

Client Alert

A report
for clients
and friends
of the firm August 2006

President Signs the Pension Protection Act of 2006 Into Law Today

This afternoon, President Bush signed into law the Pension Protection Act of 2006 (the "Act"). The Act promulgates a significant number of changes to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the Internal Revenue Code of 1986, as amended (the "Code") that will have a far-reaching impact on employee benefit plans, with the majority of changes affecting pension plans.

This Client Alert briefly identifies the most salient provisions of the Act, which extends over 900 pages. Proskauer has already issued several Client Alerts explaining in more detail the terms of particular provisions of the Act and their potential impact on our clients' businesses. We expect to continue to issue more detailed Client Alerts with respect to other provisions of the Act. For a current listing of our recent Client Alerts, please [click here](#).

Changes in Funding for Single Employer Defined Benefit Plans and Related Disclosure Rules

The Act significantly revises the rules for funding single employer, defined benefit pension plans under ERISA and the Code in an attempt to improve the funding level of these types of plans and to minimize financial risk to the PBGC (which is the entity that insures the payment of certain retirement benefits).

The Act generally repeals the existing minimum funding standards (including the requirement that a minimum funding standard account be maintained) and in its place implements a new funding regimen that establishes a 100% funding target, which generally must be satisfied over a seven-year period. The minimum contribution for a particular year will be calculated by adding the value of benefits expected

to be earned for the year to the amount necessary to amortize over seven years any prior or current shortfall in funding. Transition relief allows most plans that were not subject to deficit reduction contributions in 2007 to phase in the 100% funding requirement between 2008 and 2011.

Plans that are financially troubled have additional funding requirements and other restrictions. For example, plans that are considered "at risk" (as determined by a plan's funded percentage and, notably, not the credit rating of the sponsoring employer) are subject to accelerated funding requirements. In addition, employers in bankruptcy or sponsoring plans that are below a certain funding level are restricted in their ability to promise or pay certain benefits; these restrictions range in severity and can include a prohibition on increasing benefits or distributing lump sums to mandating an actual benefit freeze. Moreover, a plan sponsor of a poorly funded plan may be limited in its ability to set aside assets in connection with deferred compensation arrangements for high level executives.

While the Act preserves pre-existing credit balances under the prior law, it also limits their application to plans that are at least 80% funded. As with future contributions in excess of the required minimum, carried over credit balances may be credited with actual returns, but not the plan's assumed return.

The Act also specifies the interest rate and mortality table to be used for funding purposes. For plan years beginning in 2008 and thereafter, the new law will generally require that plans calculate benefit obligations using a segmented yield curve that takes into account when (from among three segments) benefit payments are expected to be made for the particular obligation. There are limited rules that permit election of a blended rate in certain circumstances. (For plan years beginning in 2006 and 2007, the Act allows plans to continue to use investment grade corporate bond interest rates in place of the 30-year Treasury rate.) The mortality

table will be published by the Department of Treasury, although certain plans may be permitted to use tables based on their particular experience.

In addition to providing these rules for valuing liabilities, the Act revises the rules regarding valuation of plan assets in order to ensure that the actuarial value of assets is closer to their fair market value, a change which may result in more volatility in asset values. For example, under the Act, the maximum smoothing period was generally reduced from five years to two, and the actuarial value of assets must be between 90% and 110% of the fair market value.

Other changes include liberalization of the deduction limitations for contributions to fully funded plans (with a transition rule for 2006 and 2007) and a new requirement that single employer plans issue annual funding notices to participants and the PBGC (among others), as multiemployer plans are currently required to do.

The rules described in this section are generally effective for plan years beginning after December 31, 2007, although there are various exceptions and transition rules for particular provisions.

Changes in Funding for Multiemployer Defined Benefit Pension Plans and Related Disclosure Rules

The changes made to multiemployer plan funding rules are somewhat less dramatic than those made to single employer plans because the Act generally retains the current funding standard account approach for funding multiemployer plans. However, the changes that were made will significantly impact the funding of multiemployer plans.

Specifically, the Act now requires accelerated recognition of gains and losses in that plans must amortize past service liability, past service liability due to plan amendments, and experience gains and losses resulting from changes in actuarial assumptions over only 15 years. In addition, as with single employer plan funding rules, the maximum deductible contribution limitations have been liberalized for multiemployer plans.

The Act also creates new funding rules for plans that fall within the Act's "endangered," "seriously endangered," and "critical" categories. Endangered and seriously endangered plans (also known as "yellow zone" plans) must adopt "funding improvement plans" that are intended to increase the plans' funded percentages generally over 10 or 15 years. Critical plans (also known as "red zone" plans) must develop "rehabilitation plans" designed to enable the plans to emerge from critical status generally over 10 years. Depending on a plan's categorization, the Act provides for the reduction of certain previously earned benefits and

contribution surcharges on employers. It also affords limited relief from excise taxes for accumulated funding deficiencies if a plan is complying with its funding improvement or rehabilitation plan.

The Act revises disclosure rules for multiemployer plans, by modifying annual funding notices (which were recently required by the Pension Funding Equity Act of 2004) to reflect these newly created categories and by requiring disclosure to employers, participants and beneficiaries of certain investment and actuarial information.

Lastly, the Act revises certain withdrawal liability rules. For instance, the Act provides that a partial withdrawal occurs if the employer ceases to have an obligation to contribute under one or more (but not all) collective bargaining agreements and transfers such work to another entity owned or controlled by the employer. The Act also provides an exception to the general rule requiring withdrawal liability payments during periods that the employer is contesting the withdrawal liability determination.

The rules described in this section are generally effective for plan years beginning after December 31, 2007, with certain funding rules containing a sunset as of December 31, 2014.

Cash Balance Plans

The Act confirms the prospective legitimacy of "cash balance" and "hybrid" plans, providing that plans that satisfy certain conditions do not violate the prohibitions on age discrimination. The Act also provides a method for converting traditional defined benefit plans into hybrid plans. Significantly, the Act specifically states that its application is prospective and no implication can be drawn with respect to prior law.

These developments were addressed in more detail in our Client Alert entitled, "Tipping the Balance for Cash Balance Plan Sponsors Under the New Pension Act and in the Wake of *Cooper v. IBM.*" For a copy of that Client Alert, please [click here](#).

Defined Contribution Plan Changes

Although a great deal of attention has focused on the Act's provisions related to defined benefit plans, the Act also contains many new rules affecting Section 401(k) and other defined contribution plans. These wide-reaching changes include, among other things:

- Accelerated vesting (three year cliff vesting or 20% per year beginning in year two) for employer nonelective contributions.

- Enhanced diversification rights with regard to investments in employer securities, including immediate diversification rights for employee elective deferrals and after-tax contributions, and diversification rights after three years for employer matching and non-elective contributions.
- A new statutory prohibited transaction exemption for the provision of investment advice by a fiduciary adviser through an “eligible investment advice arrangement” to participants in self-directed individual account plans. This development is described in more detail in our Client Alert entitled, “Investment Advice Provisions Under the Pension Protection Act.” For a copy of that Client Alert, please [click here](#).
- A new safe harbor rule that permits 401(k) plans with automatic enrollment provisions to avoid certain types of discrimination testing for elective deferrals and matching contributions, as well as “top-heavy” rules, if certain requirements are met. In addition, the Act clarifies the preemption (effective immediately) of state wage laws with respect to automatic enrollment and provides certain protection for the establishment of a default investment fund for the accounts of participants who do not make an investment election.
- Clarification of a fiduciary’s responsibilities regarding the selection of an annuity provider.
- The addition of rules permitting hardship withdrawals under a Section 401(k) plan for hardship events with respect to beneficiaries under the plan, and permitting non-spouse beneficiaries of deceased participants to direct a rollover to an inherited IRA.

These changes are described in detail in our Client Alert entitled, “New Pension Act’s Impact on 401(k) Plans and Other Defined Contribution Plans.” For a copy of that alert, please [click here](#).

Plan Assets and Prohibited Transaction Rules

The Act amends ERISA’s “plan asset” definition and creates several new exemptions from ERISA’s prohibited transaction rules that will simplify many financial transactions for ERISA-covered plans and their counterparties.

These changes were described in more detail in our Client Alert entitled, “New Pension Bill Will Amend ERISA’s ‘Plan Assets’ Definition and Add Prohibited Transaction Exemptions.” For a copy of that Client Alert, please [click here](#).

Other Rules

In addition to the above-described changes, the Act contains many other important changes, as briefly summarized below.

EGTRRA Permanence. Effective as of the date of enactment, the Act repeals EGTRRA’s sunset provisions with respect to pension plans and IRAs, thereby making various provisions of EGTRRA permanent.

Retiree Medical Benefits. The Act expands the ability of pension plans to use excess funding for the purposes of funding retiree medical benefits (through a 401(h) health account within the pension plan or a multiemployer health plan).

PBGC Premiums. The Act makes technical changes to the PBGC premiums payable by various types of plans, including the additional premiums assessed to certain terminating plans and special rules for some commercial passenger airline plans and the catering companies that service such airlines. In addition, for plan years beginning in 2008, the variable rate premium (applicable to certain underfunded single employer plans) will be based on a plan’s unfunded vested benefits valued using a three segmented yield curve of investment-grade corporate bonds.

Pension-Related Revenue Provisions. The Act amends various pension-related revenue provisions of the Code, including eligible rollover distributions, hardship distributions, qualified reservist distributions, computation of average compensation for purposes of Code Section 415 limits, and contributions to IRAs and Roth IRAs. For example, the Act liberalizes the combined deduction limit for employers that contribute to both defined benefit and defined contribution plans. In addition, the Act expands the Code’s rollover rules by allowing after-tax contributions to be rolled over into defined benefit plans and tax-sheltered annuities and allowing rollover distributions into a Roth IRA without regard to the 10% early distribution tax. In addition to the aforementioned amendments, the Act increases the annual Roth IRA contribution amount in accordance with inflation.

Other Pension-Related Changes. The Act contains various miscellaneous changes for pension plans. These include, for example, modifying the interest rates and mortality tables used to calculate lump sum benefit payments from defined benefit plans. The Act also revises the pension protections provided to spouses, including requiring a new type of joint and survivor annuity to be offered as an optional form of benefit.

Conclusion

President Bush's action this afternoon marks what is arguably the most change to ERISA (and the related provisions of the Code) since its enactment over 30 years ago. This Client Alert provides only a brief summary of the most significant of those changes. As noted above, Proskauer has issued (and expects to continue to issue) Client Alerts providing a more comprehensive analysis of various provisions of the Act.

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