



AUGUST 17, 2006

Pension Protection Act of 2006 Signed into Law

Enactment Date: August 17, 2006

Months after the House and the Senate approved their separate initial versions of pension reform legislation and after weeks of fine-tuning and internal political squabbles that many observers expected would scuttle a final package, Congress passed and sent to the President the "Pension Protection Act of 2006" (PPA) before the August recess. The massive, 907-page bill cleared its last hurdles on July 28 in the House and on August 3 in the Senate, despite its lacking the popular business tax extenders that many had assumed would be included. The President signed the bill into law today.

The PPA's expansive sweep affects nearly all employer-sponsored retirement plans. Although its most significant effects will be felt by defined benefit plans covered by the Employee Retirement Income Security Act's (ERISA) funding rules (including cash balance and other hybrid plan designs), the PPA includes important provisions affecting 401(k) and other defined contribution plans, and individual retirement arrangements (IRAs). The PPA also modifies some of the requirements applicable to nonqualified deferred compensation, retiree health benefits, and health and welfare benefits, and it contains specific provisions affecting pensions in certain industries, including airlines, state and local governments, defense contractors, and churches. In addition, the new law acknowledges the changing retirement demographics by including a provision to facilitate "phased retirement" programs.

And in a major nod to employers' concerns about their inability to address retirement issues strategically because of expiring statutory provisions, the PPA eliminates the December 31, 2010, sunset date of the retirement-related

provisions of the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) (see sidebar on p. 3). In so doing, the PPA removes the uncertainty and disruptions that would have ensued if the tax code's rules governing benefits, contributions, and compensation limits, catch-up contributions for older workers, rollover opportunities, and similar provisions were to expire.

This *Benefits Perspectives Update* provides an overview of the PPA, with analyses and commentary on key issues for retirement plan sponsors. Additional Milliman documents describing the implications of the PPA for specific benefit plan sectors are or will be available at www.milliman.com.

Effective Dates

The PPA does not have one general effective date that applies to all of its provisions. Instead, the law includes different effective dates, with some applying retroactively and others effective according to plan years (many with delayed dates for collectively bargained plans or for state and local governmental plans) or taxable years. Still others become effective when regulations are issued. The PPA generally provides that amendments to retirement plans made to comply with the law's requirements will not violate the anticutback provisions of the tax code's plan qualification rules if made by the end of the 2009 plan year (2011 for governmental plans). One exception relates to the PPA's permanent extension of a special rule for limiting lump-sum distributions, for which plans must be amended by the close of the 2008 plan year. Regardless of when amended, plans must be in operational compliance as of the effective date of the PPA's various provisions.

Funding of Single Employer Defined Benefit Pension Plans

The PPA overhauls the rules on employer contributions for single employer defined benefit pension plans that are subject to ERISA's minimum funding standards (i.e., the new funding requirements do not apply to plans sponsored by state and local governmental units or nonelecting churches). The new funding rules generally go into effect for the 2008 plan year.

The law replaces existing rules that permit a plan sponsor to select from among numerous actuarial cost methods. Instead, the PPA will ultimately require all plans to make contributions necessary to amortize unfunded benefit liabilities over seven years. The PPA prescribes key actuarial assumptions, tightens smoothing methods, and shortens amortization periods.

The new rules will force sponsors of underfunded plans to contribute substantially more than under existing law. In addition, the manner in which the PPA determines contribution requirements could lead to significant volatility from year to year in required contributions, especially for underfunded plans, but even plans that are fully funded one year may become underfunded the next, depending on changes in interest rates. However, if a plan is at least 80% funded, it will still be able to use credit balances to absorb the impact of year-to-year fluctuations in funding requirements. Thus, for the great majority of plans, the effects of the PPA will not be at all draconian, contrary to many news reports.

The PPA's funding requirements for single employer plans entail:

- *Minimum Funding Standard—Basic Method.* The PPA tightens actuarial assumptions and smoothing methods, forcing a plan to fund toward a 100% funded level more rapidly than under previous standards. Plan sponsors must determine the minimum contribution by using the "unit credit actuarial cost" method, under which the contribution requirement for a year is equal to the "normal cost" plus amortization of unfunded amounts, gains or losses, and any bases for funding waivers.

The normal cost is equal to the actuarial present value of benefits that the plan expects participants to accrue during the plan year. Increases in previously accrued benefits that

are attributable to increases in compensation are treated as new accruals, with the cost of such increases included in the normal cost amount.

Unfunded liabilities, including initial underfunding and amounts arising from gains or losses, are amortized over seven years. Under a three-year transition rule, unfunded amounts are based on 92% of plan liabilities for 2008, 94% for 2009, 96% for 2010, and 100% in 2011 and thereafter. If the plan is less funded than the relevant threshold in any of the three transition years, then the unfunded amount for the next year and all subsequent years will be based on 100% of accrued liabilities, even if a lower threshold would have applied under the transition rules. Also, any new plan established after 2007 or any plan that had been subject to the deficit reduction contribution prior to 2008 is ineligible for the transition and must use an initial unfunded amortization base of 100% of plan liabilities.

- *Interest Rate.* For the 2006 and 2007 plan years, the PPA extends the use of the corporate bond rate for the interest rates applicable in determining the deficit reduction contribution. Without the new law, the applicable interest rate after 2005 would have been based on the 30-year Treasury bond rate, which would have produced higher contribution amounts for some underfunded plans.

Beginning in 2008, plans must value their pension liabilities using a simplified yield curve consisting of three rates that match the duration of the liability with the interest rate: a short-term rate, applied to expected benefits within the first five years; a medium-term rate, applied to benefits expected after five years but before 20 years; and a long-term rate, applied to benefits expected after 20 years. A plan sponsor may elect to use the full yield curve to value a plan instead of the simplified three-segment rates. The IRS will publish the relevant prescribed interest rates based on a 24-month unweighted average of rates, using available corporate bonds within the top three quality levels. The interest rate phases in over a three-year period (i.e., 33-1/3% in 2008, 66-2/3% in 2009, and 100% in 2010 and thereafter). Use of the yield curve may mean higher liabilities and contributions than under pre-PPA law for plan sponsors in industries where the number of retirees exceeds the number of active employees, such as traditional manufacturing, for

which the lower short-term segment interest rate will yield higher liabilities than under current law.

- *Mortality Assumption.* Pension liabilities must be valued using a prescribed mortality assumption, as published by the IRS. Because the new mortality table will take

mortality improvements into account, perhaps even projecting future improvements, the likely effect is an increase in liability and costs for most pension plans. A different mortality table may be used if certain conditions are met and the employer obtains approval from the IRS.

EGTRRA Permanence: What it Means for Retirement Plan Sponsors

The PPA makes the EGTRRA provisions affecting retirement plans (and IRAs) permanent by eliminating the 2010 sunset date. With EGTRRA permanency, plan sponsors will not have to face the administrative nightmare that would have been created if the requirements for retirement plans were to revert to the pre-EGTRRA rules. In addition, for those plan sponsors that delayed adopting some of the provisions in light of uncertainties created by the expiration date, a longer-term retirement plan strategy can now be implemented.

One particular note of caution: The repeal of EGTRRA's sunset date could have some immediate effects, such as increasing pension costs and liabilities that are reported under accounting standards that currently assume the sunset date would remain in force.

Among the EGTRRA provisions made permanent by the PPA are:

- the increased limits on contributions to qualified retirement plans, 403(b) tax-sheltered annuities, and 457(b) deferred compensation arrangements;
- catch-up contributions for those aged 50 and older;
- the availability of Roth 401(k) and Roth 403(b) plans;
- the increased compensation limits taken into account in determining benefits under qualified plans;
- simplification of the "top-heavy" plan rules;
- the expansion of rollover opportunities, including for after-tax contributions;
- the repeal of the "multiple use" test for 401(k) plan deferrals and contributions subject to tax code section 401(m);
- the repeal of the "same desk" rule;
- the increase in the compensation-related limit for the maximum annual contributions to a defined contribution plan;
- the repeal of the compensation limit for multiemployer plans;
- the modified deductions for employer contributions to qualified plans, including the exclusion of 401(k) plan deferrals;
- the expanded requirements for notification of benefit accrual reduction amendments;
- a faster vesting schedule for employer matching contributions;
- the ability to reinvest ESOP dividends without the loss of dividend deductions; and
- automatic rollovers of certain mandatory distributions.

- *At-Risk Valuation.* Similar to the pre-PPA deficit reduction contribution, the required contribution is increased for plans that are “at risk,” as characterized by a significantly low funding ratio. The designation as an at-risk plan generally is determined by failing both parts of a two-pronged test. The plan fails the first prong of the at-risk test if the plan’s funded ratio is less than 65% for 2008, less than 70% for 2009, less than 75% for 2010, or less than 80% for any plan year after 2010. If the plan fails that first prong, the plan fails the second prong and is at risk if its funded ratio is less than 70%, based on a redetermination of plan liabilities using at-risk assumptions. A plan with 500 or fewer participants is exempt from the at-risk rules.

For purposes of the second prong of the at-risk determination (and for calculating required contributions for an at-risk plan), the at-risk liabilities are determined based on an assumption that any participant eligible to retire within the next 10 years will retire as early as possible and then will elect the most valuable benefit payable under the plan at that point. If a plan has been at risk during at least two of the four preceding plan years, a load factor is added in determining the funding charge, which generally will increase the funding charge by about 5% once fully phased in.

There is a five year phase-in rule for the at-risk funding target and the at-risk normal cost where the plan has been in at-risk status for less than five consecutive years. Plan years beginning before 2008 are not taken into account for this purpose.

- *Asset Valuation—Smoothing.* To determine the funding shortfall for purposes of each year’s seven-year amortization bases, the market value of plan assets may be averaged over a 24-month period. Smoothed asset values may not be less than 90% or greater than 110% of the market value of the plan assets, narrowed from the 80% - 120% corridor prior to the PPA. If a pension plan’s assets are heavily invested in securities with highly volatile market prices, the effect of this change in smoothing method will be a significant increase in the volatility of the employer’s required contribution to the plan.
- *Credit Balances.* Credit balances—the accumulation of employer contributions in excess of the minimum fund-

ing standard—must generally be subtracted from plan assets to determine a plan’s funding shortfall. Plans with large credit balances will therefore more likely need to use up the credit balance faster than under pre-PPA law. If a plan’s funded ratio (determined with a reduction of assets by any post-PPA credit balance) is at least 80%, the plan sponsor may use a credit balance to offset any required contribution. An employer may voluntarily elect to reduce or eliminate a plan’s credit balance, thereby increasing the calculated funded ratio of the plan but permanently removing the forfeited credit balance from future use to offset contribution requirements.

- *Deductibility Limit.* For 2006 and 2007, the PPA allows employers to deduct contributions to fund the plan up to the excess of 150% of its current liabilities over plan assets. Beginning in 2008, employers may deduct amounts sufficient to fund the plan up to 150% of the “at-risk” target liability (raised further for plans with a salary-based benefit formula by their ability to include the value of expected future compensation increases on accrued benefits). Furthermore, for plan years beginning in 2008, plans that are covered by the PBGC are not taken into account in applying the overall combined (defined benefit and defined contribution) deduction limit to contributions.
- *Special Rules.* The PPA provides targeted funding relief (generally in the form of delayed effective dates of the funding and benefit limit requirements) for certain plans, including: commercial airlines; rural electric, agricultural, and telephone multiple employer plans; and eligible defense contractors.

Benefit Determinations and Restrictions for Single Employer Plans

The PPA provides new rules on lump-sum distributions from a defined benefit plan. The law requires that a plan determine the minimum amount payable using the three-tier yield curve described above for valuing pension liabilities, but without the 24-months averaging. The new interest rate basis will be phased in over five years beginning in 2008. The mortality assumption used for valuing lump-sum distributions must rely on the new mortality table that the IRS will publish for the new single employer funding rules. The net result of these changes may differ for older employees versus younger employees, with the

new mortality assumption in some cases offsetting the effect of new interest rates. But once the interest rates are fully phased in, the new basis will probably produce lower regulatory floors for lump-sum cash-outs, particularly for the youngest employees.

For benefit limitations under section 415 of the tax code, a lump-sum distribution must be determined using: 5.5%, the rate that produces 105% of the amount determined under the three-tier yield curve, or the plan-specified rate, whichever of the three is greatest. This change applies retroactively to the beginning of 2006. Because the rate for the benefit limitation on lump-sum distributions has been less than 5% thus far for 2006, plans that have paid out lump sums this year may need to seek a recovery of excess amounts from former plan participants if the amount exceeds the retroactive limitation.

The PPA imposes new limitations on benefits provided under a single-employer plan, unless the plan's funded status meets certain thresholds:

- *Restrictions on Distributions*—If the plan's funded ratio is less than 60%, distributions to a participant must not exceed the amount that would be payable under a single-life annuity plus any temporary Social Security supplement. Notably, for example, a participant cannot receive a lump-sum distribution of the full value of the accrued benefit. For a bankrupt firm, the relevant threshold for the restriction on distributions is 100%.
- *Restrictions on Plan Amendments Improving Benefits*—A plan may not be amended to increase benefits if its funded ratio would be less than 80%, taking into account the value of the plan amendment, unless the employer immediately contributes the full value of the amendment to the pension fund. A plan with a benefit formula that is not based on compensation is exempt from this restriction to the extent the rate of increase in benefits attributable to the plan amendment does not exceed the rate of increase in average pay for employees affected by the amendment.
- *Restrictions on Shutdown Benefits*—Special benefits payable under a pension plan upon a shutdown of a segment of the company or other contingent event may not be paid if the plan's funded status is less than 60%.

- *Restriction on Benefit Accruals for Severe Funding Shortfall*—The accrual of any new benefits under a plan is prohibited if the plan's funded status is less than 60%.

If any plan's funded ratio would exceed the 60% threshold (or 100% for a bankrupt employer) for the restriction on distributions on the basis of unreduced plan assets but fails the test with plan assets reduced by a credit balance, then the credit balance must be eliminated to the extent necessary to avoid the distribution limitation. For the other three benefit limitations, the PPA imposes a similar rule requiring the forfeiture of credit balances on plans maintained under a collective bargaining agreement.

- *Limitations on Funding of Nonqualified Deferred Compensation*—If a publicly traded company maintains a single employer pension plan characterized as being at risk (or falls within certain other parameters, such as employer bankruptcy), any funding of its nonqualified deferred compensation arrangement for the company's top executives must be treated as immediately subject to taxation, interest, and a 20% penalty. Moreover, if the employer grosses up the executives' pay to cover the taxes, the gross-up amounts also become subject to immediate taxation.

Cash Balance and Other Hybrid Pension Plans

The PPA explicitly authorizes hybrid defined benefit plans—such as cash balance or pension equity plans—under which the benefit is determined by reference to a hypothetical account or other balance. In particular, the law establishes a specific basis whereby most existing hybrid plans are deemed in compliance with age nondiscrimination requirements.

The new hybrid plan rules generally apply for periods on or after June 29, 2005; plans that were in existence on this date have a delayed effective date for some of the new provisions. Many cash balance plans remain locked in litigation over participants' age discrimination allegations, disputes over lump-sum distribution amounts, and other concerns. While the new law settles many of those issues for the future, past law is to be interpreted without "negative inference" by the PPA's enactment. The decision in *Cooper v. IBM Personal Pension Plan* (No. 05-3588, Aug. 7, 2006) by the US Court of Appeals for the Seventh Circuit holding that IBM's hybrid plan design was not age discrimina-

tory should provide some comfort to hybrid plan sponsors, assuming it is not overturned on an appeal.

The hybrid plan requirements include:

- *Three-Year Cliff Vesting.* Accrued benefits must vest completely within three years of a participant's vesting service. Existing five-year cliff vesting or seven-year graded vesting schedules continue to apply to accruals under all other defined benefit pension plans.
- *Wear-Away Safeguards.* For a hybrid pension plan that is created by a conversion from a traditional pension plan, wear-away is prohibited. Regardless of the accrued benefit under the prior plan design, each active participant must receive an accrual under the new plan design. Furthermore, participants must be permitted to grow into early retirement subsidies that had been available under the original plan.
- *Interest Crediting Rate.* Hybrid plans that use a hypothetical interest rate in the determination of benefit accruals must use a rate within a corridor from 0% up to a market rate that the Treasury Department will publish. Plans using an interest rate within the corridor could pay the hypothetical account balance as a lump-sum distribution, avoiding the "whipsaw" issue that had plagued many hybrid plans.

Multiemployer Defined Benefit Plans

The PPA retains the current funding rules with some important changes, but creates a new funding scheme generally effective in 2008 for plans that fail statutory tests of financial soundness. The law in effect will require the fund's actuary to forecast the plan's funding status over a seven-year period, because the PPA requires the fund's actuary to certify the plan's financial status each year and indicate if the plan is in "endangered" or "critical" status. If certified as "endangered" or "critical," the PPA imposes a new set of funding rules and requirements on the trustees and bargaining parties to improve the plan's funding condition that must be met over a 10 – 15 year period for endangered plans, and over 10 years for plans in critical status. Critical plans are permitted to eliminate subsidized early retirement benefits and normal retirement benefit options. The rules applicable to funding of plans in endan-

gered or critical status expire at the end of 2014. (For more details, see also, *Multiemployer Review* (August 2006).)

In the funding area, the PPA:

- *reduces amortization periods* from 30 to 15 years for changes in actuarial assumptions and amendments changing benefits, effective beginning with the 2008 plan year;
- *raises the deductibility limit* to 140% of the plan's unfunded current liability, effective in 2006; and
- *requires, for applications filed before 2015, the IRS to grant extensions* of any existing amortization period for up to five years if the plan actuary certifies that: the plan would have a funding deficiency within nine years; the trustees have adopted a funding improvement plan; the plan will be able to pay benefits throughout the extended amortization period; and a notice of the extension application was provided to interested parties.

The PPA's withdrawal liability revisions include the imposition of partial withdrawal liability if the employer contracts out the work to another entity or entities owned or controlled by the employer that has no obligation to contribute to the plan. Construction industry plans will be permitted to restart their withdrawal liability schedule whenever unfunded vested benefits are zero.

The PPA also: permanently eliminates the 100% of compensation limit on benefits (by virtue of including EGTRRA permanence); and allows plans in some cases to adopt short-fall funding before 2015 without IRS approval.

Other Provisions

Affecting (Mostly) Defined Benefit Plans

The PPA contains numerous other provisions that will affect defined benefit plans. Two of the more significant items, which more typically affect pension plans but also could apply to money purchase plans, among others, include:

- *Phased retirement*—Effective for distributions in plan years beginning in 2007, the PPA provides a special exception to the rule that generally prohibits a qualified pension plan from making distributions to participants before they attain the plan's normal retirement age or

terminate employment. As a way to facilitate certain “phased retirement” arrangements—under which an employee cuts back his or her hours before fully retiring or terminating employment—the new law permits distributions from a defined benefit plan or a money purchase plan to an employee who has attained age 62 and has not separated from employment at the time of the distribution. This PPA provision overrides the IRS’s proposed rules on phased retirement, which would allow partial distributions for workers who reduce their work schedule by at least 20%.

- *Qualified joint-and-survivor annuities (QJSAs)*—Effective for plan years beginning in 2008, plans such as defined benefit and money purchase plans that are required to provide benefits in the form of a QJSA must also provide a joint-and-75%-survivor annuity option, if the current survivor annuity percentage is less than 75%. If the plan’s current survivor annuity percentage is 75% or greater, the plan must also offer a joint-and-50%-survivor annuity option. The law also expands the notice and consent period for waiving QJSAs from 90 days to 180 days, and modifies the notification of the right to defer to include a description of the consequences of failing to defer such receipt (effective for plan years beginning in 2007, with a delay for collectively bargained plans).

PBGC Items

The PPA includes provisions designed to limit the Pension Benefit Guaranty Corporation’s (PBGC) financial exposure that has concerned the agency over the past few years as employers sponsoring pensions terminate their plans. Among the law’s changes are:

- *Premiums.* For 2006 and 2007, the PPA extends current law so that the variable rate premiums continue to be determined using 85% of the corporate long-term bond rate. Unfunded vested benefits for the PBGC’s variable rate premium purposes will be calculated using the plan’s funding target (modified to include only vested benefits) and calculated as determined under the PPA’s new funding rules, with modifications, beginning in 2008. The full funding limit exemption is repealed so that plans that were never subject to the variable rate premium before may be under the new rules. For plans with 25 or fewer participants, the variable rate premi-

ums will not exceed \$5 per participant, beginning in plan years starting in 2007.

The PPA also makes permanent the termination premium of \$1,250 per participant for three years that Congress enacted in 2005, and makes no changes to the flat rate premiums (\$30 per participant for single employer plans and \$8 per participant for multiemployer plans).

- *Limitation on the PBGC’s guarantee of shutdown and other benefits.* The PBGC will treat benefits that become payable as a result of a shutdown or other similar unpredictable contingent event occurring after July 26, 2005, as a plan amendment, so that the agency’s guarantee is phased in over five years. Special rules apply for plans terminating after entering bankruptcy.

In addition, the PPA (with various effective dates): authorizes the PBGC to pay interest on premium overpayments at the rate that applies to underpayments; extends the agency’s “missing participant” locator program to terminating multiemployer defined benefit plans and to other terminating plans, including 401(k) and other defined contribution plans not covered by the pension insurance agency; and modifies the phase-in guarantee and allocation of assets for “substantial owner” benefits in terminating plans.

Provisions for 401(k) and Other Defined Contribution Plans

The PPA includes provisions for 401(k) and other defined contribution plans (such as 403(b) tax-sheltered annuities and 457(b) deferred compensation arrangements) that allow for participants to direct their investments.

Investment Advice to Participants

The law creates a statutory exemption from ERISA’s prohibited transaction rules for investment advice provided to plan participants if it meets certain criteria. These new rules, effective beginning January 1, 2007, will allow a “fiduciary adviser” to the plan (e.g., a brokerage firm, mutual fund family, insurance company, stock broker, etc.) to advise participants about their investments, including the allocation and use of funds in their accounts. The fiduciary adviser may be paid either by the employer or from plan assets.

To qualify for the exemption, the fiduciary adviser's direct or indirect compensation must not vary based on the investment options selected by the participant. As an alternative, the fiduciary adviser may use a computer investment model, certified by an independent expert, that takes into account the participant's individual characteristics to generate advice on the allocation of the investment options offered under the plan and that is not biased in favor of any product of the fiduciary adviser. The PPA imposes specific conditions under which eligible investment advice arrangements may operate, including requirements applicable to the fiduciary adviser (e.g., compliance with the Securities and Exchange Commission's disclosure rules; maintenance of appropriate records; reasonable compensation), disclosures to participants (e.g., fees; historical performance of the plan's investment options; privacy of personal information), and the employer/plan sponsor (e.g., authorization by the plan fiduciary; monitoring of adviser).

The Department of Labor (DOL) is required to issue a model notice that plans may use to comply with the special notice requirements. Plan sponsors must annually update the notice to reflect any material changes, and upon request, must furnish current information to a participant without charge. The law also protects plan sponsors from a prohibited transaction violation if they retain a fiduciary adviser for participants that meets the PPA's standards and monitor the adviser's performance.

Automatic Contribution Safe Harbor for 401(k) Plans

Effective in 2008, the PPA creates "qualified automatic contribution arrangements," which automatically defer a stated percentage of employee pay, that are exempt from the actual deferral percentage (ADP) test and the "top-heavy" rules for 401(k) and 403(b) plans. This provision, aimed at encouraging the adoption of such a feature, will eliminate the need for plan sponsors to compare the deferral percentage of highly compensated employees with that of nonhighly compensated employees, thereby allowing highly compensated employees to defer the maximum allowable deferral amount without worrying that some of it will be returned. If the plan design also limits matching contributions according to the PPA's requirements, the plan will automatically pass the actual contribution percentage (ACP) test.

A qualified automatic contribution arrangement must comply with each of the following criteria:

- *Uniform Application*—The arrangement must apply to every new employee who becomes eligible to participate in the plan following the adoption of the feature and to current employees who have not already made an election to participate or not participate in the plan.
- *Automatic Contribution Amount*—Absent an election by the employee to do otherwise, the plan must automatically defer a stated percentage of salary into the 401(k) plan. The automatic deferral percentage must be uniform for all employees and must not exceed 10%, but must be at least 3% for the first year the employee participates in the plan, 4% during the second year, 5% for the third year, and 6% for each year thereafter.
- *Option to Elect Out*—Each employee must be given the opportunity to elect out of the automatic contribution feature or to defer a different percentage of pay.
- *Matching Contributions*—The employer must match 100% of each nonhighly compensated employee's deferral amount up to 1% of pay plus 50% of any additional deferrals up to 6% of pay for a total maximum match of 3.5% of pay, or contribute 3% of pay for each nonhighly compensated employee eligible to participate in the plan. The rate of matching contributions for highly compensated employees must not be higher than the rate for nonhighly compensated employees. An alternative matching arrangement that results in the same or greater amount of matching contributions for each level of employee contributions will also meet these requirements.
- *Vesting*—The employee must be 100% vested in employer contributions after two years of service.
- *Distribution Restrictions*—The restrictions on distributions that generally apply to 401(k) plans must also apply to all employer contributions.
- *Notice*—Employees eligible to participate in the 401(k) plan must be given a notice before the start of the plan year that explains the automatic contribution feature and the options, and that identifies the default invest-

ment. Employees must be given a reasonable period to change the automatic contribution amounts or elect out of the program.

A 401(k), 403(b), or governmental 457(b) plan also may allow employees to withdraw their elective contributions under the automatic enrollment arrangement within 90 days of their first contribution. If it does so, it must return their automatic deferrals plus interest and treat the amounts as taxable income in the year of the distribution. Employees also forfeit their employer matching contributions. In addition, the PPA allows plans with an automatic contribution feature to avoid the 10% excise tax by returning excess contributions and excess aggregate contributions six months after the plan year ends (instead of two-and-one-half months). Corrective distributions must be included in employee income in the year of distribution.

One important element of the PPA effective immediately is its amendment to ERISA to preempt state laws that prohibit, either directly or indirectly, an employer from withholding contributions under an eligible default deferral arrangement. State laws affected include those relating to the garnishment of wages; in some instances, courts have interpreted the laws as prohibiting default deferrals to 401(k) programs. This preemption applies to all automatic enrollment programs that meet the PPA's criteria, not just the new "qualified automatic contribution" arrangement discussed above. Thus, employers may now institute automatic enrollment programs without worrying about lawsuits claiming that the deferral of an employee's wages violates a state's law.

Diversification Requirements

The PPA requires defined contribution plans holding publicly traded employer securities to give participants the ability to diversify those investments, effective under a three-year phase-in period starting with plan years beginning in 2007 (delayed for collectively bargained agreements and for employee stock ownership plans (ESOPs) that hold certain securities). Exceptions apply to the diversification requirement, most notably for certain stand-alone ESOPs. The diversification requirement is effective immediately for participants aged 55 and older who had completed three years of service before the first plan year beginning after December 31, 2005.

The law requires plans to give participants the right to immediately (i.e., at least on a quarterly basis) diversify elective deferrals and employee contributions that have been invested in employer stock. Once a participant has completed three years of service, he or she also must have the right to diversify employer nonelective and matching contributions. To satisfy the diversification requirement, the plan must offer at least three investment options (other than employer securities) into which participants can direct such amounts, and each investment option must be diversified and have "materially different risk and return characteristics."

Plans must not impose any restrictions or conditions on the investment of employer securities that are not imposed on the investment of other assets, except as required by the securities laws.

The plan administrator must notify participants of their diversification rights no later than 30 days prior to the first date that a participant is eligible to exercise those rights. The law requires the Secretary of Treasury to issue a model notice within 180 days of the PPA's enactment and permits a civil penalty of up to \$100 per day per person for a plan administrator's failure to provide the requisite notice. Plan administrators may have to develop their own notices, given that the deadline for the DOL to issue a model notice will occur after the required time period that plans must notify participants.

Other Provisions

Affecting Defined Contribution Plans

The PPA contains other provisions of interest to defined contribution plan sponsors, including:

- *Faster vesting schedule*—All employer contributions are subject to the current-law vesting schedule (i.e., three-year cliff or 20% graded over six years) that applies to matching employer contributions, effective for plan years beginning in 2007.
- *Fiduciary protection for default investments*—If a participant fails to elect an investment choice and the plan fiduciary makes a default investment selection that is consistent with to-be-issued regulations from the DOL, the fiduciary will be protected from liability, effective for plan years beginning in 2007.

- *Bonding requirements*—The PPA increases the fiduciary bonding requirement from a maximum of \$500,000 to \$1 million for plans that hold employer securities, effective for plan years beginning in 2008.
- *Blackout periods*—Plan fiduciaries will lose their protections during periods that a participant is unable to direct his or her investments unless they satisfy certain specified requirements (to be issued by the DOL) with respect to the blackout, effective for plan years beginning in 2008 (with a delay for collectively bargained agreements).
- *“Safest annuity” provider standard*—The PPA directs the DOL to clarify that the agency’s guidance (*Interpretive Bulletin 95-1*), which generally requires a fiduciary to select the safest available annuity when buying annuities to pay retirement benefits, does not apply to annuities paid as an optional form of distribution from defined contribution plans.

New Disclosure and Notice Requirements for All Retirement Plans

The PPA establishes significant, new disclosure requirements. Plan sponsors will need to provide participants more details about defined benefit and defined contribution retirement plans and must do so faster than under current law. The disclosure requirements are intended to give plan participants and other affected parties (including the federal government) more timely and useful information about their plans. The PPA directs the DOL to publish model notices and related guidance, generally within one year.

For single employer and multiemployer defined benefit plans covered by the PBGC, the PPA seeks new information in the Form 5500 annual reports. Effective for plan years beginning after December 31, 2007, both single and multiemployer defined benefit plans will have to provide more detailed information, although the law repeals the filing requirement for the Summary Annual Reports.

If two single employer plans merge and file one Form 5500, for example, the resulting plan must provide the funded percentage for each of the two plans and the new funded percentage for the merged plan. The plan’s actuary also will have to provide an explanation of the basis for all plan retirement assumptions on the Schedule B.

Plans will have to submit the Form 5500 in an electronic format that will accommodate display on the Internet within 90 days after the date of filing; such information is to be posted on the DOL’s website as well as on the plan sponsor’s intranet for employees.

Multiemployer plans will also need to include the number of contributing employers in the plan, a list of those that contribute more than 5% of the total contributions, the number of employees in the plan who no longer have an employer contributing on their behalf, the number of employers that withdrew from the plan during the year, and whether the plan is in endangered or critical status, among other information. Multiemployer plans will also have to furnish certain summary plan information to employees and unions. The new law also imposes strict deadlines by which multiemployer plans must respond to requests for information from various parties.

All defined benefit plans must provide a benefits statement to vested participants at least once every three years or annually notify participants of the availability of a statement upon request. The information in the benefits statement must include any coordination of benefits with Social Security or other plans under floor-offset arrangements. This provision is effective for plan years beginning in 2007.

Single employer pension plans, including fully funded plans, will be required to give new funding notices to workers and retirees, effective for plan years beginning after 2007. Within 120 days after the plan year ends, such plans will have to notify the PBGC, participants and beneficiaries, and any unions about the plans’ assets (including a separate statement of any prefunded amounts), liabilities, and funded ratios. Also to be included in the notice are the plan’s funding policy and asset allocations of investments based on a percentage of overall plan assets. The notice must also include the number of active and inactive participants, a summary of the rules governing plan terminations, and a description of the PBGC’s guaranteed benefits. In addition, an explanation of any material amendments or benefit increases must be included.

Multiemployer pension plans will continue to provide a funding notice, but with additional disclosures.

Small plans with 100 or fewer participants may provide the notice at the same time as they file the Form 5500.

The PPA also requires expanded “ERISA section 4010” information from pension plans that have a funding attainment percentage of less than 80% (rather than plans with \$50 million or more in underfunding). For plan years beginning after 2007, the PPA requires certain plan actuarial and employer financial information—including the amount of benefit liabilities (using PBGC assumptions in determining liabilities), the funding target, and funding target attainment—to be filed with the PBGC. The agency will have to submit a summary report on the section 4010 information to Congress.

Additional notifications to participants apply to plans that are: subject to the limitation on the forms of distribution or on additional benefit accruals; or in a distress or involuntary termination situation.

In the defined contribution plan arena, participants who have the right to direct their investments (in other than stand-alone ESOPs or one-participant plans) under a plan subject to ERISA must receive quarterly, rather than annual, benefits statements. This provision, effective for plan years beginning after December 31, 2006 (later for collectively bargained plans), requires statements to include:

- total benefits accrued;
- nonforfeitable accrued benefits, or if no benefit is vested, then the earliest date on which benefits will become nonforfeitable;
- an explanation of the floor-offset or Social Security permitted disparity that may be applied;
- a notice that investments may not be appropriately diversified if any investment exceeds more than 20% of the total fair market value of all the investments in the account; and
- the value of assets held in each investment (including employer securities) and an explanation of any restrictions on the right to direct an investment.

For a plan that does not give participants the right to direct their investments, the PPA generally requires annual benefits statements.

Miscellaneous Provisions

The PPA also includes numerous miscellaneous provisions, some of which consist of statutory or regulatory clarifica-

tions that, depending on the type of plan or the plan sponsor, will be of interest. The more notable items include:

- *For defined contribution plans*, the PPA: clarifies fiduciary liability and fiduciary protections; modifies the distribution rules for hardship reasons for certain beneficiaries; provides for penalty-free withdrawals for certain active duty military reservists and public safety personnel; and revises portability and rollover rules.
- *For governmental plans*, the law: retroactively clarifies that members of governmental plans may purchase service credits for periods during which no service has been performed (i.e., “airtime”), subject to the restrictions (e.g., the five-year limitation) on nonqualified service; clarifies that plans may satisfy the minimum distribution rules by complying with a reasonable good-faith interpretation; allows 403(b) tax-sheltered annuities to accept after-tax rollovers if the plans separately track the amounts; treats Indian tribal governmental plans (other than plans for employees in commercial activities, such as “casino” plans) as governmental plans exempt from ERISA; and extends the governmental plan nondiscrimination moratorium to plans maintained by tax-exempt international organizations and other governmental agencies.
- *In the executive benefits arena*, the PPA generally limits the amount of death benefits excludable from a corporate owned life insurance (COLI) policy to the sum of the premiums and other amounts paid by the policyholder for the contract. All other amounts will be taxable unless specific conditions with respect to notice and consent, employment period, employee status, and the policy beneficiary are satisfied.

The law also contains provisions relating to: church plans that self-annuitize; small employer (no more than 500 employees) establishment of a combined defined benefit and 401(k) plan; long-term care coverage and riders on annuity contracts; transfers of excess pension plan assets for retiree health benefits (including permitting such transfers by multiemployer plans); qualified domestic relations orders (QDROs); and medical benefit reserves for bona fide association health plans.

Conclusion

Virtually all retirement plans will be affected by the PPA, requiring plan sponsors to amend their plans, change com-

munication materials, and revise administrative manuals and practices. The new funding rules for single employer defined benefit plans, coupled with pending changes in accounting requirements, will cause many more plan sponsors to rethink how they provide retirement benefits to employees and how they fund for these benefits. An instinctive reaction to simply terminate or freeze existing defined benefit plans could turn out to be more expensive in the long run, but employers will need to pay careful

attention to plan design and asset allocation and investment decisions to minimize negative effects on their balance sheets. The PPA's green light for automatic enrollment plans and default investments means that 401(k) plans can become more effective vehicles for providing retirement benefits. Before taking any abrupt action, plan sponsors should carefully evaluate the options, the expected expense, their ability to meet benefit objectives, and the risk exposure of their existing plans.

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