

A Brief Summary of H.R. 4, The Pension Protection Act of 2006

On August 3, 2006, Congress passed the highly-anticipated Pension Protection Act of 2006 (PPA). The pension reform legislation was passed by the House on July 28, and then the Senate on August 3. The President signed it into law on August 17.

At over 900 pages, the PPA introduces sweeping changes to existing pension law. At this point, the pension community is still digesting the PPA's many provisions.

EGTRRA and Saver's Credit Permanence

Current law	Many of the EGTRRA provisions applicable to retirement savings were scheduled to "sunset" (i.e., expire) in 2010. Similarly, the Saver's Credit was scheduled to sunset at the end of 2006.
New law	The PPA repeals the sunset provisions in EGTRRA that apply to retirement savings and also makes the Saver's Credit permanent. By making these provisions permanent, the PPA greatly enhances long-range retirement planning.
Effective date	As soon as the PPA is signed into law by the President.

Defined Contribution Provisions

Vesting	
Current law	Pursuant to EGTRRA, employer matching contributions are subject to a minimum vesting of either three-year cliff or six-year graded. These minimum vesting schedules did not apply to employer non-elective contributions.
New law	Under the PPA, <u>all</u> employer contributions are subject to minimum vesting requirements (i.e., three-year cliff or six-year graded).
Effective date	This change is generally effective in 2007.

Employer securities	
Current law	Not applicable.
New law	<p>In response to Enron, the PPA requires a defined contribution plan that holds publicly traded employer securities to:</p> <ul style="list-style-type: none"> • Provide at least three alternative investment options (other than employer securities) each of which is diversified and has materially different risk and return characteristics • Allow participants to "diversify" (that is, invest in something other than employer securities) <u>participant</u> contributions at all times • Allow participants to "diversify" <u>employer</u> contributions after three years of service • Provide participants, at least 30 days before they are eligible to diversify out of employer securities, a notice describing the diversification right and the importance of diversifying investment of retirement account assets <p>These diversification rules do not apply to "traditional" ESOPs, but do apply to the more typical stock ownership plans that are made a part of 401(k) plans (sometimes referred to as "KSOPs").</p>
Effective date	These rules generally take effect in 2007, although they are phased in over three years. However, the three-year phase-in does not apply to participants age 55 and over with at least three years of service.

Participant investment advice	
Current law	Generally, plan fiduciaries are not permitted to give investment advice regarding their own products.
New law	<p>The PPA provides that plan fiduciaries may give investment advice to individual participants in a participant-directed plan if either:</p> <ul style="list-style-type: none"> • The advice fees do not vary depending on the basis of any investment option selected (flat fee exception) • The advice providers use a certified computer model (model-driven exception) <p>The fiduciary providers must satisfy additional disclosure and, in some instances, audit requirements.</p>
Effective date	These changes are generally effective in 2007.

Automatic enrollment safe harbor	
Current law	No safe harbor currently exists for automatic enrollment or automatic deferral increases.
New law	<p>The PPA establishes an “automatic enrollment safe harbor.” Specifically, if the requirements are met, the plan will be a safe harbor plan and will not be subject to ADP/ACP or top-heavy testing. In order to satisfy the safe harbor, the following requirements must be met:</p> <ol style="list-style-type: none"> 1. The default deferral percentage may not be less than three percent for the first year; four percent for the second year; five percent for the third year; and six percent thereafter (but the default may never exceed 10 percent of compensation). 2. Participants must be given the ability to “opt out” of or change the automatic deferral and/or the automatic increases. 3. The plan must provide either a non-elective contribution of three percent of pay or a matching contribution equal to 100 percent of the first one percent deferred and 50 percent of the next two through six percent deferred. 4. Employer contributions must be fully vested after two years. 5. An employee subject to the automatic enrollment program must receive a notice that explains his or her right to elect not to have elective contributions made, and how contributions will be invested if no investment election is made. The employee must have a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an affirmative election. <p>In addition, the PPA also adds a provision preempting any state wage withholding law that restricts the availability of automatic enrollment plans. (Such withholding laws generally require that a participant must affirmatively elect to have any amounts withheld from his or her compensation.)</p> <p>Superseding these laws is important if Congress wants to encourage plan sponsors to adopt automatic enrollment features.</p>
Effective date	The safe harbor is effective in 2008; the preemption of state law is effective as of the date of enactment.

Default investments

Current law	No protection currently exists for the election of default investments by the Plan Sponsor.
New law	The PPA provides for ERISA section 404(c) relief (under which fiduciaries are generally not liable for the asset allocation decisions of participants) with respect to “ <i>default</i> ” investments, so long as a notice requirement and certain requirements as to the default investment are met.
Notice requirement	The notice requirement is met if: (1) within a reasonable period of time before each plan year, a notice is provided explaining the employee’s right under the plan to designate how contributions and earnings will be invested and explaining how they will be invested in default of an affirmative election; and (2) the employee has a reasonable period of time after receipt of the notice and before the beginning of the plan year to make an election.
Default investment requirement	The PPA has required that the DOL issue final regulations within six months after enactment “on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.”
Effective date	The changes are generally effective in 2007.

Defined Benefit Provisions

The PPA provides for a comprehensive overhaul of the defined benefit plan funding rules under ERISA and the Tax Code, as well as changes to the PBGC insurance program. Changes for single employer plans affect funding, at risk plans, benefit limitations and deduction limits.

Funding

The PPA sets a new funding target for most pension plans of 100 percent. Any shortfalls must be funded over a 7-year amortization period. In general, the 100 percent funding target is phased-in over four years for eligible plans. Eligible plans will be considered fully funded if they meet interim targets of 92 percent in 2008, 94 percent in 2009, and 96 percent in 2010.

For 2006 and 2007, the temporary replacement corporate bond rate in effect for 2004 and 2005 continues to apply. Beginning in 2008, a new interest rate will be phased in over a three-year period, based on a modified yield curve. The PPA directs Treasury to update mortality tables and permits plan sponsors to request the use of a substitute table that reflects a plan's actual experience and projected trends.

Smoothing of plan assets for funding purposes is limited to 24 months and cannot result in values that are lower than 90 percent or greater than 110 percent of the fair market value of such assets. The PPA also limits the use of credit balances that a plan sponsor might have accumulated through advance contributions. Note that plans established after 2007 are not entitled to most transition rules.

At Risk Plans

Having an "at risk" plan will subject the employer-sponsor to even stricter funding requirements. The result will require accelerated contributions. Under the rules, a plan "at risk" is: (1) less than 80 percent funded using the general funding actuarial assumptions and (2) less than 70 percent funded using special "at-risk" actuarial assumption. Generally, "at risk" liabilities will be determined by assuming that employees eligible to retire in the next 10 years will retire as early as possible. Transition rules apply.

Benefit Limitations

With certain exceptions, companies that are less than 80 percent funded (or would be less than 80 percent funded with new benefits) cannot be amended to provide any enhanced or new benefits and may not be able to offer full lump sum distributions. Plans that are less than 60 percent funded, or under funded with a sponsor in bankruptcy, will be restricted from offering any lump sum benefit payments. For plans that are less than 60 percent funded, new accruals must generally be frozen. Finally, the PPA establishes restrictions on the compensation that can be set aside under a nonqualified deferred compensation plan, when a defined benefit plan's funding falls below certain levels (e.g., when a plan is considered "at risk").

Deduction Limits

As a funding incentive, the PPA amends Code Sec. 404 to increase the maximum deductible amount to 150 percent of current plan liabilities for 2006 and 2007. After 2007, deductible contributions generally may be made up to the greater of (1) the minimum required contribution or (2) an amount equal to the sum of the funding target, target normal costs, and a special "cushion account" minus the value of plan assets.

Plans with 100 or fewer participants get a break on computing benefit increases for highly compensated employees.

The PPA 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 combined plan deduction limit applies only if contributions to one or more defined contribution plans exceed a six-percent ceiling.

Reporting and Disclosure Rules

The PPA adopts significant new reporting and disclosure rules of immediate interest to sponsors and administrators, including new defined benefit funding notices and enhanced benefit reporting and disclosures to participants.

Hybrid/Cash Balance Plan Provisions

The PPA provides that a plan does not violate ERISA “if a participant’s accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant.” This language seems to fix the age discrimination problem, but only prospectively. The PPA includes Senate language stating that past law is to be interpreted with “no negative inference” from the enactment of these new provisions.

In addition, the PPA resolves the question of what constitutes a legitimate hybrid plan by providing that for certain other ERISA and Tax Code rules applicable to the determination of a participant’s accrued benefit, the present value of a participant’s accrued benefit (or any portion thereof) may, under the terms of the plan, be expressed as the balance in the hypothetical account or as an accumulated percentage of the participant’s final average compensation.

Under the new plan design, all current and new hybrid plans will have to satisfy requirements relating to:

- Interest crediting with floors and ceilings (elimination of whipsaw)
- Three-year cliff vesting
- Special rules for conversions from tradition plans (including restrictions on “wearaway”)

These changes are generally effective for periods beginning after June 29, 2005; new rules for determination of accrued benefits are effective from date of enactment.

For plans in existence on June 29, 2005, the interest crediting rules and three-year vesting rule are effective in 2008.

Conclusion

Please note that this is only a brief summary of the countless new retirement provisions in the PPA. The actual legislation is over 900 pages long and impacts a number of areas of the law. This summary is not intended to be comprehensive and if you have any questions regarding this summary, please contact Oswald Financial, Inc.