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Management Alert

The Defined Benefit Plan Provisions of the Pension Protection Act of 2006

Strengthening the defined benefit pension plan funding rules was the significant moving force behind the Pension Protection Act of 2006 (Act), which Congress recently passed and the President has stated he will sign. The Act will have a significant impact on defined benefit pension plans. Highlights include:

1. Hybrid/Cash Balance Plan Provisions Included in the Pension Protection Act

The Act includes a number of provisions intended to clarify the legal status and requirements applicable to "hybrid" account-based defined benefit pension plans, including cash balance and pension equity plans. These plans have been the subject of extensive litigation in recent years, particularly as to (i) whether such account balance-based pension plans are inherently age discriminatory, (ii) whether the conversion from a traditional pension plan to a cash balance plan is age discriminatory and violates Internal Revenue Code rules regarding benefit accruals, and (iii) how lump-sum distributions are calculated (the so-called "whipsaw" issue). The following provides a brief overview of the Act's provisions:

- Age Discrimination: Effective as of June 30, 2005, the Act provides that a hybrid plan does not violate the age discrimination rules if a participant's accrued benefit would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant. In determining a participant's accrued benefit for this purpose, the accrued benefit may be expressed as the balance of a hypothetical account. "Similarly situated" means that the participants are identical in every respect (i.e., period of service, compensation, position, date of hire, work history) except age. This provision was intended to clarify the legal status of cash balance plans prospectively, in light of the decision by the Federal District Court for the Southern District of Illinois in *Cooper v. IBM*, a key case holding that cash balance plans violate age discrimination rules. Since the legislation was passed, however, *Cooper v. IBM* was reversed on appeal by the Seventh Circuit.

- Conversions: The Act imposes restrictions on converting a traditional defined benefit plan into a hybrid plan. Specifically, the Act would prohibit the "wear away" of pre-conversion accrued benefits if the conversion occurs after

June 29, 2005. ("Wear away" is when a participant does not earn new benefits for a period until his or her post-conversion benefit exceeds the pre-conversion accrued benefit). Instead, the Act takes an A plus B approach where a participant's accrued benefit after the conversion must be at least equal to the sum of the participant's accrued benefit for years of service before the conversion using the old formula plus the participant's accrued benefit for years of service after the conversion using the new formula. In addition, the Act requires preservation of early retirement subsidies associated with benefits accrued under the pre-conversion plan.

- Interest Rate Requirement: Effective as of January 1, 2008, any interest credited by a hybrid plan must be at a rate that is not less than zero and is not greater than a market rate of return. The IRS is to issue rules governing the calculation of a market rate of return.

- Whipsaw: The Act eliminates the "whipsaw" calculation for distributions made on or after the date of enactment by allowing a hybrid plan to pay a lump sum distribution equal to the hypothetical account balance, even for balances accrued before the Act.

- Vesting: Effective January 1, 2008, hybrid plans must provide that a participant is 100% vested after three years of service. It is unclear how this schedule will apply to benefits accrued before the effective date.

2. New Rules for Determining Minimum Required Funding

Effective for plan years beginning in 2008, the Act replaces the current funding system with a much-simplified single funding regime designed to fully fund most plans. Under this new regime, the minimum required contribution for any plan year equals:

(i) the present value of all benefits that are expected to accrue under the plan during the plan year, plus

(ii) the "shortfall contribution" necessary to amortize over seven years the difference between the plan's current assets and 100% of liabilities on the first day of the plan year.

The Act provides an "all or nothing" transition rule. Plans that meet an annually-increasing minimum funding requirement are exempt from making the shortfall contribution for that year. The transition minimum funding requirement is 92% in 2008, 94% in 2009 and 96% in 2010. Beginning in 2011, all plans must fund their shortfall contribution. Accordingly, some employers may wish to increase the funding of their plans to ensure they will meet the transition minimum funding requirement beginning in 2008.

3. Assumptions for Determining Required Funding

Beginning in 2008, plans must use new actuarial assumptions when determining a plan's liabilities. The Act specifies interest rates that must be used when determining a plan's required funding. These rates are in three maturity "segments": liabilities due (1) in five or fewer years, (2) between five and 20 years, and (3) longer than 20 years. The new interest rates will be determined using a yield curve comprised of corporate bonds of appropriate maturities. A plan may disregard the segments and use a true yield curve, but can revoke this election only with the permission of Treasury. Interest rates are smoothed over 24 months with no weighting.

The Act requires the Treasury to publish a mortality table for determining liabilities. The Treasury Department has proposed regulations to replace the current morality table (GAM 1983) with RP-2000, and it is expected this table will become final for 2008. However, a plan may substitute its own mortality table based on actual experience and projected trends if Treasury determines the table is based upon sufficient actual experience.

If a plan is "at-risk", it must use different rules when determining its liabilities to calculate its minimum required

funding. A plan is "at-risk" if the plan's funding target attainment percentage is both less than 80% without regard to the at-risk liabilities and less than 70% counting at-risk liabilities. The 80% test will be phased in from 2008 through 2011. Plans with 500 or fewer participants are not subject to these at-risk rules.

If a plan is at risk, its liabilities are calculated by assuming that workers eligible to retire in the next 10 years will retire as early as possible. The at-risk liability is phased in at 20% per year for each year in which the plan is at-risk. If a plan is at-risk for the current year plus at least two of the previous four years, the at-risk liability is increased by 4% plus $700 per participant.

4. Treatment of the Credit Balance

If a plan sponsor makes a contribution in excess of the minimum required contribution, the excess plus interest is treated as a "credit balance" that can be credited against future required contributions. The Act makes the following changes to credit balance treatment:

- Assets are required to be reduced by any credit balance when determining the amount of a shortfall contribution.
- Credit balances cannot be used to offset minimum contributions for a plan with funding of less than 80% for the preceding year.
- Credit balance cannot be created by any contribution to the extent that the contribution has the effect of avoiding any of the benefit limits discussed in the next section.

5. Benefit Limits

The Act limits the benefits that a plan can pay if its "adjusted funding target attainment percentage" falls below certain levels. This percentage is the ratio of assets (minus carryover and pre-funding balances) to the target liability (without regard to at-risk status). The percentage is then adjusted by adding the amount of annuity purchases for non-highly compensated employees in the last two years to both the assets and the liabilities.

- If the adjusted percentage is below 80% for the plan year, the plan cannot increase benefits.
- If the percentage is between 60% and 80%, lump sum benefit payments are limited to the lesser the present value of the participant's PBGC guaranteed benefit or 50% of the lump sum the participant would otherwise receive. The participant's remaining benefit is payable in the form of an annuity.
- If the adjusted percentage is below 60% for a plan year, the Act prohibits the plan from triggering shutdown benefits or accelerated payments, including lump sums, and would freeze benefit accruals.

These restrictions do not apply to plans that are 100% funded (determined without reducing assets for credit balances), special rules apply to new plans and plans of employers in bankruptcy.

If a plan becomes subject to a benefit limit, the plan must notify all participants and beneficiaries within 30 days.

6. New Participant Notice

Beginning with the 2008 plan year, the Summary Annual Report requirement is repealed and replaced with a new plan funding notice for single-employer pension plans with more than 100 participants. This notice must be provided 120 days after the close of the plan year to participants, beneficiaries, unions and the PBGC. The notice must contain the following information:

- The total assets and liabilities of the plan for the current and two preceding years (determined in the same manner as the funding rules).

- The number of participants in the plan, broken down by: active participants, retired or separated participants receiving benefits, and retired or separated participants eligible for future benefits.
- The plan's funding policy and the asset allocation of the plan's investments as of the end of the year (as a percentage of total assets).
- A summary of any material plan amendments, scheduled benefit increase or reduction, or other known events taking place in the current year, with a material effect on plan liabilities and assets for that year.
- A summary of the PBGC plan termination rules.
- A general description of the plan benefits eligible for PBGC insurance, with an explanation of any limitations.
- A statement that the person may obtain a copy of the annual report upon request.
- Whether the plan was required to file a PBGC 4010 notice.
- The plan's funding attainment percentage.

The Department of Labor is required to provide a model notice within one year of the Act's enactment.

7. Benefit Statements

For plan years beginning in 2007, the plan administrator of a defined benefit pension plan must either provide

- A benefit statement at least once every three years to each participant with a vested benefit who is still employed; or
- Notice to participants annually that they may request a benefit statement and information on how to request one.

Benefit statements must show the participant's total accrued benefit, vested percentage and, if applicable, a description of any Social Security or floor-offset provisions. The Department of Labor is directed to develop model benefit statements.

8. Distribution Election and Notice Period

Effective for 2007, the Act extends the period for providing distribution notices to a participant from 90 days before the applicable annuity starting date to 180 days before that date. In addition, the Act requires that the distribution notice includes a description of the participant's right to defer receipt of a distribution and the consequences of failing to defer receipt of the distribution.

9. "Qualified Optional Survivor Annuity"

For plan years beginning after December 31, 2007, defined benefit pension plans and money purchase pension plans must offer a "qualified optional survivor annuity" in addition to the qualified joint and survivor annuity (QJSA). If the survivor continuation percentage under a plan's QJSA is less than 75%, the survivor continuation percentage under "qualified optional survivor annuity" must be 75%. If the survivor continuation percentage under a plan's QJSA is at least 75%, the survivor continuation percentage under "qualified optional survivor annuity" must be 50%.

10. Phased Retirement

Effective for plan years beginning on or after January 1, 2007, a defined pension plan may make payments to active employees who are 62 years old.

11. New Lump Sum Assumptions

For plan years beginning on or after January 1, 2008, the applicable interest rate and mortality table for determining a participant's minimum lump sum will be:

- the interest rate determined monthly by the Secretary of the Treasury based on a corporate level yield curve (phased in over five years), and

- the mandated mortality table for minimum required funding

12. Revisions to PBGC Form 4010 Filing Requirement

Under the Act, a company must file a PBGC Form 4010 for any plan with a funding status of less than 80% for the preceding year. The PBGC 40140 filing includes confidential corporate information and a statement of the plan's funded status.

If you have any questions concerning the Pension Protection Act, please contact the Seyfarth Shaw LLP attorney with whom you work or any employee benefits attorney on the website at www.seyfarth.com. In addition, Seyfarth Shaw will sponsor a teleconference client briefing on the new Act on August 17, 2006. Visit www.seyfarth.com/events, or contact Craig Maas at cmaas@seyfarth.com or 312-460-6422 to register.

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