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Pension Briefing

LEGISLATION

Senate passes Pension Protection Act, Bill goes to President

Seeking to avert a meltdown and taxpayer bailout of traditional private pension plans, Congress has passed a comprehensive pension reform bill. The mammoth Pension Protection Act of 2006 (H.R. 4) passed the House by a vote of 279 to 131 on July 28, 2006. The Senate voted 93 to 5 to approve the bill on August 3, 2006. President Bush intends to sign the bill as soon as it reaches his desk.

The pension reform portion of the final bill addresses pension funding, participant education, hybrid plans, reporting and disclosure, plan terminations, and numerous other pension and employee benefit rules. This legislation reflects more than a year of often frequent acrimonious negotiations. The final provisions are complex, representing the first comprehensive pension legislation in more than 30 years.

This special Report provides an overview of some of the major provisions of the Pension Protection Act.

New minimum funding rules apply beginning in 2008

The Act repeals the current funding rules, effective after 2007. Current law would apply in 2006 and 2007. However, beginning with the 2008 plan year, the funding standard account mechanism and the current two-tiered funding system will be replaced with a single funding method. An employer maintaining a single-employer defined benefit plan that is not 100 percent funded would not be required to make a deficit reduction contribution, but would be required to make a minimum contribution that is based on the plan's assets (reduced by credit balances), funding target, and target normal cost and that is sufficient to amortize unfunded plan liabilities over a period of seven years. Unlike current law, under which employers are required to fund up to 90 percent of a plan's total liabilities, the Act increases the funding target to 100 percent of target or current liabilities.

Interest rate assumptions: Segmented yield curve. The Act radically changes the actuarial assumptions and methods used to determine present value, authorizing a new interest rate and a new mortality table. Specifically, the Act, while retaining the blended rate of corporate bonds, introduces a segmented "yield curve" that would consist of three different interest rates (based on the unweighted average of interest rates on investment grade corporate bonds) applicable to benefits payable in different time periods.

The bipartisan Pension Protection Act (H.R. 4) represents the most sweeping overhaul to U.S. pension laws in more than 30 years.

Credit balances. The Pension Act does not eliminate existing credit balances or prevent excess contributions from being maintained as a credit balance after the new funding rules go into effect in 2008. However, the Act separates existing credit balances from those that may be accumulated and maintained after the funding rules go into effect. Specifically, the Act divides credit balances into: (1) a funding standard carryover balance, which reflects a balance in the funding standard account at the end of the 2007 plan year and (2) a prefunding balance, which may be elected by a plan to accumulate excess contributions after application of the new rules beginning in 2008.

The funding standard carryover balance and the prefunding balance may be credited against the minimum required contribution (if the plan is sufficiently funded), reducing the amount that must be paid for the year. However, credit balances used to offset the required minimum contribution will also reduce the value of plan assets. Accordingly, plan sponsors are allowed the alternative

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option of electing to reduce or waive the funding standard carryover and the prefunding credit balance so as to prevent the reduction of plan assets.

At-risk plans subject to increased liability. Plans with more than 500 participants that have a funded target attainment percentage in the preceding year below designated thresholds, which reflect at-risk liabilities that assume participants will retire at the earliest date allowed under the plan with the most valuable form of benefit, will be deemed "at-risk," and subject, beginning in 2008, to increased target liability. The funding percentage would be determined by subtracting credit balances from plan assets. The increased at-risk liability payment would be phased in over a five consecutive year period beginning in 2008.

CCH Note: It is important to note that a plan's at-risk funding target and a plan sponsor's attendant funding obligation are not determined by the financial condition of the plan sponsor, as reflected in credit ratings. At-risk status is strictly a function of the plan's funded status and specified participant demographics.

70/80 percent threshold test for at-risk status. Plans with more than 500 participants during each day of the preceding plan year (aggregating all single-employer defined benefit plans maintained by the employer, predecessor employer or a member of the employer's controlled group) are subject to a two-tiered determination of at-risk status. Specifically, a plan is at-risk if: the funding target attainment percentage (i.e., ratio of plan assets (reduced by credit balances) to the funding target for the preceding plan year, determined without regard to at-risk liability) is less than 80 percent, and the funding target attainment percentage for the preceding plan year, determined by applying the specified at-risk actuarial assumptions, is less than 70 percent.

CCH Note: Both components of the test must apply in order for plan to be treated as at-risk. Thus, if a plan fails the 70-percent at-risk test, but satisfies the 80-percent ongoing liability test, it will not be subject to at-risk liability.

Transition rule phases in 80-percent test. The 80-percent funding target component of the at-risk test is phased in over a four-year period, beginning in 2008. The applicable percentages will be: 65 percent in 2008, 70 percent in 2009, 75 percent in 2010, and 80 percent in 2011 and thereafter. The funding target attainment percentage for the preceding plan year of plan years beginning in 2008 may be estimated, pursuant to regulations to be issued by the Treasury.

Waiver of minimum funding standards

The Treasury is authorized, under rules comparable to current law, to provide a temporary waiver of the minimum funding requirements for an employer that is unable to satisfy the minimum funding standard for a plan year without "substantial business hardship." The minimum required contribution for a single-employer plan will be reduced by the amount of the waived funding deficiency. However, in the event a plan has a waived funding deficiency for any of the five preceding years, the minimum required contribution for the plan year will be increased by a waiver amortization charge for the plan year.

An employer maintaining a single-employer defined benefit plan may be required to provide security to the plan as a condition for a waiver of the minimum funding standards. In addition, no plan amendment that has the effect of increasing plan liabilities may generally be adopted during the waiver period.

Benefit limits under single-employer plans

Single-employer defined benefit plans that fall below specified funding levels will be subject to new limits on: the payment of unpredictable contingent event benefits (e.g. shutdown benefits), plan amendments, lump-sum distributions, and benefit accruals. The restrictions, which are based on the plan's ratio of plan assets to target liability (adjusted funding target attainment percentage) and triggered by variant thresholds, will, generally effective beginning in 2008, require benefit accruals to be frozen and prevent underfunded plans that have been in effect for over five years from implementing amendments adding benefits or otherwise increasing plan liabilities or paying the full amount of a lump-sum distribution, without additional contributions by the plan sponsor.

Plans may continue to provide unpredictable contingent event benefits. However, an unpredictable contingent event benefit may not be paid if the plan's adjusted funding target attainment percentage for the plan year is less than 60 percent or would be less than 60 percent as a consequence of the occurrence of the event.

An employer also may not adopt an amendment to a single-employer defined benefit plan that is less than 80 percent funded that will have the effect of increasing plan liabilities, unless it makes additional contributions to the plan. The Act continues to authorize accelerated distributions, such as lump-sum payments, but subjects "prohibited payments" under plans that are below specified funding levels to restrictions. Single-employer defined benefit plans must further provide for the cessation of all benefit accruals under the plan in the event the plan's adjusted funding target attainment percentage is less than 60 percent. The limitations will not, however apply during the first five years that a plan (or a predecessor plan) is in effect.

CCH Note: An employer may not use a prefunding balance or a funding standard carryover balance in satisfaction of an additional contribution that is required to avoid or terminate the application of a limit on the payment of unpredictable contingent event benefits, the adoption of amendments increasing benefit liabilities, or benefit accruals applicable to underfunded plans.

Presumption of continued underfunding. Plans subject to a benefit limitation for the preceding plan year will be presumed to be subject to the limit in the current year until the plan actuary certifies the actual adjusted funding target attainment percentage for the current year. Specifically, the adjusted funding target attainment percentage of the plan as of the valuation date of the plan for the current plan year will be presumed to be equal to the adjusted funding target attainment percentage of the plan as of the valuation date for the preceding plan year.

Multiemployer plans

The Act makes a number of major changes to multiemployer plan funding rules as well. New funding rules are added for multiemployer plans that are in endangered, seriously endangered, or critical status, including relief from excise taxes for an accumulated funding deficiency. These provisions are generally effective for plan years beginning in 2008.

Individualized investment advice

Under a new prohibited transaction exemption, qualified "fiduciary advisers" are allowed to offer personally tailored professional investment advice to help employees manage their 401(k) plans, individual retirement accounts (IRAs), and other plans. The fiduciary adviser may be affiliated with the investment funds offered in a 401(k) plan but would have to meet disclosure, qualification, and other self-dealing safeguards. Further, if these conditions are met, employers or plan sponsors would not be obligated to monitor the specific advice given to any particular participant or beneficiary, though they would retain the responsibility to prudently select and monitor advice providers.

Individualized investment advice may be provided to 401(k) plan participants, without running afoul of the prohibited transaction rules, if fiduciary advisers provide investment advice under an "eligible investment advice arrangement." Such an arrangement is one under which (1) portfolio recommendations are generated for a participant based on an unbiased computer model that has been certified and audited by an independent third party, or (2) fiduciary advisers provide their investment advice services by charging a flat fee that does not vary depending on the investment option chosen by the participant.

The Secretary of Labor, in consultation with the Secretary of the Treasury, has been directed to determine whether investment advice provided through a computer model would be feasible for individual retirement accounts and individual retirement annuities (IRAs), medical savings accounts (Archer MSAs), health savings accounts (HSAs), and education savings accounts (Coverdell ESAs). The DOL determination must be made by the end of 2007.

If the Secretary of Labor determines an appropriate model is available for such plans, a computer model, certified by the Secretary of Labor, will be an option for providing investment advice for such plans. If the Secretary determines that an appropriate model is not available, the Secretary has been directed to grant a prohibited transaction exemption that protects account holders from biased advice without requiring fee-leveling or a computer model. The exemption will sunset on the later of two years after an appropriate computer model becomes available, or three years after issuance of the exemption.

PBGC provisions

For post-2007 plan years, the variable rate premium will be based on a plan's unfunded vested benefits valued using a three segmented yield curve of investment-grade corporate bonds with varying maturities and in the top three quality levels (for 2006 and 2007, unfunded vested benefits will be calculated using 85% of the corporate bond rate).

The exemption to pay variable rate premiums for plans that are at the full funding limit will be repealed. In addition, the additional premium for certain underfunded terminating plans is made permanent.

Limits will be imposed on the extent to which the PBGC will guarantee benefits that become payable due to plant shutdowns and other contingent events.

Deduction limits

For 2006 and 2007, the new law amends Code Sec. 404 to increase the maximum deductible contribution to single-employer DB plans to 150 percent of current plan liabilities. After 2007, the Act increases the deductible limit to an amount equal to the year's normal cost (generally, the cost of benefits accrued in the year) plus the amount necessary to fully fund the plan's funding target. In addition, employers can contribute and deduct a "cushion" equal to 50% of the funding target plus additional amounts reflecting projections of participants' compensation and statutory compensation limits. Special rules are provided for plans with 100 or fewer participants. The deduction limit for multiemployer plans increases to 140 percent of current liability.

The new law also increases allowable deductions for an employer that maintains both a defined contribution plan and a defined benefit plan by excluding contributions to defined benefit plans insured by the PBGC. For 2006 and later years, the contribution limits apply only if defined contributions exceed a 6% ceiling.

DB/K plans

For plan years beginning after 2009, small employers (those with 500 or fewer employees) are permitted to establish a combined defined benefit—401(k) (DB/K) plan. The arrangement would be governed by one plan document, and and there would be specific accounting for the DB and DC portions of the trust. In general, the defined benefit rules would apply to defined benefit portions of the plan and the defined contribution rules would apply to the defined contribution portions of the plan. The 401(k) component of the plan must have an automatic enrollment feature and must meet minimum matching contribution requirements.

Cash balance plans

The new law seeks to provide greater legal certainty to cash balance/hybrid plan arrangements, which have been the subject of much recent litigation. The Act provides rules for testing hybrid plans for age discrimination under the Code, ERISA, and the Age Discrimination in Employment Act. In the case of a conversion from a defined benefit to a cash balance plan, the "wearaway" of benefits that a participant has earned at the time of conversion is prohibited. Hybrid plans may treat the hypothetical account balance as the lump-sum value.

Diversification requirements for DC plans

Defined contribution plans are required to meet new diversification requirements with regard to any portion of employee contributions, elective deferrals and employer contributions invested in employer securities. With regard to employee contributions and elective deferrals invested in employer securities, an individual would have to be allowed to elect to direct the plan to divest employer securities into other investment options. An individual who is a participant in the plan with at least three years of service or is a beneficiary of such a participant would be able to elect to divest the portion of the account invested in employer securities that is attributable to employer contributions in other investment options. This provision is generally effective for plan years beginning after December 31, 2006.

Reporting and disclosure

Plan administrators will have to comply with a number of new reporting and disclosure requirements. The annual funding notice requirement that currently applies to multiemployer plans, will apply to single-employer defined benefit plans, generally effective for plan years beginning after 2007. In addition, for post-2007 plan years, additional information will be required in the annual report filed with respect to a defined benefit plan. Simplified reporting rules are provided for smaller plans.

A notice of the right to diversify out of employer securities (see "Diversification requirements for DC plans" above) must be provided by the plan administrator to an applicable individual not later than 30 days before the first day that the individual is eligible to divest. The Secretary of Treasury is authorized to issue a model notice to satisfy this requirement.

Plan amendments

Plan amendments made pursuant to the Act may be retroactively effective and will not violate the anti-cutback rules if made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan).

IRAs and tax refunds

Taxpayers will have more options when it comes to depositing their tax refunds. Under the new law, taxpayers can direct the IRS to deposit their refunds into IRAs.

In May, the IRS announced that taxpayers will be able to split their refunds and deposit them into as many as three different bank accounts. The IRS expects to issue new Form 8888, for taxpayers to use to split their refunds in time for the 2007 filing season.

Military and public service personnel

Individuals who are called to active military duty may make penalty-free early distributions from their IRAs, 401(k)s, and similar arrangements. The taxpayer must be a member of the Reserves who is called to active duty after September 11, 2001, and before December 31, 2007. The new law gives service personnel up to two years after the end of their active duty period to re-contribute the amounts they withdrew and avoid paying income tax on the distributions.

The Act also waives the 10-percent penalty on early distributions from a government plan for certain public safety employees. In addition, distributions from a government plan to pay for health or long-term care insurance premiums of a retired public safety officer will be excluded from income up to $3,000.

401(k) hardship withdrawals

The new law instructs the Treasury to issue rules within 180 days of enactment that allow 401(k) plan withdrawals for hardships and unforeseen financial emergencies with respect to any person who is listed as a beneficiary under the 401(k) plan. The Treasury rules are to be consistent with hardship withdrawals now allowed for spouses and Sec. 152 dependents.

Nonspouse beneficiaries

A taxpayer may roll over his or her deceased spouse's interest in a qualified retirement plan, government plan, or tax sheltered annuity into an IRA. The taxpayer will not be taxed except as normal distributions are taken. The Act extends this special treatment to nonspouse beneficiaries.

Direct plan-to-Roth IRA rollovers

Effective for distributions after December 31, 2007, the new law will allow direct rollovers from a qualified retirement plan, tax-sheltered annuity, or governmental plan directly to a Roth IRA and will treat it as a Roth conversion if all other conversion qualifications (e.g., income below the $100,000 level before 2010) are met.

CCH Note: Prior to this change, savvy taxpayers had to go through a two-step process to reach the same result: first roll over the amount to a traditional IRA, and then convert the traditional IRA to a Roth.

PERMANENT EGTRRA RETIREMENT PROVISIONS

EGTRAA made many taxpayer-friendly changes to the Tax Code's retirement plan rules. It authorized catch-up contributions for older workers, increased contribution limits and benefits, made some retirement arrangements more attractive for small businesses, expanded rollover options for taxpayers with 457 and 403(b) plans, targeted relief to certain groups, and provided many other incentives. Like most of EGTRRA's provisions, the enhanced retirement savings incentives were temporary and would have ended after December 31, 2010. The new law repeals the sunset provisions in EGTRRA that apply to retirement savings. Long-range retirement planning is enhanced by making these provisions permanent.

EGTRRA 2010 sunset eliminated

The major EGTRRA retirement provisions that would be made permanent rather than sunset at the end of 2010 include:

- Permanent higher dollar amount for IRA contributions ($4,000 starting in 2006, $5,000 in 2008, inflation adjusted thereafter);
- Permanent higher dollar limits on defined contribution plans ($44,000 in 2006), elective deferrals (including $15,000 in 2006 for 401(k) plan deferrals), 457 plan deferrals ($15,000 in 2006), SIMPLE plan contributions ($10,000 in 2006) and compensation that may be taken into account under a plan;
- Permanent increases in the annual benefit limit under a defined benefit plan ($175,000 for 2006);

- Permanent catch-up contributions for older workers ($1,000 after 2005 for IRAs, $2,500 for SIMPLE plans, $5,000 for 401(k) plans);
- Permanent faster vesting of employer matching contributions (full vesting under three- or six-year schedules);
- Permanent greater portability for 403(b) and 457 plans;
- Permanent higher deductible amounts for employer contributions to employee retirement plans (inflation-adjusted to $220,000 in 2006; 25-percent compensation deduction limit for stock bonus and profit-sharing plans);
- Permanent Roth 401(k)s and 403(b)s;
- Permanent start-up tax credit for new small employer-sponsored plans (maximum $500/year for each of the first three years);
- Permanent deemed IRAs set up under an employer plan allowing separate employee contributions;
- Permanent enhanced rollover rules (including qualified plan rollovers of distributions of after-tax contributions, direct rollovers from IRAs to employer plans, and rollovers of distributions from governmental 457 plans, 403(b) plans, or cash-outs);
- Permanent ESOP enhancements; and
- Permanent modifications to the top-heavy nondiscrimination and coverage rules.

None of the post-2010 extensions appear to require any immediate action, with the exception of the Roth 401(k) option for employee-share contributions. While the Roth 401(k) option has been available since the start of 2006, many employers have not revised their plans out of concern that the expense of maintaining separate Roth accounts for employees would outweigh the benefits if further Roth contributions were not allowed after 2010. Now that the future of the Roth 401(k) is secure, many employers are expected to amend their plans by the end of this year. These rules apply equally to 403(b) plans.

EGTRRA authorized the IRS to waive the 60-day rollover rule when failure to waive the requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the taxpayer's reasonable control. Before EGTRRA (and after 2010 if it were not for this legislation), the IRS could waive the 60-day rule in only two circumstances: (1) the taxpayer is performing military service in a combat zone or (2) the taxpayer is affected by a Presidentially-declared disaster.

Defined benefit plan limits. EGTRRA's "permanent extensions" are not exclusively focused on defined contribution plans. EGTRRA increased the maximum annual defined benefit plan limit. In 2001, only the lesser of 100 percent of three-year-high average compensation or $140,000 could be paid out annually. EGTRRA initially boosted it to $160,000 and indexed it for inflation in $5,000 increments; today it is $175,000. The new law makes this treatment permanent.

If benefits begin before Social Security retirement age, the dollar limit on annual benefits is subject to an actuarial reduction. Conversely, the dollar limit is increased if benefits begin after Social Security retirement age. Under EGTRRA, the dollar limit is reduced if benefits begin before 62 and increased for benefits beginning after 65.

EGTRRA also increased the compensation limit that may be taken into account for determining benefits under a qualified plan ($220,000 in 2006, adjusted for inflation thereafter).

Saver's Credit

Unlike the other EGTRRA provisions that were to sunset at the end of 2010, the Saver's Credit would have ended very soon, in tax years beginning after December 31, 2006. The new law makes the Saver's Credit permanent. Under this provision, lower- and middle-income taxpayers can claim a nonrefundable tax credit for their contributions or deferrals to retirement savings plans and IRAs.

The credit amount is equal to the credit rate (50, 20, or 10 percent) times the dollar amount of qualified retirement savings contributions for the year (not to exceed $2,000), based on income and filing status.

As an enhancement to the Saver's Credit, the new law provides that the adjusted gross income amounts used to figure the amount of the credit will be adjusted for inflation starting in 2007.

IRA rollovers to charities

Under the new law, taxpayers will be able to make tax-free distributions from IRAs for charitable purposes through December 21, 2007. The maximum annual cap is $100,000.

This treatment applies to traditional and Roth IRAs. No charitable deduction, however, will be allowed for any portion of these withdrawals that would have been otherwise taxable.

The pension and benefit provisions of H.R. 4 and the Joint Committee on Taxation's technical explanation are at ¶29,145.