

Employee Benefits Law Update

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PENSION PROTECTION ACT: Impact on Single-Employer Defined Benefit Pension Plans *By Edward Frueh*

The Pension Protection Act of 2006 (the "Act") contains a number of provisions which will result in major changes in the way defined benefit pension plans are funded and maintained. The eventual impact of the Act is still uncertain. Although the Act is designed to make funding and, hence, retirement benefits more secure, the Act may increase the cost of maintaining defined benefit plans as a result of heightened reporting and disclosure obligations (leading to greater administrative costs) and higher premiums for underfunded plans. As a result, the Act may hasten the current tendency of employers to move from traditional defined benefit plans to cash balance plans or defined contribution plans.

The following is a summary of the most important aspects of the Act dealing with single-employer defined benefit plans.¹

New Minimum Funding Standards

The Act significantly changes the funding rules for defined benefit plans. Current law requires that a single-employer defined benefit plan must meet certain minimum funding standards; generally, a plan with more than 100 participants must be funded up to at least 90% of its current liabilities. A plan which fails to meet this funding standard is subject to special rules and must make a special deficit reduction contribution. Additionally, under current law plans generally can amortize any funding shortfall over 30 years. Determinations of current liability are based on an interest rate and mortality table prescribed by the IRS.

The Act adds new Code section 430 and new ERISA section 303. The current funding rules are repealed and new rules are introduced:

- The new minimum funding level is the plan's "funding target." The funding target is 100% of all liabilities accrued by the plan to date. The new funding target will be phased in over four years beginning in 2008.
- In the case of a funding shortfall, the plan must amortize the shortfall amount over 7 years (rather than the current 30 years).

- If a plan does not meet the 100% funding target, the minimum required funding contribution for the year is equal to the sum of (1) the present value of the benefits expected to accrue during the plan year (the "target normal cost") and (2) the amortization of the funding shortfall.
- For purposes of determining a plan's current liabilities, the temporary interest rate that was in effect for 2004 and 2005 and which was based on long-term investment grade corporate bonds will continue to apply in 2006 and 2007. Effective for 2008, the interest rate will be based on a modified yield curve of corporate bonds of varying maturities which will be published on a monthly basis. However, plans will need to use three different interest rates depending on the expected period over which the liabilities will be paid: (1) within five years of the valuation; (2) between 5 and 20 years after the valuation date; or (3) more than 20 years after the valuation date.
- The IRS is directed to prescribe a new mortality table that will more closely reflect pension plan experience and anticipated trends. (Currently, the 1983 Group Annuity Mortality table is used.) The table will be revised at least every 10 years. The IRS will publish a special mortality table for determining disability benefits. Finally, in certain circumstances large plan sponsors may, upon request, use a separate mortality table constructed by the plan's enrolled actuary and based upon the plan's actual experience.

Benefit Limitations

Under current law, the IRS may under certain circumstances grant a waiver to a plan sponsor of all or part of the contribution required under the minimum funding standard. If such a waiver is in effect, no plan amendment may increase the liabilities of the plan by any increase in benefits, accrual rate or accrued benefits. Additionally, in certain circumstances, if a plan is less than 60% funded, the employer must give security if a plan amendment increases the plan's liabilities. Other restrictions limit benefit increases when the employer

sponsoring a plan is involved in bankruptcy proceedings and limit benefit payments to life annuities in the case of certain liquidity shortfalls.

The Act adds new Code section 436 and new ERISA section 206 which tighten the restrictions on benefit increases and payments and add new restrictions on benefit accruals.

- Subject to certain exceptions, a plan can not be amended to increase benefits if it is less than 80% funded (or would be less than 80% funded after taking the amendment into account).
- Also subject to certain exceptions, a plan that is less than 60% funded, or that is less than 100% funded and whose sponsor is in bankruptcy, can not make benefit payments in any form other than a life annuity.
- If a plan is less than 60% funded, it must freeze all future benefit accruals as of the valuation date for the current plan year. This restriction does not apply to new plans for the first 5 years after they are established. Additionally, the restriction does not apply if the plan sponsor makes contributions to the plan, or provides security, to satisfy the 60% requirement.

Restrictions on Funding of Nonqualified Deferred Compensation Plans

Consistent with recent focus on executive compensation, the Act links single-employer defined benefit plans with nonqualified deferred compensation plans. Under prior law a sponsor of both a defined benefit plan and a nonqualified deferred compensation plan could fund the nonqualified plan irrespective of the funding status of the defined benefit plan. There was no relationship between the funding of the two separate types of plans.

Effective August 17, 2006, the Act amends Code section 409A to provide that in the case of a plan sponsor of both a defined benefit plan and a nonqualified deferred compensation plan:

- During a “restricted period,” any amount set aside or reserved, either directly or indirectly, or transferred to a trust or other arrangement or restricted for payments under a nonqualified deferred compensation plan for certain executives will be considered a taxable transfer to the individual and will also be subject to the 20% tax and interest imposed under Code section 409A.
- The “restricted period” is any time:
 - during which the plan sponsor is bankrupt,

- the defined benefit plan is “at risk,” or
- during the 12 month period beginning six months before an underfunded defined benefit plan is terminated.
- The affected executives are generally the current and former chief executive officers and the four highest paid executive officers as well as certain directors, officers and shareholders covered by section 16(a) of the Securities and Exchange Act.
- Additionally, if the plan sponsor reimburses an affected individual for the taxes imposed, then the reimbursement itself will be included in the amount subject to the penalty under section 409A and the plan sponsor will not be able to deduct the reimbursement.

Pension Benefit Guarantee Corporation Premiums

Currently, a single-employer defined benefit plan is potentially subject to 3 types of premiums payable to the Pension Benefit Guarantee Corporation (the “PBGC”). All defined benefit plans must pay a flat-rate premium per participant. For 2006, this premium is \$30; the flat rate premium is subject to indexing in subsequent years. Additionally, underfunded plans must also pay a variable rate premium of \$9 per every \$1,000 dollars of unfunded vested benefits. The variable rate premium is waived, however, if the plan has made its full required funding contribution for the year. Finally, plans terminated after 2005 and before 2011, are subject, under the Deficit Reduction Act of 2005, to a termination premium of \$1,250 per participant for the year of termination and each of the two following years.

Effective for plan years beginning on or after January 1, 2007, the Act:

- Eliminates the exception to the variable rate premium for underfunded plans which make their full funding contribution for the year; all underfunded plans must pay the variable premium.
- Introduces a new reduced variable rate premium for small plans (those whose sponsor has 25 or fewer employees).
- Makes permanent the termination premium imposed by the Deficit Reduction Act.

Interest Rate for Lump Sum Calculations

An important change for all single-employer defined benefit plans involves the assumptions used in making lump sum

calculations. Generally, for purposes of determining the minimum value of a lump sum distribution, a plan must use the 30-year Treasury rate and the 1994 Group Annuity Reserving mortality table. In calculating the Code section 415(b) limit on benefits, the interest rate used to determine the lump sum equivalent of a straight life annuity for 2004 and 2005 could not be less than the greater of 5.5% or the interest rate specified in the plan.

The Act amends relevant provisions of the Code and ERISA to change the relevant interest rate and mortality table for determining the minimum value of a lump sum payments and for calculating the lump sum equivalent of a straight life annuity for purposes of the Code section 415(b) limits.

- Beginning in 2008 and phased in over 5 years, the interest rate used in determining the minimum value of a lump sum distribution will be the modified yield curve interest rate discussed above used to determine a plan's current liabilities based on the rate for the month before the date of the distribution (with the three segments depending on the duration of the liability).
- The mortality table for determining the value of lump sum distributions will be the mortality table prescribed for use under the minimum funding rules.
- For purposes of calculating the lump sum equivalent of a straight life annuity under the Code section 415(b) limitations, effective for plan years beginning after December 31, 2005, the interest rate must not be less than the greater of:
 - 5.5%,
 - the interest rate specified in the plan, or
 - a rate that results in a benefit of no greater than 105% of the benefit obtained by using the modified yield curve interest rate used to determine the minimum value of a lump sum distribution.

The effect of these changes in actuarial assumptions is likely to be smaller lump sum distributions.

Reporting and Disclosure Obligations

The Act adds new significant plan reporting and disclosure obligations. Currently, a multiemployer plan must provide an annual notice (described below) to all participants and beneficiaries and to various interested parties within nine (9) months after the close of the plan year describing the funding status of the plan. Additionally, a plan sponsor with

unfunded vested benefits that total more than \$50,000,000 must file a report with the PBGC disclosing the plan's assets and liabilities and certain corporate information. This latter report is required under ERISA section 4010 and is typically referred to as the section 4010 information.

The Act makes the following changes to these requirements:

- Effective as of plan years beginning in 2008 (with certain limited transitional rules for 2006 and 2007), all single-employer defined benefit plans (not just multi-employer plans) must provide an annual notice describing the funding status of the plan. The plan must provide the notice to all participants and beneficiaries and to the PBGC.
- Generally, the notice must be provided no later than 120 days after the close of the plan year. For plans with 100 or few participants, the notice may be provided when the Form 5500 is filed.
 - The annual funding notice must disclose a number of things, including:
 - whether the plan is 100% funded for the plan year in question and for each of the two preceding plan years (and, if not, the actual funding percentage);
 - the value of the plan's assets and liabilities for the plan year in question and each of the two preceding plan years determined in the same manner as required under the funding rules;
 - the value of the plan's assets and liabilities as of the last day of the plan year in question determined using fair market value and the modified yield curve interest rate used in determining variable rate premiums;
 - the number of active participants, retired or separated participants receiving benefits, and retired or separated participants entitled to future benefits;
 - the funding policy of the plan and its asset allocation of investments;
 - any plan amendment, any benefit increase or decrease or any other event having a material effect on plan liabilities for the plan year in question.

The Department of Labor will publish a model notice.

The Act also:

- Broadens the current section 4010 filing requirement to include any plan which is less than 80% funded for

the preceding year.

- Enhances certain Form 5500 disclosure requirements.

Deduction Limits

Subject to certain specified limits, employer contributions to qualified retirement plans are generally deductible. The deduction limit for defined benefit plans is generally the greater of:

- the amount necessary to satisfy the minimum funding requirement for the year, or
- the total of the plan's normal cost for the year and the amount necessary to amortize various unfunded liabilities over a 10-year period.

The maximum deductible amount can not, however, exceed the full funding limitation for the year in question.²

The Act significantly increases the deduction limits:

- For 2006 and 2007, the deduction limit is 150% of the plan's current liabilities.
- Effective 2008, the maximum deduction limit will generally be the greater of:
 - the sum of the plan's funding target, target normal cost and a so-called cushion amount over the value of the plan's assets; or,
 - the minimum required contribution for the plan year.

The Act also establishes enhanced deduction limits for employers who sponsor both a defined benefit plan and a defined contribution plan.

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

ENDNOTES

- ¹ This article is not intended to be a comprehensive analysis of all provisions of the Act dealing with single-employer defined benefit plans. It considers in summary form only certain especially significant provisions of the Act. The Act also contains a number of provisions dealing with multiemployer defined benefit plans. This article does not address any of those provisions.
- ² The full funding limitation is the excess of (a) the accrued liability of the plan over (b) the lesser of (i) the market value of the plan assets or (ii) the actuarial value of the plan assets.

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