DEFINED BENEFIT ISSUES UNDER THE PENSION PROTECTION ACT OF 2006

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The Pension Protection Act of 2006 (the "PPA") significantly overhauls the pension funding rules, and provides welcome relief for hybrid plans (i.e., cash balance plans). This summary is only intended to highlight the most important changes that will impact pension and cash balance plans for clients of Palmieri & Eisenberg ("P&E").

1. **Minimum Funding Standards**.

   a. **Defined Benefit Plans**. PPA replaces the minimum funding standard account rule and the deficit reduction contribution for certain plans with a single minimum funding calculation. The general effective date of this change is for the 2008 plan year, but there are transition rules.

   b. **Basic Minimum Funding Contribution**. The amount is the sum of: (1) the target normal cost (present value of benefits expected to be accrued in the current year, including an increase in benefits attributable to services performed in prior years by reason of an increase in compensation during the current plan year); **plus** (2) shortfall amortization charge (determined over a **7**-year period, but phased in through 2011), **plus** (3) waiver amortization charge, if any (over **5** years). If there is no funding shortfall for the year (i.e., plan assets, reduced by any credit balances, equals or exceeds the funding target for the year), the minimum contribution is the target normal cost for the plan year reduced by such excess (but not below zero). See Section 430 of the Code for the minimum required contribution calculation.

   c. **Interest Rate Assumptions**. Current liability is determined using **3** segments (**0-5** years, more than **5** years up to **15** years, over **15** years), phased in over **3** years beginning in 2007 (unless the employer foregoes the phase-in) based on a yield curve that is derived from a **2**-year weighted average of interest rates on investment-grade corporate bonds.

   The Pension Funding Equity Act ("PFEA") rates are extended through the 2006 and 2007 plan years for purposes of the interest rate permissible range and the current liability calculation.

d. **Mortality Table**. Tables are to be prescribed by the Treasury for both healthy and disabled participants. Large plans may petition the IRS to use a plan-specific mortality table pursuant to certain restrictions and demonstrations.

e. **At-Risk Plans**. Additional required actuarial assumptions, resulting in increased funding targets, would apply to **at-risk** plans, including the assumption that employees within **10** years of retirement will retire at the earliest possible time, and that employees are assumed to elect the most valuable payment option. An additional loading factor would apply to plans that are in at-risk status for at least **2** of the last **4** years. A **"70/80"** at-risk funding target would be triggered if, at the prior valuation date, plan liabilities were both: (i) less than **80%** funded (without regard to at-risk liabilities); and (ii) less than **70%** funded using the at-risk liabilities and subtracting the credit balance. The **80%** test is phased in using **65%** in 2008, **70%** in 2009, **75%** in 2010 and **80%** for 2011, and thereafter. PPA exempts from the at-risk funding requirements plans with **500** or fewer participants on every day of the preceding year (treating all defined benefit plans of an employer as a single plan).

f. **Valuation Date**. The first day of the plan year has to be used, except for small plans (a small plan is one with **100** or fewer participants).

g. **Valuation of Plan Assets**. Generally, fair market value is to be used, but certain smoothing is allowed over a period not to exceed **24** months. Smoothing cannot result in a value that is more than **110%** or less than **90%** of the current value of assets.

h. **Credit Balances**. Generally, a plan retains credit balances in **2** pieces: (i) a carryover balance from 2007; and (ii) a pre-funding balance from contributions in excess of funding rules in 2008 and later plan years. A plan may elect to use its credit balance to satisfy a minimum funding obligation only if the assets are at least **80%** funded (from the prior valuation date) based on the pre-funding balance, but not carryover balance. Credit balances would reflect the investment performance of plan assets and would be subtracted from assets for most determinations under the bill.

i. **Contribution Deadlines/Quarterly Contributions**. The due date for a required contribution is **8½** months after the close of the plan year (but adjusted for interest if made after the valuation date for the plan year). Quarterly contributions are required if there was a funding shortfall in the prior year. Plans with **100** or fewer participants are not subject to the quarterly contribution requirement.

j. **Funding-Based Benefit Limitations**. PPA imposes the following suspensions and restrictions on plan amendments, accruals or distribution options, applicable to single-employer defined benefit plans.

i. **Shutdown Benefits (Applies only to Plans funded below a 60% level)**. Shutdown benefits and other unpredictable contingent benefits would be restricted if the plan is below a **60%** funding level, unless the employer makes a prescribed additional contribution. The PBGC guarantee for such benefits would be phased in over a **5**-year period commencing when the event occurs. This is not applicable for the first **5** years of a plan's existence.

ii. **Restrictions on Benefit Increases (Applies to Plans funded below an 80% level)**. PPA will not allow a plan amendment that increases plan benefits if a plan is below an **80%** funding level, unless the employer makes a prescribed additional contribution. An amendment is subject to this rule if it increases benefit liabilities due to an increase in benefits, the addition of new benefits, a change in the rate of benefit accrual or a change in the rate at which benefits become vested. This is not applicable for the first **5** years of a plan's existence.

iii. **Restrictions on Accelerated Distributions and Lump Sum Payments (Applies only to Plans funded below a 60% level)**. PPA prohibits distributions in excess of the monthly life annuity payable under the plan when the plan's funding level is less than **60%**. This also applies if the employer is in bankruptcy unless the plan is **100%** funded. The employer could put up security to permit larger distributions to be made. Plans less than **60%** funded may not pay lump sums.

iv. **Restrictions on Accelerated Distributions and Lump Sum Payments (Applies only to Plans funded above a 60% level, but below an 80% level)**. A limited payout, rather than a prohibition on any distribution in excess of the monthly life annuity is allowed if a plan's funding level is above **60%**, but below **80%**. The employer could put up security to permit larger distributions to be made. Plans at least **60%** but less than **80%** funded can make lump sum payments limited to the lesser of: (i) **50%** of the amount that would have been paid without restriction; and (ii) the present value of the participant's PBGC benefit.

v. **Cessation of Future Accruals (Applies to Plans funded below a 60% level)**. A plan has to cease further accruals if funding falls below **60%**, with an exception during the first **5** years of a plan's existence, or if the employer makes an additional contribution prescribed by the statute.

vi. **Notice to Participants**. ERISA Section 101(j) requires notice to participants on the restrictions regarding shutdown benefits or accelerated distributions, as described above. This notice also would be required when future accruals cease under the rules described above. The notice is required within **30** days following the plan being subject to any of these restrictions. This provision is enforceable through the penalties under Section 502(c)(4) of ERISA.

vii. **Effective Date**. The above rules are generally effective in 2008, but not before 2010 for collectively bargained plans.

k. **Restrictions on Non-Qualified Deferred Compensation Plans**. Adverse tax consequences result if amounts are set aside for nonqualified deferred compensation when a defined benefit plan is in at-risk status (i.e., less than **80%** funded), or the employer is in bankruptcy for the **12**-month period that begins **6** months before a distress termination date. New Section 409A(b)(3).

2. **Lump Sum Distributions**.

a. **Minimum Lump Sums under Section 417(e)**. PPA replaces the current rules under Section 417(e) of the Code (which uses **30**-year Treasury rates) under the **3**-segment approach described above in the minimum funding rules, with a phase-in of **20%** a year from 2008-2012 (current rules remain in effect for 2006 and 2007).

b. **Interest Rate Assumption for Section 415 Lump Sums**. PPA adopts the PFEA rule with a twist. The interest rate used is the **greater of**: (i) **5.5%**; (ii) the rate that would provide a benefit of not more than **105%** of the benefit that would be provided if the Section 417(e)(3) rate were used; or (iii) the plan's rate. This rule is effective in 2006.

3. **PBGC Rules**.

a. **Flat Rate Premium**. No changes are made to the PBGC flat rate premium. The Deficit Reduction Act of 2005 already increased the per-participant flat-rate premium to **$30** for single-employer plans and to **$8** for multiemployer plans.

b. **Variable Rate Premium**. The rules for 2004 and 2005 will continue for 2006 and 2007 and then be amended to reflect the interest rates in the new funding rules. In addition, for employers with **25** or fewer employees, a **$5** cap would apply to the variable premium. The full funding limitation exemption is repealed. The variable rate premium must be computed using the three-segment yield curve beginning in 2008; risk-based premium is based on unfunded vested benefits.

c. **Surcharge Premium Made Permanent**. PPA makes permanent the surcharge premium of **$1,250** per participant for certain distress terminations, as added by the Deficit Reduction Act of 2005, which was to expire in 2010.

4. **<u>Benefit Accruals Under Hybrid Plans</u>**.

a. **<u>Age Discrimination</u>**. PPA clarifies that all defined benefit plans (including cash balance and pension equity plans) are not inherently age discriminatory as long as benefits are fully vested after **3** years of service and interest credits do not exceed a market rate of return. The PPA further provides that the age discrimination test is met if a participant's accrued benefit is not less than the accrued benefit of any similarly situated younger employee. "Similarly situated" means that the participants are identical in every respect (<u>i.e.</u>, period of service, compensation, position, date of hire, work history), except age. The accrued benefit can be tested on the basis of an annuity payable at normal retirement age, a *hypothetical account balance* (<u>i.e.</u>, cash balance plan), or the current value of the accumulated percentage of the employee's final average pay. No definition of a cash balance plan is provided with respect to the application of this rule, except any interest credited by a plan must be no more than a market rate of interest, effective for plan years beginning in 2008 or later (unless the employer elects to apply earlier). Corresponding amendments are made to the Age Discrimination in Employment Act ("ADEA").

b. **<u>Conversions</u>**. PPA prohibits wear away of pre-conversion accrued benefits if the conversion occurs after June 29, 2005. No inference is to be drawn with respect to earlier conversions.

c. **<u>Whipsaw</u>**. PPA eliminates the "whipsaw" problem by allowing the lump sum distribution from a hybrid plan to be equal to the hypothetical account balance (<u>i.e.</u>, cash balance plan) or the accumulated percentage of final average pay. This rule is effective for distributions made after the date of enactment.

d. **<u>Vesting</u>**. Hybrid plans (<u>i.e.</u>, benefits based on a hypothetical account or as an accumulated percentage of final average pay) have to have full vesting in no more than **3** years of service. This rule is effective for plan years beginning in 2008 or later, unless the employer elects earlier application.

e. **<u>No Inference as to Prior Years</u>**. PPA provisions are prospective only and provide no clarification of the legal status of hybrid plans for past years. Thus, PPA leaves unresolved the age discrimination and whipsaw issues under prior law.

5. **<u>Deduction Limits</u>**.

a. **<u>Contributions to DB Plans</u>**. Beginning in 2008, the maximum deductible contribution equals: (i) the target normal cost; plus (ii) **150%** of the applicable funding target; plus (iii) an allowance for future pay or benefit increases; minus (iv) assets. For 2006 and 2007, the deduction limit is raised to **150%** of current liability minus plan assets. PPA allows expected compensation and benefit increases to be taken into account in calculating the limit. If the plan is covered by the PBGC, the actuary may also project increases in the compensation dollar amount under Section 401(a)(17) of the Code. For plans with **100** or fewer participants, benefit increases due to amendments adopted within the past two years cannot be taken into account.

PPA also repeals the alternative maximum deductible contribution determined using an interest rate of **90-105%** of a **4**-year weighted average **30**-year Treasury rate. Contributions in excess of this limit are subject to a **10%** excise tax.

b. **Combined Limit under Section 404(a)(7)**. The limit under Section 404(a)(7) of the Code is determined without regard to all DB plans that are covered by the PBGC. In addition, only employer contributions (other than 401(k) contributions) to a DC plan that *exceed **6%** of participant compensation* are subject to the limit. Elective deferrals would continue to be disregarded from the deduction limits.

The excise tax under Section 4972 of the Code applies to DC contributions that are nondeductible solely because of Section 404(a)(7), but only to the extent such contributions are matching contributions made by the employer.

c. **Multi-Employer Plans**. PPA increases the deduction limit for multi-employer plans effective in post-2007 years.

d. **Effective Date**. The deduction rules are effective for plan years beginning in 2008 or later. For the 2006 and 2007 plan years, the maximum DB deduction is increased to **150%** of current liability. In addition, the higher Section 404(a)(7) limit, except for the disregarding of PBGC-covered plans, is effective for post-2005 years.

6. **Miscellaneous ERISA Issues**.

a. **Additional Disclosures**. Certain additional information would be required on the annual Form 5500. It is intended that defined benefit plans would be exempt from the Summary Annual Report ("SAR") requirement, which essentially limits the SAR to DC plans. These rules will take effect for post-2007 years.

b. **Unemployment**. States would be prohibited from reducing unemployment compensation for pension distributions that are nontaxable because they are rolled over. This is effective on the enactment date.

c. **Distribution Notice and Consent Rules**. The **90**-day notice period is expanded to **180** days for the Section 402(f) and Qualified Joint and Survivor Annuities rollover notice. This is effective for years beginning in 2007 or later.

d. **Phased Retirement**. A DB plan is permitted to allow for in-service distributions to a participant who has reached age **62**, even if normal retirement age is later than age **62**. This applies to distributions made in plan years beginning in 2007.

e. **Transfers to Fund Retiree Health Benefits**. PPA expands the ability to transfer surplus assets under a DB plan to fund retiree health benefits, pursuant to Section 420 of the Code. This applies to transfers made after date of enactment.

f. **Tax Refunds**. A taxpayer can direct a tax refund to be paid directly into an IRA, for taxable years beginning in 2007.

g. **Tax-Free IRA Distributions for Charitable Giving**. Up to **$100,000** could be distributed tax free from an IRA if it is made to a charitable organization, and the IRA owner is at least **70½** years old. This rule will not apply to distributions from SEP-IRAs or SIMPLE-IRAs. This rule will apply only to distributions in 2006 and 2007.

h. **Plan Asset Definition**. PPA adds a new Section 3(42) of ERISA to adopt the DOL's **25%** threshold for "benefit plan investors" to determine if the underlying assets of an entity are plan assets (for purposes of being subject to Title I of ERISA), immediately after the most recent acquisition of an equity interest in the entity. "Benefit plan investors" would be employee benefit plans subject to Part 4 of ERISA and Section 4975 of the Code (under this definition, certain interests held by entities that are similar to plans, such as foreign or governmental plans, would be precluded when determining whether the **25%** threshold is met).

i. **Coercive Interference with ERISA Rights**. PPA increases penalties to **$100,000** and imprisonment up to **10** years for willful acts of coercive interference with a participant's ERISA rights. This provision is effective for violations occurring on or after the enactment date.

j. **Section 415(b) Limit**. In a DB plan, average compensation may be calculated by taking into account years of service for which the employee was *not* an active participant in the plan. Section 415(b)(3), as amended, would continue this rule in the current regulations (that the Treasury had proposed to reverse). This provision is effective for post-2005 years. Also, for church plans, the compensation limit under Section 415(b)(1)(B) applies only to highly compensated employees.

7. **Plan Amendments**. Amendments would be required by the end of the 2009 plan year, with anti-cutback relief. Governmental plans would have an additional two years to amend.

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