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Summary of Significant Provisions in the Pension Protection Act of 2006 Relating to Single Employer Defined Benefit Plans

On August 17, 2006, the President signed the Pension Protection Act of 2006 (the "Pension Act"). The Pension Act is hundreds of pages long, and makes significant changes to the rules governing retirement plans. The main focus of the Pension Act is defined benefit plans; specifically, more stringent rules concerning the funding of such plans. These rules will increase the costs of maintaining defined benefit plans. They also will likely continue the trend away from defined benefits plans toward a retirement system more focused on defined contribution plans.

In an earlier Alert (New Pension Legislation will Significantly Change U.S. Pension and IRA Investments) we discussed some of the investment-related aspects of the Pension Act. This Alert provides a summary of the key aspects of the Pension Act which impact single employer defined benefit plans including:[1]

- increased funding requirements;
- increased deduction limitations;
- changes to the rules governing lump sum distributions, and new benefit restrictions on underfunded plans;
- restrictions on nonqualified plan funding;
- reporting obligations;
- PBGC premium calculations; and
- rules governing cash balance plans.

Future Alerts will focus on other aspects of the Pension Act such as the changes to qualified plan distribution provisions and enhanced portability, and the changes impacting defined contribution plans such as automatic enrollment.

Increased Funding Requirements for Defined Benefit Plans

The intent of the Pension Act's funding provisions is to increase the funded status of defined benefit plans in order to make such plans more secure. In general, these rules are effective in 2008 (with certain transition rules). Under these new rules:

[1] This Alert is not intended to summarize every aspect of the Pension Act's provisions relating to defined benefit plans. Instead, we seek to highlight those areas we think are of the most interest to our readers. For more specific guidance regarding the Pension Act's application to any specific situation, please feel free to contact any member of the Compensation & Benefits Group.

- Minimum funding provisions will require annual contributions equal to the present value of benefits accruing during the year plus an amount necessary to fully fund any past funding shortfalls over seven years. Under current law, a defined benefit plan is required to be funded up to 90% of its liabilities rather than the 100% required by the Pension Act. Under current law, plans which were not funded at the 90% level are subject to stricter funding rules.

- Under the Pension Act funding shortfalls (if any) will generally be amortized over seven years. Prior to the Pension Act, defined benefit plans had thirty years to amortize such deficits. The Pension Act's funding shortfall rules are phased in between 2008 and 2010.

- The Pension Act mandates the use of new interest rate assumptions and mortality tables. These rules are phased in starting in 2008, with full implementation in 2010. Under current law defined benefit plans (other than those funded at less than 90%) are allowed to calculate their liabilities based on "reasonable" rates of return and a mortality table specified by the IRS. Plans funded at less than 90% of liabilities are required to use the same IRS mortality table, but are also required to assume a rate of return based on an IRS specified investment-grade corporate bond rate.

  The new interest rate assumptions imposed by the Pension Act (which will apply to all defined benefit plans) are also based on corporate bond rates. However, different interest rates will be used depending on which of three time periods the benefits are reasonably expected to be paid. These categories are:

  - benefits payable within five years of the valuation date

  - benefits payable between five and twenty years from the valuation date; and

  - benefits payable more than twenty years from the valuation date.

  The Pension Act also requires the use of a revised IRS mortality table that is expected to more accurately reflect benefit liabilities. This new mortality table will be updated by the IRS at least every ten years. A different mortality table will apply to disabled participants. In addition, large employers may be able to use a mortality table that reflects their specific employee population.

- The Pension Act retains the existing rule that allows the value of a plan's assets to be determined based on an average over a period of years. However, the Pension Act reduces the maximum permitted period from five years to two years, and requires that the value be between 90% and 110% of current fair market value.

- Plans which are considered "at-risk" under the Pension Act (generally plans with more than 500 participants which fall below certain funding thresholds) will be subject to special accelerated funding rules. A plan will be considered "at-risk" if it is (A) less than 80% funded based on the regular assumptions described above; or (B) less than 70% funded based on special at-risk calculations.

Deduction Limitations

Beginning in 2008, the Pension Act increases the deduction limitations for contributions to defined benefit plans, both to reflect the increased funding obligations and to encourage the full funding of defined benefit plans. In 2006 and 2007, the deduction limit will be increased as well, with the maximum deductible contribution being raised to 150% of the plan's current liability.

Lump Sum Distributions/Benefit Restrictions

- As is the case with the interest and mortality rates used to calculate a defined benefit plan's funding obligations, the assumptions used to calculate the lump sum value of the participant's accrued benefit are similarly changed by the Pension Act. In general, these changes will result in smaller lump sum distributions. These changes will be phased in from 2008 through 2011, and will be fully effective in 2012.

- Under the Pension Act, defined benefit plans which are underfunded may be prohibited from making distributions in any form other than an annuity until the plan attains sufficient funded shares. These funding requirements are phased in starting in 2008. Further, plans which fail to meet these funding requirements will be prohibited from being amended to increase benefits. Finally, severely underfunded plans will be required to freeze future benefit accruals.

Deferred Compensation Plan Funding Restrictions

Effective as of August 17, 2006, certain sponsors of defined benefit plans will be prohibited from funding their nonqualified deferred compensation plans (through either rabbi or secular trusts). These sponsors are those (including members of their controlled group): (A) who are in bankruptcy; (B) who maintain an "at-risk" plan (as defined above); or (C) who have had a defined benefit plan terminated in a distress or involuntary termination during the 12 month period beginning six months before the funding of the nonqualified plan. Violation of this rule will be treated as a violation of section 409A of the Internal Revenue Code. Accordingly, immediate income taxation and a 20% penalty tax based on the nonqualified plan deferrals will be imposed on certain high ranking officers of the nonqualified plan sponsor. Any tax-restoration payment made in response to this section 409A penalty will both (A) not be deductible by the employer; and (B) be includible as part of the amount subject to the section 409A penalties.

Reporting Obligations

The Pension Act imposes a new requirement on defined benefit plan sponsors to provide an annual plan funding notice. A model notice will be available for this purpose. This notice must be provided to the Pension Benefit Guaranty Corporation ("PBGC"), to each plan participant and beneficiary, and to each labor organization representing participants or beneficiaries in the plan. This notice must be furnished no later than 120 days after the end of the plan year for plans with 100 or more participants (with the Form 5500 for smaller plans). The notice generally is required for plan years starting on or after January 1, 2008, but there also are limited notice requirements for the 2006 and 2007 plan years. The notice must include certain specific information, including:

- Events (such as plan amendments or scheduled benefit increases) having a material effect on plan liabilities or assets;

- A statement as to whether the plan's funding target attainment percentage for the applicable plan year, and for the two preceding plan years, is at least 100% (and, if not, the actual percentages);

- The total assets (separately stating the prefunding balance and the funding standard carryover balance) and liabilities of the plan for the applicable plan year and for the two preceding plan years;

- The value of the plan's assets and liabilities as of the last day of the applicable plan year;

- The number of active participants, inactive participants who are receiving benefits, and inactive participants who are entitled to future benefits under the plan; and

- A statement setting forth the funding policy of the plan and the asset allocation of investments under the plan (expressed as percentages of total assets) as of the end of the applicable plan year.

PBGC Premium Rates

Single employer defined benefit plans are currently required to pay a flat $30 per-participant premium to the PBGC. Underfunded plans are subject to an additional variable rate premium equal to $9 per $1,000 of unfunded vested benefits. A variable rate premium is not due if a contribution equal to the plan's full funding limit is made by the plan sponsor. For plan years starting in 2007, the Pension Act eliminates the full funding exception to the variable rate premium. Further, the $1,250 per participant premium imposed by the Deficit Reduction Act of 2005 on employers who terminate defined benefit plans in bankruptcy has been made permanent.

Cash Balance Plan Rules Clarified

The Pension Act provides good news for cash balance plans as it clarifies their treatment under both the Code and ERISA. In general, a cash balance plan is a defined benefit plan which characterizes its benefit as a hypothetical account balance similar to a defined contribution plan. This "account" is increased annually by a percentage of each active participant's compensation, and by a hypothetical rate of return.

The Pension Act resolves (prospectively) arguments that cash balance and other "hybrid" plans discriminate against older members under age discrimination rules, provided certain vesting and interest crediting rules are followed. In general, these rules require 3 year vesting and a specified deemed interest rate which is no greater than a market rate of return. With respect to existing cash balance plans, the 7th Circuit recently held that cash balance plans do not result in a per se violation of these age discrimination rules. See, Cooper v. IBM Personal Pension Plan, 457 F.3d 636 (7th Cir., 2006).

The Pension Act also eliminates (again prospectively only) the so-called "whipsaw" effect, which could otherwise result in a participant's payment being greater than his or her hypothetical account balance. The "whipsaw" effect occurs when the rate of interest credited to a hypothetical account under a cash balance plan is greater than the interest rate used to calculate the present value of the age 65 accrued benefit. In this situation the present value of the participant's accrued benefit would be greater than the hypothetical account balance, and this greater present value would have to be paid to the participant.

In addition to resolving the age discrimination and whipsaw issues, the Pension Act clarifies how existing traditional defined benefit plans can be converted to cash balance plans. These conversion rules provide much needed certainty, but at a price. They provide that the value of a participant's accrued benefit under the converted plan may not be determined utilizing a "wear-away" formula. This will increase the cost of cash balance conversions for employers.

Conclusions

Defined benefit plan sponsors will want to work closely with their advisors to determine the impact these new rules will have on their funding obligations. Increased funding now may be necessary to help reduce the impact these rules will have when they become effective. It is too early to say whether

the cash balance plan provisions contained in the Pension Act will lead sponsors to elect to convert their existing plans into this format. It is a good bet, however, that the Pension Act's provisions will continue the trend toward putting increased importance on 401(k) and other defined contribution plans.

Circular 230 Disclosure

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