
|---|
| The IRS has published proposed regulations that would allow pre-normal retirement age distributions in limited circumstances, although they have been criticized as overly restrictive. The Act's provisions are not a complete response, as many companies are interested in offering phased retirement programs beginning at ages earlier than 62. Both Congress and the IRS will likely monitor how useful employers find these changes and we can expect future regulatory guidance and possibly legislative changes to facilitate phased retirement. |

# Automatic Enrollment in 401(k) Plans

The Act removes any perceived state-law impediments to automatic enrollment 401(k) plans and includes new rules to encourage their adoption. Current IRS regulations make it possible for 401(k) plans to use negative elections under which employees' pay is automatically reduced to fund 401(k) contributions until and unless they elect otherwise. This technique has proven effective in increasing participation by young, low-paid, or financially unsophisticated employees. Some states, however, have asserted that it violates local payroll withholding laws notwithstanding that ERISA, with limited exceptions, preempts all state laws that relate to ERISA-covered employee benefit plans.

## ERISA

The Act explicitly protects automatic enrollment plans against state interference, effective on the date of enactment. In addition, it requires that enrollment be accompanied by a notice explaining the participant's right to elect out of the plan or to change the rate of contribution, the time periods for making elections, and how contributions will be invested in the absence of any contrary direction by the participant. Contributions made for automatic enrollees who have not elected otherwise must be invested in accordance with guidelines to be established under Department of Labor regulations.

## Nondiscrimination Safe Harbor

The Act creates an optional nondiscrimination safe harbor for automatic enrollment plans. A plan is deemed to satisfy the nondiscrimination rules for elective deferrals and matching contributions if it provides a minimum match of 100 percent of elective deferrals up to 1 percent of compensation, plus 50 percent of elective deferrals between 1 percent and 6 percent of compensation. For example, a participant with annual pay of $30,000 who defers $1,200, or 4 percent of compensation, under a safe harbor automatic enrollment 401(k) plan would receive a $750 match (100 percent of $300 (1 percent of pay) plus 50 percent of $900). The plan would then not have to perform the 401(k) and matching contribution discrimination tests. The current-law nondiscrimination safe harbor continues to be available for all 401(k) plans, including those with automatic enrollment.

A plan qualifies for the automatic enrollment safe harbor only if the contribution rate for automatic enrollees is at least 3 percent during the first year of participation, 4 percent during the second, 5 percent during the third, and 6 percent thereafter. The plan may specify a higher percentage, up to 10 percent.

| Observations |
|---|
| Employers now have three options for dealing with the 401(k) nondiscrimination rules: (1) perform regular testing, taking corrective action if the plan fails the test; (2) institute automatic enrollment and comply with the new safe harbor; or (3) comply with the old safe harbor. The first option involves the least financial commitment, but executives and other highly paid participants may not be able to defer as much as they would like. Depending on facts and circumstances, either of the |

safe harbors may be the less expensive approach. It should be noted that nothing in the Act requires 401(k) plans to include automatic enrollment, and plans with automatic enrollment are not required to follow the safe harbor design; an automatic enrollment plan can still be tested annually. The approach chosen for complying with the nondiscrimination standards needs to be weighed carefully, since it must be made before the year begins and cannot readily be changed.

### Other Automatic Enrollment Rules

The Act contains several other provisions intended to simplify the administration of automatic enrollment 401(k) plans:

- An employee who is automatically enrolled may be given a 90-day window to elect out of the plan and withdraw the contributions made on his or her behalf and the earnings related to those amounts. The distribution is taxed in the year of receipt and is not subject to the 10 percent penalty tax that ordinarily applies to distributions before age 59-1/2. This rule applies not only to 401(k) plans but also to section 403(b) plans and eligible section 457(b) plans that have automatic enrollment.
- If an automatic enrollment plan performs nondiscrimination testing rather than relying on a safe harbor, refunds to correct violations may be made within six months after the end of the year without penalty to the employer. The normal rule is that the employer must pay a 10 percent excise tax on refunds made later than two-and-a-half months after year-end.
- Two related changes apply to refunds from both regular and automatic enrollment plans. First, attributable income need be added only through the end of the preceding plan year, so long as the refund is made within the two-and-a-half or six-month window. Second, all refunds, regardless of when they are made, will now be taxed in the year of distribution. Previously, refunds made within two-and-a-half months after year-end were included in taxable income for the prior year.
- Plans that give automatically enrolled employees proper notice of their right to opt out of the plan and that invest automatic contributions in accordance with guidelines to be established under Labor Department regulations are treated as complying with section 404(c) of ERISA, which furnishes limited protection against fiduciary liability. Meeting the notice and investment requirements is also a condition for ERISA preemption of state payroll withholding laws. The Act requires the Labor Department to issue final regulations within six months after enactment.

### Effective Dates

Except for the clarification of the scope of ERISA preemption, the automatic enrollment provisions are effective for plan years beginning after December 31, 2007. Prior to that time, employers can continue to rely on current IRS rules permitting automatic enrollment.

## Diversification Requirements

The collapse of Enron highlighted the risks that employees run when they invest a large portion of their retirement accounts in stock of their employer. The Act responds by limiting the ability of plans to mandate investment in employer stock.

The Act requires any defined contribution plan that holds publicly traded employer securities (or nontraded tracking stock related to the performance of a subsidiary of a public company) to permit participants to diversify account balances invested in those securities. At least three materially different alternative investment options must be made available. All participants must be allowed to diversify the investment of their elective deferrals and after-tax contributions. Those with three or more years of service must be allowed to diversify the investment of other contributions made on their behalf. This rule is phased in ratably over three years for securities acquired before 2007, except for participants who are age 55 or older and who have three years of service.

These provisions do not apply to employee stock ownership plans (ESOPs) that have no elective deferrals, after-tax employee contributions, or matching contributions and do not form part of another qualified plan. All ESOPs remain subject to the existing, less stringent diversification requirements.

The new diversification rules are effective for plan years beginning after December 31, 2006, with an extended effective date for collectively bargained plans and for certain ESOPs.

| Observations |
| --- |
| Mandatory investment in employer stock is rare for elective deferrals but not uncommon for matching and other employer contributions. Plans affected by the new rules have a short deadline for compliance, effectively the end of the first quarter of 2007. That is not a great deal of time for what may be a significant alteration of administrative processes. |

# Investment Advice to Participants

ERISA fiduciary standards and prohibited transaction rules often inhibit employers from furnishing investment information to plan participants. The Act creates a new prohibited transaction exemption permitting plan fiduciaries to be compensated for giving participants investment advice, subject to rules intended to limit the possibility of abuse. Different rules apply for employer-sponsored plans and individual retirement accounts.

For ERISA-covered, employer-sponsored plans, a fiduciary that is a registered investment company, bank, insurance company or registered broker-dealer will be allowed to give investment advice to participants without engaging in a prohibited transaction if either (1) its fee does not vary depending on the investment choices that participants make or (2) its recommendations are based on a computer model certified by an independent third party. Under either approach, the statute requires several safeguards, including an annual audit of the arrangement. This exemption is available for advice provided after December 31, 2006.

A similar exemption is provided for individual retirement accounts, except that advice based on computer models will be exempted only if the model complies with guidelines to be developed by the Labor Department. If the Labor Department determines that no suitable computer programs are available, it is directed to develop an alternative prohibited transaction class exemption that will permit disqualified persons to render investment advice to IRA owners under conditions designed to prevent abuse.

# Other Modifications to the Prohibited Transactions Rules

The Act modifies a number of the prohibited transaction rules to deal with plan participation in block trades brokered by a party in interest, transactions with parties in interest through regulated electronic communications networks, and certain cross-trading and foreign exchange transactions. Three of the changes, all of which are effective on the date of enactment, are of particular significance:

- A new exemption permits service providers that are not fiduciaries and have no other relationship to a plan to engage in sales, exchanges, leases, and loans with plans, as long as the plan receives adequate consideration.
- Parties that engage in prohibited transactions involving securities or commodities are given 14 days from the discovery of the prohibited transaction to take corrective action without incurring a penalty. This relief is not available to parties that know or should have known that the transaction was prohibited or for transactions involving employer securities.
- Investment funds and limited partnerships will not be treated as ERISA fiduciaries if investments by ERISA-covered plans account for less than 25 percent of assets of the investment fund or limited partnership. Under prior law, the investments of non-ERISA governmental and foreign plans were also taken into account.

# Combined Defined Benefit/401(k) Plans for Small Employers

The Act allows companies with up to 500 employees to establish combined defined benefit and automatic enrollment 401(k) plans beginning in 2010. These plans will have a single plan document and trust fund, and will be required to file only one Form 5500 annual report. Otherwise, they will operate as separate plans, independently subject to all ERISA and Internal Revenue Code qualification rules. These plans will be subject to strict rules governing minimum benefit and contribution levels, vesting, and uniformity of benefits, rights, and features.

# Chapter 4: Permanency of Prior Law & Related Tax Incentives

The Act makes permanent more than three dozen rules affecting IRA and retirement plan sponsors and participants enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. In the absence of new legislation, these provisions were scheduled to expire at the end of 2010. In general, these provisions:

- Increased the amounts individuals could contribute to tax-favored retirement plans and IRAs (including providing for "catch-up contributions" for those age 50 and older);
- Increased other limits on contributions and pension benefits;
- Created Roth 401(k) plans and made other, simplified, plan design options possible;
- Enhanced portability of retirement benefits by expanding rollover options; and
- Reduced administrative burdens on plan sponsors.

The Act also extends the "saver's credit" scheduled to expire at the end of 2006, enables more individuals to make deductible or Roth IRA contributions by increasing maximum adjusted gross income limits, and shortens minimum vesting requirements.

## Contribution and Other Annual Limit Increases

### Individual Contribution Dollar-Limit Increases

The Act makes permanent the current maximum amounts that an individual can annually contribute to an IRA and defer to a 401(k) or 403(b) plan. If EGTRRA had been allowed to expire, these contribution limits would have reverted to pre-EGTRRA levels with only, at most, adjustments for inflation.

The following table illustrates the limits in effect in 2006, what Deloitte Tax LLP estimates they will be in 2011, and what they would have been without extension of the EGTRRA increases. As the table shows, these limits are significantly greater than what would have resulted had the current rules been allowed to lapse.

| Contribution Limits | | | |
|---|---|---|---|
| **Type of Contribution** | **Limit in 2006** | **Limit in 2011* Under the Act** | **Limit in 2011* EGTRRA Not Extended** |
| IRA | $4,000 | $5,000 | $2,000 |
| IRA Catch-Up (Age 50+) | $1,000 | $1,000 | $0 |
| 401(k)/403(b) Deferral | $15,000 | $16,500 | $13,500 |
| 401(k) Catch-Up (Age 50+) | $5,000 | $5,500 | $0 |
| SIMPLE IRA/SIMPLE 401(k) | $10,000 | $11,500 | $8,000 |
| SIMPLE Catch-Up (Age 50+) | $2,500 | $2,500 | $0 |
| * Estimates based on inflation assumptions in *The Budget and Economic Outlook* (Congressional Budget Office), January 2006. | | | |

## Other Annual Dollar-Limit Increases

The Act also permanently extends the EGTRRA increases in:

- The dollar limit on the maximum contributions for an individual under a defined contribution plan (including employer, employee pre-tax, and employee after-tax contributions),
- The maximum annual benefit an individual can receive from a defined benefit plan, and
- The maximum amount of compensation that may be considered by the plan in calculating benefits and satisfying various regulatory requirements.

If EGTRRA had been allowed to expire, the contribution and benefit limits would have reverted to pre-EGTRRA levels, adjusted for inflation. The following chart shows these limitations in 2006, what Deloitte Tax LLP estimates they will be in 2011, and what they would have been without extension of the EGTRRA increases:

| Contribution and Benefit Limits | | | |
|---|---|---|---|
| **Limit** | **Limit in 2006** | **Limit in 2011* Under the Act** | **Limit in 2011* EGTRRA Not Extended** |
| Defined Contribution Plan Limit | $44,000 | $49,000 | $45,000 |
| Defined Benefit Limit | $175,000 | $195,000 | $175,000 |
| Compensation Limit | $220,000 | $245,000 | $220,000 |
| * Estimates based on inflation assumptions in *The Budget and Economic Outlook* (Congressional Budget Office), January 2006. | | | |

## Percentage and Other Limit Increases

In addition to retaining higher dollar limits enacted in EGTRRA, the Act makes permanent other EGTRRA rules that have the effect of increasing either the amount that can be contributed or the benefit that can be paid from a plan:

- First, the percentage limit on total contributions for an individual participant under a defined contribution plan will remain at 100 percent of compensation, rather than reverting to the pre-EGTRRA limit of 25 percent.
- Second, the limit on benefits payable from a defined benefit plan will be reduced for early commencement only if payment begins before age 62. Prior to EGTRRA, benefits commencing before Social Security retirement age were subject to a reduced limit. Effective for years beginning in 2006, the Act allows compensation earned before an employee became a participant to be taken into account for purposes of determining his or her maximum annual pension benefit, reversing a restriction included in proposed IRS regulations.
- Third, the deduction limit for contributions to defined contribution plans continues at 25 percent of aggregate compensation (up to the compensation limit) rather than reverting to the pre-EGTRRA level of 15 percent for profit sharing plans and 25 percent for money purchase pension plans.
- Fourth, the Act continues the rule that makes contributions on account of 401(k) elective deferrals deductible in full, without regard to any deduction limitations. This EGTRRA change sparked the invention of "solo 401(k) plans," which are now a popular savings vehicle for self-employed individuals.
- Fifth, the limitation on contributions to 457(b) deferred compensation plans for governmental and tax-exempt employers continues to be computed separately from the limitation on deferrals under a 401(k) plan or a 403(b) arrangement. As a result of this "decoupling," employees of these entities may make twice the elective deferrals as other individuals.[1]

| Observations |
| --- |
| Reversion to the pre-EGTRRA compensation limit would have been particularly unfavorable for highly paid defined benefit plan participants. In a traditional defined benefit plan, the additional benefit that accrues in a given year is generally based on average compensation over a period of years (typically the five years ending with the current year). Under current IRS regulations, the reinstatement of the pre-EGTRRA limit on compensation in 2011 would have applied to all years in the averaging period, so that the maximum pay that could be taken into account would have been sharply reduced. Affected participants would not have suffered a benefit cut -- other rules prevent that -- but their benefits would have been frozen, possibly for several years. |

[1] This assumes that the entity sponsors either a 401(k) or a 403(b) plan. Governments cannot sponsor 401(k) plans other than grandfathered plans in existence as of May 5, 1986. Only public schools and organizations exempt from tax under section 501(c)(3) may sponsor 403(b) plans.

# New Design Features

In addition to increasing in the amount that can be saved for retirement, EGTRRA made several new plan design features available. The Act increases the attractiveness of these design features by making them permanent.

## Roth 401(k) Plans

The Act permanently extends a provision allowing plan participants to qualify for the favorable tax treatment of a Roth feature in a 401(k) or 403(b) plan. A Roth feature allows an employee to make after-tax contributions, which, along with earnings, qualify for tax-free distribution if certain conditions are satisfied.

Some 401(k) and 403(b) plan sponsors have been reluctant to adopt Roth features, in part out of concern over their future prospects. One of the requirements for tax-free distribution is that the account be in existence for at least five years. Roth 401(k) and 403(b) accounts, which only became available in 2006, could not have satisfied this requirement. Although this problem likely would have been solved by a legislative correction or regulatory interpretation, the uncertainty was enough to make some plan sponsors reluctant to adopt Roth features. Now that Roth features have been made permanent, more plan sponsors may adopt them.

## Deduction for Reinvested ESOP Dividends

The Act makes permanent rules that allow employers to deduct dividends paid on stock held by an employee stock ownership plan (ESOP), provided that participants are permitted to elect either to take a distribution of the dividends or reinvest them in additional shares of employer stock. Prior to EGTRRA, the ESOP had to distribute these dividends in order for the employer to obtain a deduction.

## Other Plan Design Provisions

The Act permanently extends rules that:

- Make it possible for educational and charitable organizations that maintain 403(b) plans to make contributions for former employers for up to five years following termination of employment;
- Prohibit ESOP allocations to owners of certain closely held S corporations;
- Require automatic rollover of mandatory cash-out distributions between $1,000 and $5,000;
- Permit employers to establish in-plan IRAs; and
- Permit individuals to establish retirement plans for their household help without the risk of an excise tax on the contributions.

The Act also adds a new provision allowing 401(k) and 403(b) plans to make hardship distributions with respect to any beneficiary of a participant, not just a spouse or dependent. The Treasury Department is directed to issue regulations to this effect within six months of enactment.

| **Observations** |
|---|
| The ability to maintain an IRA within an employer's plan is designed to offer more cost-effective investment opportunities to IRA participants. In addition, there can be cost savings to the individual by eliminating separate account maintenance fees. Participants should consider the investment options available in the plan and the potential cost savings when deciding whether to contribute to an in-plan IRA. |

# Portability

## Distributions

EGTRRA significantly eased the rules governing rollovers of retirement savings from one type of tax-favored retirement fund to another by removing barriers that either prohibited specified types of rollovers or required the use of a conduit IRA to accomplish the rollover. The Act further expands rollover opportunities by allowing nonspouse beneficiaries to roll over distributions from qualified plans, 403(b) plans, and some other retirement arrangements, beginning in 2007. In addition, the Act allows direct rollovers from retirement plans to Roth IRAs after 2007. Under current law, a rollover from a plan to a Roth IRA generally requires the interposition of a conduit traditional IRA.

The Act also permanently extends rules that:

- Allow after-tax contributions to employer retirement plans to be rolled over into IRAs;
- Grant the IRS the authority to extend the 60-day rollover period when failure to comply is due to events beyond the reasonable control of the individual; and
- Allow benefits accrued in 403(b) plans or eligible governmental 457 plans to be used to purchase additional service credit in governmental defined benefit plans.

The Act also imposes a new distribution mandate. Defined benefit and money purchase pension plans are required to offer an annuity option with a 75 percent survivor annuity, as well as a lesser option at least equalling the 50 percent survivor annuity that they generally provide already. This requirement is effective for plan years beginning after 2007 (or later for collectively bargained plans).

Another new provision prohibits states from reducing unemployment benefits on account of tax-free rollovers of retirement benefits. It is effective for weeks beginning on or after the date of enactment.

## Vesting

The Act changes the vesting rules for employer contributions made to defined contribution plans after 2006. Special rules apply to collectively bargained plans and certain leveraged ESOPs. Under current law, matching contributions are subject to faster vesting rules than other employer contributions. The Act applies the matching contribution rules to all contributions. The following chart sets forth these rules:

| Vesting Rules | | | | | | |
|---|---|---|---|---|---|---|
| | Current Law | | | | Under the Act | |
| | Matching Contributions | | Other Contributions | | All Contributions | |
| Year | 3-Year Cliff | 6-Year Graded | 5-Year Cliff | 7-Year Graded | 3-Year Cliff | 6-Year Graded |
| 1 | 0% | 0% | 0% | 0% | 0% | 0% |
| 2 | 0% | 20% | 0% | 0% | 0% | 20% |
| 3 | 100% | 40% | 0% | 20% | 100% | 40% |
| 4 | 100% | 60% | 0% | 40% | 100% | 60% |
| 5 | 100% | 80% | 100% | 60% | 100% | 80% |
| 6 | 100% | 100% | 100% | 80% | 100% | 100% |
| 7 | 100% | 100% | 100% | 100% | 100% | 100% |

| Observations |
|---|
| In addition to employers' other turnover costs, the cost of maintaining a defined contribution plan may increase due to the decrease in forfeitures that could have been used to reduce future employer contributions. |

# Changes Affecting Plan Administration

## Simplification

The Act also made permanent a number of administrative simplifications introduced by EGTRRA. These include:

- Repealing the multiple-use test in discrimination testing of 401(k) and matching contributions;
- Eliminating the "same-desk rule," which generally did not allow distributions from 401(k), 403(b), or 457(b) plans when an employee performed the same functions for a successor employer after a merger or other corporate reorganization;
- Shortening from one year to six months the required suspension period for individuals who take hardship distributions from a 401(k) or 403(b) plan;
- Disregarding rollover accounts for the purpose of determining whether a participant's account balance did not exceed $5,000 and therefore could be distributed automatically without the participant's consent;
- Easing restrictions on the elimination of optional forms of distribution in defined contribution plans;

- Easing the top-heavy rules (which require minimum contributions on behalf of non-key employees covered by top-heavy plans) through changes that reduce the likelihood that a plan will meet the criteria for top-heavy status;

- Allowing employers to continue counting matching contributions for purposes of top-heavy minimum contribution requirements;

- Repealing rules that restricted owners of businesses from borrowing from qualified plans; and

- Clarifying that certain employer-provided retirement planning advice is not subject to federal income tax.

The Act also requires the Department of Labor to issue regulations within one year of enactment to ease the restrictions on qualified domestic relation orders by clarifying timing and ordering issues.

## Other Changes Affecting IRA Contributions

The Act extends the nonrefundable "saver's credit," which provides low-income taxpayers who contribute to retirement plans or IRAs a credit of up to $2,000. In addition, beginning in 2007, the income levels used in determining eligibility for the credit will be indexed.

The Act also provides for inflation indexing of the income limits used for determining eligibility for Roth IRA contributions and deductions for contributions to traditional IRAs. Eligibility to make Roth IRA contributions is limited to taxpayers with adjusted gross income below a specified level. In addition, an active plan participant's ability to take a tax deduction for traditional IRA contributions is phased out as the taxpayer's adjusted gross income increases. Prior law specified phaseout thresholds that increased over the years, but were not subject to inflation adjustments. The Act provides for inflation adjustments for these amounts, effective in 2007. In both cases, the new inflation adjustments are made in $1,000 increments.

The Act makes other changes for IRAs. For tax years after 2006, it allows individuals to have a portion of their tax refunds deposited directly into an IRA. In addition, it temporarily allows tax-free distributions of up to $100,000 from IRAs for charitable purposes if an individual is age 70-1/2 or older. These distributions must be made by December 31, 2007.

# Chapter 5: Health Care Provisions

The Act includes several provisions designed to increase funding for retiree medical costs and otherwise provide tax benefits for funding health care and long-term care costs. Some provisions allow the use of qualified plan assets to help subsidize the escalating costs of retiree medical benefits; others expand the use of alternative tax-preferred vehicles to help pay for either current or future insurance coverage.

## Use of Excess Pension Plan Assets

The law currently allows sponsors of single-employer defined benefit plans to transfer excess pension assets once a year to separate accounts used to pay for retiree medical benefits (the one-year transfer). The amount that can be transferred is limited to the expected cost of retiree medical benefits for the year of the transfer. Further, for a sponsor to make such a transfer, plan participants must be vested in their pension benefits and the plan sponsor must maintain retiree medical benefits at a certain level for the year of transfer and the four subsequent years. The Act expands this provision in a number of ways.

### Transfers of Amounts for Future Retiree Health Benefits

The Act offers sponsors of single-employer plans the option of making a transfer of excess pension assets to fund the estimated retiree medical costs of a period of up to 10 years. This transfer is available even in years when the one-year transfer is not available, because the asset accumulations required to qualify for this transfer are not as great as those required for the one-year transfer. Plan sponsors making this transfer will be required to maintain the plan's funded status at this minimum level during the transfer period (either by additional contributions or transfers back from the health accounts), and must maintain retiree medical benefits at a certain level for the transfer period and for four years subsequent to the transfer period.

While employers can start making these qualified future transfers after enactment, the amount that can be funded for future years is to be determined in accordance with guidance to be issued by Treasury.

### Transfers to Fund Collectively Bargained Retiree Health Benefits

The Act allows employers that provided retiree medical benefits under all benefit plans during its taxable year ending in 2005, and whose aggregate cost of providing such benefits in that year was at least 5 percent of gross receipts, to make similar transfers to fund the expected medical costs of retirees covered under the terms of a collective bargaining agreement (CBA). The minimum level of plan funding needed to make any transfer is the same amount needed to make the qualified future transfers discussed above. The maximum transfer is a reasonable estimate of what the employer will pay for the benefits under the CBA (and consistent with generally accepted accounting principles) during the life of the beneficiaries or such shorter time if the CBA limits the benefits. Employers will have to maintain benefits at a level no lower than an amount specified in the CBA.

Employers can start making these transfers after enactment.

### Transfers Permitted for Multiemployer Plans

The Act allows multiemployer collectively bargained plans to make transfers for funding one year of retiree medical costs, but not the expanded funding permitted for single employers under the Act. To do this, all employers contributing to the plan are treated as a single employer, subject to adjustments that Treasury will make as necessary to reflect the fact that the plan is not maintained by a single employer. This change permits transfers in taxable years beginning after 2006.

## Tax-Free Use of Governmental Retirement Plan Dollars for Health and Long-Term Care Insurance Premiums

Beginning in 2007, the Act permits a retired public safety officer to direct, tax-free, up to $3,000 dollars a year from a governmental retirement plan to pay for health or long-term care insurance premiums. A "public safety officer" is a law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew who worked for a public agency. The health or long-term care premium payments must be for the participant, the participant's spouse, or a dependent. The plan must pay the insurer; individuals cannot receive reimbursements for having paid the premiums.

## Reserves Permitted for Association Health Plans

The Act increases deductions for payments to certain association health plans that provide health benefits to employees of members other than through insurance, and without regard to health status. Associations (generally trade associations) establish these group plans to facilitate the provision of health benefits to employees of small businesses.

For taxable years beginning after 2006, the Act allows a deduction to fund a reserve of up to 35 percent of the sum of the medical benefit costs for the current year and the change in claims incurred but unpaid for the current year.

## Long-Term Care Insurance

The Act provides rules that establish the treatment of qualified long-term care insurance coverage to be offered as part of, or as a rider to, an annuity or life insurance contract. In the case of either type of contract, a charge against the cash value for the qualified long-term care portion of the coverage will not be includible in gross income. Rather, the amounts paid for qualified long-term care reduce the individual's investment in the annuity or life insurance contract. Additionally, the Act liberalizes the rules relating to tax-free exchanges of insurance and annuity contracts to include combination products, as well as for exchanges of stand-alone qualified long-term care insurance contracts. The Act also adds a reporting requirement related to charges against the cash value or cash surrender value of a combined arrangement used to pay for qualified long-term care coverage. Finally, the Act clarifies the treatment of policy acquisition expenses by issuers of combination contracts. The Act's changes generally apply to contracts issued after 1996 for taxable years beginning after 2009.

# Chapter 6: PBGC, ERISA, & Special Provisions

## Relief for Airlines

The Act contains special funding rules for pension plans of commercial passenger airlines and airline catering companies. In general, these plans are exempt from the normal funding rules, and can instead elect either to amortize their funding shortfalls over 10 years (instead of the normal seven) or follow special rules that allow shortfalls to be amortized over 17 years.

Several restrictions apply to plans for which the 17-year period is chosen. In general, benefit levels must be frozen and certain benefits must be eliminated altogether. Special participant notice, minimum coverage, and deduction limitation rules also apply. In addition, if the plan terminates, the Act increases the plan sponsor's termination premiums and restricts the Pension Benefit Guaranty Corporation's benefit guarantees.

## PBGC Provisions

Several provisions in the Act affect premiums and benefit guarantees under the single-employer insurance program of the PBGC. Most of these changes are intended to shore up the PBGC. The Act also contains several other provisions affecting plan sponsors and the PBGC.

### PBGC Premiums

Pension plans insured by the PBGC pay both a flat-rate, per-participant premium and a variable-rate premium equal to 0.9 percent of unfunded vested benefits. The Deficit Reduction Act of 2005 (DRA 2005, P.L. 109-171) increased annual flat-rate premiums from $19 to $30 per participant for plan years beginning after 2005, with annual inflation indexing after 2006. The Act does not affect fixed-rate premiums, but it provides new rules for determining variable-rate premiums based on yield curve segment rates, which will be phased in beginning in 2008. The current methodology is retained for 2006 and 2007. The Act also limits the annual variable-rate premiums owed by employers with 25 or fewer employees to $5 per participant for plan years beginning after 2006.

Pension plan sponsors are also subject to termination premiums of $1,250 per participant for up to three years if they "dump" pension liabilities on the PBGC and then emerge from bankruptcy. These premiums, enacted on a temporary basis as part of DRA 2005, are made permanent under the Act.

## Benefit Guarantees

The Act limits the PBGC's guarantee for plant shutdown and other unpredictable contingent-event benefits (benefits that are not payable on account of the participant's age, service, compensation, death, or disability) that occur after July 26, 2005. Guarantees of these benefits are phased in over five years, beginning on the date of the event that gives rise to them. For example, if a plan terminates three years after a plant shutdown, enhanced benefits payable on account of the shutdown are only 60 percent guaranteed.

## Expansion of the Missing Participant Program

Under current law, when participants in a terminating PBGC-insured plan cannot be located, the value of their benefits is transferred to the PBGC, to be held until the proper recipient is found. The Act expands this program to include missing participants in terminating defined contribution plans and certain other plans that the PBGC does not insure. The new program will be available after the PBGC publishes regulations describing it in detail.

## Other Changes Affecting the PBGC

The Act also:

- Requires, subject to certain confidentiality protections, that the information exchanged with the PBGC as part of a distress or involuntary termination be provided to plan participants within 15 days;
- Expands the filing requirements of underfunded pension plans and requires the PBGC to provide Congress with annual summaries of this information;
- Changes the PBGC's benefit guarantee rules for substantial owners and for plans that terminate while an employer is in bankruptcy;
- Grants the PBGC authority to pay interest on premium overpayments;
- Accelerates the PBGC's computation of benefits attributable to recoveries from employers;
- Allows investment-grade employers to use more favorable interest rates for spinoffs of a fully funded pension plan; and
- Subjects the PBGC to greater congressional oversight, including Senate confirmation of its executive director.

# Voluntary Correction Programs

The Act contains the first legislative endorsement of the Employee Plans Compliance Resolution System (EPCRS), the voluntary compliance program that has grown out of IRS compliance programs first initiated in the early 1990s. Under EPCRS, plan sponsors can avoid the harsh consequences of plan disqualification (which mostly befall plan participants) by voluntarily correcting plan compliance failures. The Act calls for continued improvement of the EPCRS program, with an emphasis on making it better understood and more favorable to small employers, reducing the need for IRS approval of plan corrections, allowing more failures to be corrected voluntarily during audit, and assuring overall fairness.

# Plan Amendments and Transition Rules

Plan administrators must operationally comply with the Act in accordance with the effective date of each provision. However, the Act provides that plan sponsors have until the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of governmental plans), to adopt plan amendments and be exempt from the anti-cutback rules.

# Improved Access to Information

The Act contains several provisions that affect access to plan information. For plan years beginning after 2007, it requires certain Form 5500 information to be made available on the Internet and on the employer's Intranet (if it has one). It also changes certain requirements regarding the provision of periodic benefit statements. For plan years beginning after 2006, it requires plan administrators to provide quarterly benefit statements to defined contribution plan participants and beneficiaries who have the right to direct the investment of plan assets, and annual statements to those participants and beneficiaries without such investment rights. The Act generally requires the provision of benefit statements to participants in defined benefit plans at least every three years. Alternatively, a plan administrator may provide annual notice of the availability of such statement. Defined contribution benefit statements must provide an explanation of the importance of portfolio diversification, including a discussion of the inherent risk of holding more than 20 percent of the portfolio in a single security, such as an employer security, and a notice indicating that further information on investing and diversification is available on the Department of Labor Web site. The Act also directs the Department of Labor to issue model benefit statements within one year of enactment.

The Act reduces the information that must be provided in some cases. It eliminates the blackout notice requirement retroactively from enactment for plans that allow for self-directed investment if the plan covers only one individual, or only partners in a partnership, and spouses. For plan years after 2006, it also eliminates the Form 5500 reporting obligations of certain one-participant and partner-only plans with less than $250,000 in assets and simplifies the reporting obligations of plans with fewer than 25 participants.

# ERISA Provisions

The required bond for plan officials is increased from $500,000 to $1 million for plans holding employer securities effective for plan years beginning after 2007. The Act also increases the criminal penalties for coercive interference with the exercise of someone's ERISA rights from a $10,000 fine and one year in prison to a $100,000 fine and 10 years in prison, for violations occurring on or after the date of enactment.

# Employer-Owned Life Insurance

The Act amends the tax treatment of certain employer-owned life insurance. In general, life insurance proceeds are excludable from the gross income of the beneficiary. In recent years, litigation has arisen over the tax or regulatory treatment of contracts covering a broad-based employee population. Under the Act, if an employer owns a life insurance policy on the life of a former employee, any proceeds in excess of the premiums (plus any other amounts the employer paid for the policy) are includable in the employer's gross income. Provided certain notice and consent requirements are met, exceptions apply to amounts paid (1) to the employee's heirs, (2) with respect to an individual who was an employee at any time within 12 months of his or her death, or (3) with respect to an individual who was a director or highly compensated employee or individual when the policy was issued. The Act also imposes reporting and recordkeeping requirements. The Act's provisions generally apply to contracts issued or materially changed after the date of enactment.

# Changes Affecting Certain Entities

The Act contains a number of provisions that apply only to plans maintained by certain entities:

- **Governments and Associated Entities --** The Act contains several provisions that promote retirement savings by participants and address administrative issues. The Act promotes greater retirement savings for government employees by retroactively clarifying the rules for purchasing permissive service credits in order to facilitate their purchase. It also allows individuals who received a distribution from an eligible 457 plan before 1997 to participate in such plans. The Act also contains provisions that ease the administration of governmental plans. Effective for years beginning after the date of enactment, the Act extends to federal and other governmental plans the exemption from nondiscrimination rules that currently applies to state and local governmental plans. The Act also directs Treasury to issue regulations allowing governmental plans to apply a reasonable good-faith standard to comply with the minimum distribution requirements. These rules require distributions by April 1 of the year following the year in which the participant reaches age 70-1/2 or retires, whichever is later. In addition, for years beginning on or after the date of enactment, the Act expands the definition of a governmental plan to include plans maintained by Indian tribal governments.

- **Churches --** For plan years beginning after the date of enactment, the Act provides that certain church plans that self-annuitize, rather than purchasing annuities from an insurance company, can satisfy the required minimum distribution rules by following the rules that apply to section 403(b) arrangements. For years after 2006, the Act increases the amount of pension benefits that can be provided for nonhighly compensated participants by eliminating the dollar limit that applies to annual pension benefits. In addition, for years beginning after the date of enactment, the Act generally exempts church plan investments in debt-financed real property from taxation under the unrelated business income tax rules.

- **Schools --** Generally, effective after enactment, the Act also provides deferred taxation and exemption from age discrimination and various other requirements to certain educational entities' voluntary early retirement incentive and employment retention plans.

# Provisions Affecting Military and Public Safety Personnel

The Act contains special rules for military and public safety personnel. In general, distributions from retirement plans and IRAs are subject to an additional 10 percent tax if the participant is not at least 59-1/2 years old (55 if the participant has separated from service). The Act exempts reservists called to active duty for at least 179 days between September 12, 2001, and December 30, 2007, from this tax. For public safety personnel who participate in governmental pension plans and have separated from service, the Act drops the minimum age requirement for exemption from the tax to 50 (from 55), effective for distributions after the date of enactment.

# Other Relief Provisions

Effective one year after the date of enactment, the Act increases the opportunities for divorced spouses of railroad employees to get retirement benefits under the Railroad Retirement Act.

In addition, under very limited circumstances, participants in 401(k) plans sponsored by certain bankrupt employers under criminal indictment or conviction may make special IRA catch-up contributions for 2007, 2008, and 2009.

The Act also provides for greater transfers of excess funds from Black Lung disability trusts to accident and health plans in taxable years beginning after 2006.

Finally, for remuneration for services performed in years beginning after 2006, test proctors and room supervisors who administer college entrance or placement examinations are given protections under the rules of section 530 of the Revenue Act of 1978 without regard to the consistency rules.

# Appendix: Effective Dates of Principal Provisions

## Provisions Effective Retroactively

- Cash balance and hybrid plan rules (generally on or after June 29, 2005)
- Plant shutdown benefit guarantees (effective for benefits triggered after July 26, 2005)

## Provisions Effective on Enactment

- EGTRRA permanency
- Funding future retiree medical benefits
- Airline funding relief
- PBGC termination premiums
- PBGC missing participant program (upon publication of regulations)
- Employer-owned life insurance (for contracts issued or materially changed after enactment)
- Increased defined benefit plan deduction limits
- Restrictions on executive deferred compensation based on defined benefit plan funding
- Cash balance and hybrid plan whipsaw provisions

## Provisions Effective in 2007

- Joint and 75 percent survivor annuities
- Defined contribution plan vesting
- IRA inflation adjustments
- Investment diversification
- Investment advice
- Phased retirement distributions

## Provisions Effective in 2008

- Defined benefit plan funding (with transition relief through 2010) and related deduction rules
- Benefit limitations based on plan funding
- Funding notice requirement
- Direct rollovers to Roth IRAs
- Calculation of variable-rate PBGC premiums
- Lump-sum distribution interest rate assumptions (phased in through 2012)
- Automatic 401(k) plan enrollment

## Provisions Effective in 2009

- Plan amendments

## Provisions Effective in 2010

- Long-term care insurance tax rules

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