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COMPENSATION & EMPLOYEE BENEFITS LAW BULLETIN

A BIRDSEYE VIEW OF THE PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 (the "Act") is arguably the most comprehensive pension reform legislation passed in decades and comes on the heels of the downfall of corporate giants such as Enron and WorldCom, resulting in employees experiencing unprecedented losses in their retirement plans. The Act was signed by the President on Thursday, August 17, 2006.

The Act is quite expansive (over 900 pages in length) and, among other things, impacts the funding of defined benefit plans, makes the provisions of EGTRRA permanent, clarifies the prospective legal status of cash balance plans, provides protection for ERISA fiduciaries who provide participant investment advice, expands funding for retiree health plans and provides for a small employer combination defined benefit plan and 401(k) plan. Because of the many aspects of the Act, this is the first in a series of installments in which we will examine the Act's main provisions. In this first installment, we provide a brief overview of the main provisions of the Act organized based on effective date. This installment is limited to those provisions effective retroactively, as well as those which become effective upon the Act's enactment and in 2006 and 2007. The later installments will provide information on provisions which will become effective after 2007.

Please keep in mind that this e-alert is intended to serve as a very general overview. Plan sponsors are strongly encouraged to discuss with their benefits counsel how the Act specifically affects the administration and design of their plans. Plan Sponsors should also stay tuned because there will likely be a technical corrections bill enacted to address deficiencies and needed clarifications to certain provisions of the Act.

PROVISIONS EFFECTIVE RETROACTIVELY

Cash Balance and Other Hybrid Plans – generally effective on and after June 29, 2005

The Act clarifies the rules governing hybrid defined benefit plans. The two most common hybrid plans are cash balance plans and pension equity plans. A cash balance plan defines an employee's "account" based on an annual contribution rate for each year of service plus earnings at a rate specified in the plan (instead of actual investment earnings). A pension equity plan defines an employee's retirement benefit as a percentage of his final average compensation for each year of service under the plan. Hybrid plans are funded, administered and regulated as defined benefit plans.

The Act resolves, on a prospective basis, some of the major controversies surrounding hybrid pension plans. The Act amends the Internal Revenue Code, ERISA and the Age Discrimination in Employment Act to provide that all defined benefit plans, including hybrid plans, are not age discriminatory as long as they satisfy certain specified vesting and interest crediting requirements. Generally, benefits must be fully vested after three years of service and interest credits may not exceed a market rate of return (to be defined under Treasury Regulations). A hybrid plan will not be deemed to be age discriminatory if a participant's accrued benefit is not less than the accrued benefit of any similarly situated younger employee. The Act states that the new provisions should not be construed to create an inference with respect to the legal status of plans for past years (allowing for the possible continuation of disputes to be resolved by the courts). For plans in existence on June 29, 2005, the interest crediting rule and the vesting rule described above is effective for plan years beginning after December 31, 2007, unless the plan sponsor elects earlier application as provided under the Act.

The Act also imposes requirements on converting a traditional defined benefit plan to a hybrid plan, such as a prohibition on a wear away of pre-conversion accrued benefits. The conversion requirements are effective for conversions adopted after, and taking effect after, June 29, 2005. No inference is to be made regarding the legality of earlier conversions.

PROVISIONS EFFECTIVE ON ENACTMENT OF THE ACT AND IN 2006

Cash Balance and Other Hybrid Plans

With respect to hybrid plans as discussed above, the Act allows for lump-sum distributions to be equal to the hypothetical account balance (i.e., a cash balance plan) or the accumulated percentage of final average pay (i.e., a pension equity plan). This differs from current law, which often required the plan to pay more than the account balance or accumulated percentage of final average pay due to other specific requirements for calculating the amount of a lump-sum distribution. (Under current law this is referred to as the "whipsaw" effect.) This provision is applicable for distributions made after the Act's enactment date.

EGTRRA

The Act makes permanent the retirement savings rules and plan features affecting pension plans, IRAs and 529 college tuition programs enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which were scheduled to expire at the end of 2010. Some of the provisions that were made permanent include increased limits on contributions (including catch-up contributions for those age 50 and older), pension benefits and IRAs. The Act also made permanent the Saver's Credit previously scheduled to expire at the end of 2006. In addition, the income limits on the Saver's Credit will be indexed for inflation beginning in 2007.

Funding of Retiree Medical Benefits

The Act expands the ability of plan sponsors to make a qualified transfer of excess defined benefit plan assets to a separate account to help fund retiree medical benefits for a period of up to 10 years. Plan sponsors making this transfer will be required to maintain the plan's funded status at minimum levels during the transfer period and must maintain retiree medical benefits at certain levels for the transfer period and for four years thereafter. The new provisions apply to transfers made after the Act's enactment date; however, the amount that can be funded for future years is to be determined in accordance with guidance to be issued by the Treasury.

Automatic Enrollments and ERISA Preemption

The Act encourages the adoption of automatic enrollment features in 401(k) plans by providing that as long as the plan provides the required notice (as prescribed in the Act) to plan participants before each year, any state law that would prohibit or restrict automatic enrollments would be preempted by ERISA. The notice must explain an employee's right to opt out of the automatic enrollment, the employee's right to change the contribution rate and the manner in which such automatic enrollment contributions are to be invested. The notice requirement raises the question of whether a similar notice is now required in states that had previously acknowledged that ERISA did pre-empt its wage and hour laws as they related to automatic enrollment. The provision is effective on the Act's enactment date.

Expansion of the PBGC Missing Participant Program

Currently, when a Pension Benefit Guaranty Corporation ("PBGC") insured defined benefit plan terminates, the value of the benefits of missing participants is transferred to the PBGC. The Act expands the program to allow for the transferring of the value of the accounts for missing participants in a terminating defined contribution plan. This provision will be effective upon issuance of final regulations by the PBGC.

Employer-Owned Life Insurance

Under current law, life insurance proceeds are excludable from the gross income of the beneficiary. With respect to certain employer-owned life insurance policies, any proceeds in excess of the premiums are includable in the employer's gross income. Provided that certain notice and consent requirements are met, there are exceptions to this provision for amounts paid (1) to the employee's heirs; (2) for an individual who was an employee during the 12 months prior to his or her death; or (3) for an individual who, at the time the contract was issued, was a director or highly compensated employee. The provision is generally effective for contracts issued or materially changed (including new lives added under an existing contract) after the Act's enactment date.

PROVISIONS EFFECTIVE FOR PLAN YEARS BEGINNING IN 2007

Employer Securities/Investment Diversification Rights

The Act provides new investment diversification requirements which may greatly affect defined contribution plans that hold employer securities. In brief, the Act requires the following of any defined contribution plan that holds publicly traded employer securities:

- all participants must be immediately permitted to diversify employee contributions and elective deferrals invested in employer securities;
- participants with at least three years of service must be allowed to diversify other contributions in employer securities made on their behalf;
- at least three materially different alternative investment options must be made available;
- for existing plans, the provisions are phased in over three years for employer securities acquired before 2007, except for participants who are age 55 or older and who have three years of service;
- a notice of the right to diversify is required to be furnished no later than 30 days before the first date that a participant is eligible to diversify (the notice is not required sooner than 90 days after the Act's enactment); and
- the provisions do not apply to stand-alone ESOPs, privately held companies and one-participant plans.

Investment Advice to Participants

The Act creates a new prohibited transaction exemption under both the Internal Revenue Code and ERISA permitting a "fiduciary adviser" under an "eligible investment advice arrangement" to be compensated for giving participants investment advice. Generally, a fiduciary that is a registered investment advisor, bank, insurance company or registered broker-dealer is deemed to be a "fiduciary adviser". Such person or entity will be allowed to give investment advice to participants without engaging in a prohibited transaction if either (1) the fees charged do not vary depending on the investment choices that a participant makes (i.e., a compensation-based exemption); or (2) the recommendations made are based on a computer model that meets certain requirements (i.e., a computer-based model exemption). Under either approach, the Act includes several safeguards, including an annual audit of the arrangement and participant disclosure requirements. The exemption is available for investment advice provided after December 31, 2006.

ERISA 404(c) Protection for Default Investments

ERISA 404(c) protection (which provides limited protection against fiduciary liability for investment loses) is extended to default investments directed by fiduciaries for participants who fail to make an affirmative investment election (which often will be the case in a plan offering automatic enrollment). The Department of Labor is directed to issue guidance concerning acceptable designs for default investment options eligible for this rule. This default investment rule is effective for plan years beginning after December 31, 2006.

Benefit Statements

A defined contribution plan that allows participant direction of investments must provide a benefit statement at least once per calendar quarter. If the plan does not allow participant direction, benefit statements must be provided once per year. A defined benefit plan must provide a statement at least once every three years. Statements may be delivered electronically. This provision is effective for plan years beginning after December 21, 2006.

Phased Retirement Distributions

The Act provides that a defined benefit plan may allow for in-service distributions to a participant who has reached age 62. Under current law, in-service distributions from defined benefit plans cannot be made to participants who have not reached the plan's normal retirement age, which is usually age 65. This provision applies to distributions made in plan years beginning after December 31, 2006.

QJSA Notices

Current law provides that the plan administrator of a defined benefit plan must provide a notice explaining the ramifications of electing to waive a QJSA. The notice must be sent between 30 and 90 days before a participant's annuity starting date. The Act changes this period to permit the explanation to be provided up to 180 days before the annuity starting date. The Act also expands the information that must be provided in the notice. This change is effective for plan years beginning after December 31, 2006.

Defined Contribution Plan Vesting

The Act requires that employer nonelective contributions to defined contribution plans must vest 100% after three years of service (i.e., three-year cliff vesting), or must vest 20% per year over a two-six year schedule (i.e., two to six year graded vesting.) This is the same vesting schedule currently required for matching contributions. This provision generally becomes effective for employer nonelective contributions made in plan years beginning in 2007, except for certain collectively-bargained plans and leveraged ESOPS with outstanding securities acquisition loans.

After-Tax Portability

The Act expands the portability of after-tax amounts by allowing rollovers of such amounts (including Roth accounts) between different types of employer-sponsored plans such as allowing a rollover from a qualified plan to a 403 (b) plan. The change is effective for distributions after December 31, 2006.

Distribution Notice

The Act directs the Treasury to modify the regulations to provide that notices describing the consent requirements for distributions in excess of $5,000 must describe the consequences of failure to defer receipt. This change is effective for distributions made after December 31, 2006. The Act further provides that a plan will not be treated as failing to satisfy the notice requirement if the notice is provided within 90 days after the Secretary of the Treasury issues the required modifications if the plan administrator makes a reasonable attempt to comply with such requirements.

Other Provisions with 2006 and 2007 Effective Dates

• Determinations of the high three-year average compensation for the 100% prong of the 415 annual benefit limit may be calculated using years of service in which the employee was not an active participant in the plan (effective for 2006).
• Waiver of the 10% early distribution penalty on distributions to qualified reservists called to active duty, in excess of 179 days, after September 11, 2001 and before December 31, 2007; waives dollar limits on contributions to IRAs to allow qualified reservists to repay distributions within certain time limits.
• Directs the Treasury to expand the hardship distributions rules to permit distribution if the hardship exists for a person who is a beneficiary under a plan (not just for the participant and his or her dependents).
• Simplifies annual reporting for plans with less than 25 participants.

If you need further information or assistance regarding the Act, please contact any of the attorneys in the Compensation and Employee Benefits practice group at Troutman Sanders LLP.

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