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A legal update from Dechert's Employee Benefits and Executive Compensation Group

The Pension Protection Act of 2006

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (the "Act") which makes sweeping changes to the rules applicable to tax-qualified retirement plans. The Act significantly overhauls the pension funding rules, including the way in which annual minimum required contributions and maximum tax-deductible contributions are determined. The Act also requires defined benefit plans to utilize new interest rate assumptions in calculating lump sums, imposes restrictions on benefit accruals, certain benefits payable by and amendments to underfunded plans, and requires additional reporting and disclosure by employers.

In addition to the changes made to defined benefit plan rules, the Act includes a number of provisions impacting defined contribution plans, including changes that permit automatic enrollment, require increased diversification for plan's that contain employer stock, and make permanent certain retirement plan provisions previously enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") that were due to expire. Finally, the Act also contains several provisions that will affect nonqualified deferred compensation arrangements and health care plans. This update summarizes some of the Act's most significant changes.

Defined Benefit Plans

Pension Funding Requirements

For plan years beginning after 2007, the Act repeals the present-law pension funding rules, and provides an entirely new set of rules for determining minimum required contributions. Under the new rules, the minimum required contribution to a defined benefit plan generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. A plan's "funding target," for any plan year, is the present value of all benefits accrued or earned as of the beginning of that plan year. A plan's "target normal cost," for a plan year, is the present value of benefits expected to accrue or be earned during that plan year. For this purpose, an increase in any benefit attributable to services performed in a preceding year by reason of a compensation increase during the current year is treated as having accrued during the current year.

The goal of the new funding rules is to have a defined benefit plan be fully funded after seven years. The less funded a plan is, the higher the minimum required contributions will be. However, plans considered "at-risk," as described below, will be subject to accelerated funding.

Under the Act, the minimum required contribution for a defined benefit plan, for any plan year, may be determined in accordance with the following table:

If . . .	The minimum required contribution is:
The value of plan assets (reduced by any credit balance) is less than the funding target	The sum of (1) the target normal cost, (2) any shortfall amortization charge, and (3) any waiver amortization charge
The value of plan assets (reduced by any credit balance) equals or exceeds the funding target	The target normal cost, reduced (but not below zero) by the excess of (1) the value of plan assets (reduced by any credit balance) over (2) the funding target

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For this purpose, the term "credit balance" refers to the sum of excess credits to an employer's funding standard account under present law and contributions in excess of the minimum contributions required for plan years beginning after 2007.

A plan will have a "funding shortfall" for any plan year, if the plan's funding target for that year exceeds the value of the plan's assets (reduced by any credit balance). A funding shortfall must be amortized over seven years. Therefore, a plan's "shortfall amortization charge" is generally the sum of the amounts required to amortize any funding shortfall for the plan year and the six preceding years. A "waiver amortization charge" is the amount required to amortize a waived funding deficiency.

Under the Act, the value of plan assets is generally fair market value as of the applicable valuation date. To reduce the effect of market fluctuations, the value of an asset may be averaged over two years, and the resulting value must be between 90% and 110% of the asset's fair market value as of the applicable valuation date. Present law allowed an assets value to be averaged over 5 years, so there is less flexibility under the new rules.

The Act specifies the interest rates and mortality table that must be used in determining a defined benefit plan's target normal cost and funding target. For its interest rate assumption, the Act uses three interest rates (called "segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period (i.e., less than five years, between five and 20 years, and 20+ years). Each segment rate will be determined and published monthly by the IRS on the basis of a corporate bond yield curve. This corporate bond yield curve is a 24-month average of yields on investment grade corporate bonds which have varying maturities. The Act provides transition rules for determining the segment rates for plan years beginning in 2008 and 2009 under which the segment rates are blended with rates used under present law.

In lieu of using the segment rates described above, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which a plan year begins (that is, without regard to a 24-month averaging). Such an election applies to the plan year for which it is made and all succeeding plan years, and may be revoked only with the IRS's consent.

For its mortality assumption, the IRS will prescribe mortality tables by regulation. In certain cases, the Act allows an employer to elect to apply its own mortality table, with IRS approval.

As under present law, the due date for the payment of a minimum required contribution for a plan year is generally eight and one-half months after the end of the plan year. However, quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year.

At-Risk Plans

The Act applies special actuarial assumptions in determining the funding target and target normal cost of a defined benefit plan which is considered "at-risk." A defined benefit plan generally is treated as being "at-risk" for a plan year if, for the preceding plan year, the plan's "funding target attainment percentage" (the ratio that the value of a plan's assets (less credit balances) bears to the plan's funding target) was less than 80% using the normal actuarial assumptions *and* less than 70% using certain more conservative "at-risk" actuarial assumptions. A transition rule applies for determining at-risk status for 2008 through 2010.

Under the Act, the at-risk rules do not apply for a plan year if the plan had 500 or fewer participants on each day during the preceding plan year. If a defined benefit plan is at-risk, the Act increases the minimum required contribution, by requiring that certain more stringent actuarial assumptions be used, and by increasing the plan's funding target and normal cost. The effect of these rules is to phase in the higher required minimums, at 20% per year, over 5 years.

Credit Balances

The Act allows that credit balances be applied to reduce the minimum required contributions in certain cases. Alternatively, credit balances may be waived, and the waived amounts will not reduce asset values for purposes of the funding rules.

Deduction Limit

The Act provides generous increases in the amount of the annual maximum deductible contribution to a defined benefit plan.

Under the Act, for 2006 and 2007, the maximum deductible contribution to a defined benefit plan is not less than the excess (if any) of (1) 150% of the plan's

current liability (calculated under pre-Act law) over (2) the value of plan assets.

For years beginning after 2007, the maximum annual deductible contribution generally is equal to the greater of (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a "cushion amount" over the value of plan assets, and (2) the minimum required contribution for such year. If the plan is not "at risk," the Act allows certain increases to the amounts in (1).

The "cushion amount" for a year is generally the sum of (1) 50% of the plan's funding target for such year and (2) the amount by which the plan's funding target for that year would increase if determined by taking into account increases in participants' compensation for future years, or, if the plan does not base benefits on compensation, increases in benefits that are expected to occur in succeeding plans years, determined on the basis of average annual benefit increases over the previous six years.

Benefit Limitations

After 2007, if a defined benefit plan's "adjusted funding target attainment percentage" (the ratio that the value of a plan's assets (less credit balances) bears to the plan's funding target, in both cases increased by the amount of annuities purchased for non-highly compensated employees during the preceding two years (the "funding percentage")) does not satisfy certain thresholds, the plan will be subject to limitations on benefit increases, lump sum payments, and shutdown benefits, and may be required to suspend benefit accruals.

If a defined benefit plan's funding percentage is less than 60%, all future benefit accruals under the plan must cease. Also, the Act:

- Limits the amount of retirement benefit payments when the funding percentage is less than 80%, or when the employer is in bankruptcy and the funding percentage is less than 100%
- Prevents the payment of shutdown benefits if the plan's funding percentage is less than 60%, or would be less than 60% taking into account the occurrence of the shutdown event
- Does not allow an amendment which would increase benefit liabilities to be made if the plan's funding percentage is less than 80%, or would be less than 80% taking such amendment into account

If the first restriction applies, a plan will not be permitted to make full lump sum distributions or purchase annuity contracts. In certain cases, the employer may avoid or terminate one of the foregoing restrictions by making an additional contribution to the plan which increases the plan's funding to a sufficient level.

The plan administrator must provide written notice to participants and beneficiaries within 30 days after a plan has become subject to the cessation of benefit accruals, the restriction on the amount of regular retirement benefit payments or the prohibition on the payment of shutdown benefits.

Lump Sum Distributions

Under the Act, for plan years after 2007, lump sum distributions under a defined benefit plan are to be computed using the segment interest rates previously discussed, with certain adjustments, and the mortality table used for computing minimum required contributions, modified as appropriate by the IRS. Use of the new interest rate assumption will be phased in at the rate of 20% per year from 2008 to 2012, gradually replacing the 30-year Treasury Securities interest rate used under present law.

Annual Funding Notice

The Act establishes a new notice requirement for defined benefit plans, which pertains to the plan's funding, effective for plan years after 2007. The notice must be provided, for each plan year, to the PBGC, participants and beneficiaries, and any union representing plan participants. The notice must include the following:

- Identifying information (e.g., the name of the plan, the plan number, etc.)
- The number of active participants, the number of participants who are retired or separated from service and receiving benefits, and the number of retired or separated participants who are entitled to future benefits
- The plan's funding policy and asset mix
- Information on any plan amendment, scheduled benefit increase or reduction, or other known

event which will have a material effect on plan liabilities or assets

- The plan's funding percentage for the current and the two preceding plan years, and the assets and benefit liabilities for the current and the two preceding plan years
- Whether the employer or any of its controlled group members was required to file a report with the PBGC under ERISA Section 4010 (see discussion below) for the plan year covered by the notice
- A summary of the rules for plan terminations and the benefits which are guaranteed by the PBGC
- A statement that a person may obtain a copy of the plan's annual report (i.e., Form 5500) upon request, through the Department of Labor's Internet website, or through an Intranet website maintained by the employer

Generally, each funding notice must be provided within 120 days after the end of the plan year to which it relates. As a result of this new funding notice, defined benefit plans will no longer be required to provide a summary annual report to participants.

Section 4010 Reporting

Under the Act, for plan years after 2007, a filing with the PBGC will be required, for any plan year, if the funding target attainment percentage (see the At Risk Plan section above) at the end of the preceding plan year for any defined benefit plan maintained within a controlled group is less than 80%. The PBGC filing must include:

- The amount of the plan's benefit liabilities
- The funding target of the plan, determined as if the plan has been in "at-risk" status for at least 5 years
- The plan's funding target attainment percentage

Benefit Statements

For plan years beginning after 2006, the Act revises ERISA's benefit statement requirements. Under the new requirements, the plan administrator of a defined benefit plan is required either:

- To furnish a benefit statement, at least once every three years, to each participant who has a vested accrued benefit under the plan, and who is an employee at the time the statements are furnished
- To furnish at least annually to each such participant a notice of the availability of a benefit statement, and the manner in which the participant may obtain it

In addition, the plan administrator is required to furnish a benefit statement to a participant or beneficiary upon written request, limited to one request during any 12-month period.

Any benefit statement must be written in a manner calculated to be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the recipient. A benefit statement provided to a participant is required to indicate the participant's total accrued benefit, and the participant's vested accrued benefit, or the earliest date on which the accrued benefit will become vested.

Phased Retirement Distributions

Under present law, a defined benefit plan generally may not make payments to a participant before his or her retirement or separation from service. Proposed regulations provide for a phased retirement program that would allow employees who are at least age 59 1/2, and who are eligible for retirement, to reduce the number of hours they customarily work by at least 20% and receive a pro rata portion of their retirement benefits. The Act goes beyond the proposed regulations and allows a defined benefit plan to make in-service distributions to a participant after he or she attains age 62, without any requirement that the participant's work hours be reduced. This rule applies to distributions made in plan years beginning after 2006.

Joint and Survivor Annuities

Under the Act, generally effective for plan years beginning after 2007, defined benefit plans and money purchase pension plans will have to offer both a joint and 50% spousal survivor annuity and a joint and 75% spousal survivor annuity as a form of benefit payment.

Furthermore, after 2006, defined benefit plans and money purchase pension plans are required to provide the written explanation of the qualified joint and survivor annuity and other optional forms of benefit payment no less than 30 days and no more than 180 days (replacing the 90 days under present law), before any distribution starts. Also, the explanation is to describe a participant's right, if any, to defer receipt of benefit payments, and the consequences of a failure to defer.

Defined Contribution Plans

401(k) Plan Automatic Enrollment

The IRS has long permitted employers to automatically enroll eligible employees in the employer's 401(k) plan pursuant to so-called "negative elections." However, there have been questions concerning whether these negative elections comply with the various state wage and hour laws. Effective immediately, the Act specifically preempts all state wage and hour laws that would directly or indirectly prohibit or restrict negative elections. Effective for years after 2007, the Act also includes several rules that will make the administration of automatic enrollment plans easier and possibly more attractive to plan sponsors.

Employers may give participants a 90-day window to elect out of the plan, and if an employee does so, the plan may distribute the employee's account balance immediately without penalty. However, the distributions are includible in income when received. An employer who sponsors an automatic enrollment plan will have six months, rather than the two and a half months under present law, in order to make refunds if a plan fails the applicable nondiscrimination tests.

The Act also clarifies that an employer may adopt an automatic enrollment plan for new hires only. The Department of Labor is instructed to provide regulations regarding the appropriate investment vehicles for participants who are automatically enrolled in a plan.

Effective for years after 2007, the Act adopts a new optional automatic enrollment "safe harbor," that will permit employers to avoid the ADP and ACP nondiscrimination tests and the "top heavy" rules. This new safe harbor requires the plan to provide:

- That default contributions are at least 3% of pay in the first year of participant and that they increase annually to at least 6% in the fourth year of participation (with a maximum contribution of 10% of pay)
- *Either* matching contributions must be made for all eligible non-highly compensated employees at a rate of 100% of the first 1% of pay contributed plus 50% of the next 5% of pay contributed *or* a non-elective contribution equal to 3% of pay to all eligible employees must be made
- Matching contributions or non-elective contributions must vest after two years of service

The Act creates two new notice requirements for plans that utilize automatic enrollment. One notice is applicable to plans intending to satisfy the safe harbor requirements, and the second notice is applicable to plans that allow for the 90-day withdrawal window. Both notices must be provided annually before each plan year.

Diversification of Employer Stock

Effective after 2006, the Act provides that employee elective deferrals and after-tax contributions may not be required to be invested in employer stock. The Act further requires that an employee must be able to direct the investment of matching and profit sharing contributions in at least three other investment options after a maximum of three years of service. If a plan already holds employer securities, the rules are phased in over a three-year period except with respect to a participant who is age 55, in which case the new diversification rules apply for all years after 2006. The diversification rules do *not* apply to stand-alone ESOPs.

Faster Vesting in Profit Sharing Contributions

Nonelective profit-sharing contributions currently may vest under either a five-year cliff vesting or three to seven-year graded vesting schedule. The Act requires that nonelective profit-sharing contributions vest on a three-year cliff schedule or two to six-year graded vesting schedule. This requirement is now identical to the rules that apply to matching contributions.

EGTRRA Provisions Made Permanent

In 2001, EGTRRA significantly changed many of the limits applicable to retirement plans. Many of these provisions were to "sunset" after December 31, 2010. The Act makes certain of the EGTRRA changes per-

manent, including the permissibility of catch-up contributions, increased deferral dollar and percentage of compensation limits, deductibility of reinvested ESOP dividends, Roth 401(k) plans, and automatic rollover of accounts between $1,000 and $5,000.

Hardship Distributions

Currently, hardship distributions may only be made due to the hardship of the participant and the participant's spouse or dependent. The Act immediately expands the rules to include distributions being made due to the financial hardship of a participant's beneficiary (other than a spouse or dependent). The same rules now apply to 401(k), 403(b), and 457 plans, as well as nonqualified deferred compensation under section 409A of the Code.

More Frequent Account Statement

Effective in 2007, the Act requires that a defined contribution plan which permits investment direction by participants must provide quarterly benefit statements. Prior law required statements only upon request and no more than once per year. The benefit statements must include detailed information regarding vested status, the value of a participant's investment funds, information about diversification, and information about the Department of Labor website.

Investment Advice

Currently, fiduciary rules generally inhibit the provision of investment advice to plan participants. The Act creates an exception that permits a registered investment adviser, bank, or similar institution to provide investment advice to participants if the fee does not vary based on the choices a participant makes and its recommendations are based on certified computer models. In addition, the Act extends fiduciary protection to employers who change investment funds (such as in a plan merger) if the funds are "mapped" to funds with similar characteristics. Other rules regarding ERISA's fiduciary standards were revised and are explained in more detail in our August 2006/Special Alert *Dechert OnPoint: Congress Approves Pension Protection Act of 2006*.

Rollover Rules

Effective in 2007, participants will be able to rollover after-tax amounts through a direct rollover to defined contribution plans, defined benefit plans, and 403(b) annuities, if the plan or annuity separately accounts for the contributions. Effective in 2007, nonspouse beneficiaries of a qualified plan will be able to transfer amounts directly to an IRA, and it will be treated as an inherited IRA in the same manner as a spousal IRA for purposes of the minimum required distribution rules. Starting in 2008, distributions from qualified plans, 403(b) annuities, and 457 plans may be rolled over directly to a Roth IRA.

Nonqualified Deferred Compensation Plans

Funding Limitations

Under the Act, during a "restricted period," an employer may not set aside assets in a trust or other arrangement for purposes of funding nonqualified deferred compensation of certain "covered" employees. This rule applies even if the trust is a "rabbi trust," in which the assets remains subject to the claims of the employer's creditors.

Any asset set aside, in contravention of these rules, and any subsequent appreciation in the value of or earnings with respect to such asset, would become currently taxable to the applicable covered employee, and, in addition, would subject such employee to a 20% penalty tax and interest on the amount includable in income. If an employer provides a gross-up payment to the employee to reimburse him or her for the amount includible in income under this rule, the gross-up payment itself will be taxable, and would also subject the employee to a 20% penalty tax and interest on the gross-up payment he or she receives. In addition, the gross-up payment is nondeductible by the employer.

A "restricted period" is:

- Any period in which the employer maintains a defined benefit plan that is "at risk" (as described in the Defined Benefit Plans section above)
- Any period in which an employer which maintains a defined benefit plan is in bankruptcy
- The period which begins six months before, and ends six months after, the date on which a defined benefit plan of the employer is terminated in an involuntary or distress termination

In general, a "covered" employee is the chief executive officer, the four highest paid officers (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934.

These rules apply to assets set aside after the date the Act was signed (i.e., August 17, 2006).

Welfare Benefit Plans

Company-Owned Life Insurance

Under current rules, amounts received under a life insurance contract paid by reason of the death of the insured are not includible in income for Federal tax purposes. The Act eliminates tax-free treatment for death benefits received under a company-owned life insurance policy that exceed the premiums paid. However, such income need not be recognized if the insured employee (1) was either (i) employed by the company at any time during the 12-month period before death, or (ii) was a director or highly compensated employee; (2) was notified in writing that the company purchased life insurance on his or her life; and (3) has provided written consent to such insurance. This provision generally applies to policies issued after the date of enactment (i.e., August 17, 2006).

Transfer of Pension Assets

Current law allows for the transfer of excess pension plan assets to retiree medical accounts under such plans. No more than one qualified transfer may be made in any taxable year. The amount of excess assets transferred may not exceed the amount reasonably estimated as the employer's current retiree health liabilities. Effective immediately, the Act expands permissible excess asset transfers to include future medical cost and amounts negotiated under a collective bargaining agreement. The Act provides significantly more flexibility with respect to such transfers.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

Robert W. Ballenger
Philadelphia
+1 215 994 2208
robert.ballenger@dechert.com

Stanley D. Baum
New York
+1 212 698 3838
stanley.baum@dechert.com

Richard D. Belford
New York
+1 212 698 3607
richard.belford@dechert.com

Susan M. Camillo
Boston
+1 617 728 7125
susan.camillo@dechert.com

David F. Jones (Chair)
Philadelphia
+1 215 994 2822
david.jones@dechert.com

Paul S. Kimbol
Philadelphia
+1 215 994 2603
paul.kimbol@dechert.com

Ryan M. Metz
Philadelphia
+1 215 994 2821
ryan.metz@dechert.com

Melissa K. Ostrower
New York
+1 212 698 3624
melissa.ostrower@dechert.com

Abigail B. Pancoast
Philadelphia
+1 215 994 2574
abigail.pancoast@dechert.com

Drew A. Picciafoco
Boston
+1 617 728 7109
drew.picciafoco@dechert.com

Beth L. Rubin
Philadelphia
+1 215 994 2535
beth.rubin@dechert.com

Stephen W. Skonieczny
New York
+1 212 698 3524
stephen.skonieczny@dechert.com

Frank B. Tripodi
New York
+1 212 698 3871
frank.tripodi@dechert.com

Kathleen Ziga
Philadelphia
+1 215 994 2674
kathleen.ziga@dechert.com

Dechert LLP

www.dechert.com

U.S.

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