ALLIANCE BENEFIT GROUP

CLIENT REPORT

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PENSION PROTECTION ACT—OVERVIEW

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 ("PPA") into law. This new law is the most sweeping change to qualified retirement plans since the passage of ERISA in 1974.

This issue of the *Client Report* is entirely dedicated to PPA and it provides highlights of some of the important features affecting defined benefit and defined contribution plans.

Generally, to comply with PPA, plans will have to be amended on or before the last day of the first plan year beginning on or after January 1, 2009.

Please contact your Alliance Benefit Group of Indiana consultant if you have any questions about the material covered in this issue or if you want more in-depth information on any of the law changes.

As the IRS and DOL issue regulations pertaining to PPA, we will provide further updates in future issues of *Client Report*.

EGTRRA PERMANENCY

The Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) contained several provisions relating to retirement plans. Under the PPA, these provisions that were to expire December 31, 2010 have been made permanent. Some of the key provisions of EGTRRA that will now continue are –

- For those participants who are age 50 and older, additional qualified plan and IRA contributions ("catch-up contributions");
- Enhanced rollover options;
- Increased contribution limits, including salary deferrals to 401(k), 403(b) and 457 plans;
- Increased IRA contribution limits; and
- Ability to make Roth contributions to 401(k) and 403(b) plans.

SPECIAL POINTS OF INTEREST:

- *Defined Benefit Deduction Limit*
- *Cash Balance Plan Lump Sum Benefits*
- *Defined Benefit Benefit Limitations*
- *Automatic Enrollment*
- *Defined Contribution Vesting Schedule*
- *Defined Contribution Missing Participants*
- *Effective Dates*

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DB Plan Funding

The most dramatic change in PPA was to funding rules for defined benefit plans, resulting in accelerated minimum-required contributions and higher deductible contributions for many plans.

Minimum Funding: The PPA funding target is to have assets at least equal to the present value of all benefits accrued as of the plan's valuation date (i.e., 100% funded). Any shortfall below the funding target must be amortized over 7 years.

PPA introduces the concept of an "at-risk" plan that has a funded ratio of less than 80%. Plans may still use the funding standard account credit balance to reduce required contributions, although there are restrictions for some underfunded plans.

These minimum funding changes are effective beginning in 2008, with phased in relief for some plans.

Deduction Limit: Effective in 2006, sponsors can fund and deduct an amount up to 150% of the plan's current liability less plan assets. Beginning in 2008, the deduction limit uses the PPA funding target rather than the current liability.

Plans with 100 or fewer participants will not be able to increase benefits for highly-compensated employees in the plan and immediately increase the deductible contribution.

Employers who sponsor a defined benefit and a defined contribution plan will receive relief from the 25% of compensation combined plan deduction limit. Plans covered by the PBGC will not have a combined plan limit beginning in 2008. Plans not subject to PBGC will have the first 6% the employer contributes to the defined contribution plan ignored when applying the combined plan limit beginning in 2006.

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Cash Balance Plans

Sponsors of cash balance plans can sleep easier now that these plans have specific recognition in the law. PPA clarified that cash balance plans are not inherently age discriminatory and allows them to consider either the annuity or lump sum benefit to comply with age discrimination rules. This provision is effective June 29, 2005, but it does not affect ongoing litigation.

Effective August 17, 2006, a cash balance plan can pay a lump sum benefit equal to the account balance rather than converting the account balance to an annuity at normal retirement and then discounting it to the payout age, referred to as "whipsaw".

Effective in 2008, PPA also gives details on how to determine the opening account balance for clients who convert from a traditional defined benefit plan to a cash balance plan. Plans will be allowed to credit a rate of return to account balances based on a market index. The IRS will issue regulations providing details on market indices, and combinations of the indices, that will be allowed.

Effective in 2008, cash balance plans must use 3-year cliff vesting.

OTHER DEFINED BENEFIT PLAN ISSUES

Additional PPA provisions that impact defined benefit plans include:

- **PBGC Premiums.** Current rules for the variable rate premium for 2004 and 2005 continue to apply for 2006 and 2007 and will then be modified to reflect interest rates under the new funding rules for 2008.

  Variable rate premium exemptions for plans subject to the full funding limit have been eliminated

  The variable rate premium must be computed using the three-segment yield curve beginning in 2008.

- **Executive Deferred Compensation.** Adverse tax consequences will result if amounts are set aside for nonqualified deferred compensation when a defined benefit plan is underfunded.

- **QJSA.** A plan will be required to offer a 75% survivor annuity option if the QJSA has a survivor percentage less than 75%, and 50% survivor annuity option if the QJSA has a survivor percentage greater than 75%.

- **Phased Retirement.** Defined benefit plans may allow in-service distributions to a participant who has reached age 62, even if the normal retirement age is later.

- **Benefit Limitations.** Suspension and restrictions on plan amendments, accruals or distribution options may be imposed on certain underfunded plans.

- **Funding Notice.** Single-employer defined benefit plans, like multiemployer plans, will have to furnish annual funding notices to participants no later than 120 days after the end of the plan year (small plans have to provide the notice coincident with the filing of the Form 5500).

- **Minimum Lump Sum Distributions.** Current rules apply for 2006 and 2007, thereafter the 30-year Treasury rate is replaced with a rate based on the yield curve. The transition to the new rate will be phase in 20% a year from 2008-2012.

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AUTOMATIC ENROLLMENT

The PPA provides several incentives for plan sponsors to adopt an automatic enrollment feature into their existing 401(k) plans. Furthermore, the PPA provides for a new "safe harbor," beginning in 2008, which would automatically satisfy the ADP and ACP tests, as well as the top heavy rules, providing all requirements are met.

Safe Harbor: In order to satisfy the automatic enrollment safe harbor, several requirements must be met. Plans must automatically defer compensation on behalf of all newly-eligible employees, unless they elect otherwise. Plan sponsors do not have to apply this arrangement to employees already participating in the plan or those that have elected not to participate. The automatic contribution rate must be at least 3% of compensation for the first year, increasing annually to at least 6%, but may not exceed 10% of compensation (sponsors may consider automatically deferring 6% of compensation from the beginning to avoid annual increases). The matching formula must be at least 100% of elective deferrals up to the first 1% of compensation, plus 50% of elective deferrals from 1% to 6% of compensation. In lieu of a safe harbor match, the plan can provide a 3% nonelective contribution. Participants must be 100% vested in employer contributions within 2

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AUTOMATIC ENROLLMENT

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years. Safe harbor initial and annual notices must incorporate automatic enrollment disclosures.

In order to take advantage of the smaller match requirement and longer vesting of employer contributions provided for under the new automatic enrollment safe harbor, a "current law" safe harbor plan will have to add an automatic enrollment feature, as well as comply with all the requirements for the new safe harbor plan beginning in 2008.

Employers now have more options for satisfying 401(k) discrimination rules, by either: (1) performing regular testing and taking corrective action if the plan fails, (2) complying with current law safe harbor rules, or (3) instituting the new automatic enrollment safe harbor.

Other Automatic Enrollment Provisions: As of August 17, 2006, ERISA preempts state payroll withholding rules, making it clear that automatic enrollment is encouraged.

In addition, the PPA provides for, beginning in 2008, the permissive withdrawals of "erroneous automatic contributions" (contributions made by automatic enrollment that an employee designates were made erroneously) within 90 days of the date the first automatic contribution was made on behalf of the employee, provided certain requirements are satisfied. Amounts returned are treated as compensation and the 10% early withdrawal penalty does not apply.

Also in 2008, ADP/ACP refunds from a plan with an automatic enrollment arrangement may be made up to 6 months after the close of the plan year without a 10% excise tax and such amounts (i.e., contributions and earnings) must be included in income in the year of distribution.

All employer contributions (not just matching contributions) must vest at least as quick as either a 3-year cliff or 6-year graded vesting schedule.

OTHER DEFINED CONTRIBUTION PLAN ISSUES

The following PPA provisions are effective beginning in 2007, unless stated otherwise:

- **Investment Advice.** Some relief is granted to plan sponsors and fiduciaries from fiduciary liability and prohibited transaction restrictions when fiduciary advisors are appointed to provide advice to participants.
- **Default Investments.** Provided that plans comply with DOL regulations (to be published) and provide notice to participants, fiduciaries of plans are protected when they provide for the investment of a participant's account balance in the absence of an affirmative investment election in "default investments."
- **Mapping.** Effective in 2008, a participant's account may be reallocated to new investment options with characteristics that are similar to the characteristics of the existing participant-directed investment, pro-vided that requirements are met.
- **Diversification.** Plans must permit participants to diversify amounts attributable to elective deferrals and after-tax employee contributions at all times; amounts attributable to employer matching and nonelective contributions may be diversified after a participant completes 3 years of service.
- **Vesting Schedule.** All employer contributions (not just matching contributions) must vest at least as quick as either a 3-year cliff or 6-year graded vesting schedule.

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Other Defined Contribution Plan Issues

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- **Hardship Distributions.** Hardship rules are expanded to permit withdrawals for financial hardships or unforeseeable emergencies by the participant's beneficiary under the plan, even if the beneficiary is not the participant's spouse or dependent (effective after final regulations implementing these provisions are issued).
- **Rollovers.** With regard to rollovers:
  - Portability of after-tax amounts has been expanded.
  - Nonspouse beneficiaries may roll over benefits to an IRA, with such IRA then satisfying the minimum distribution requirements.
  - Effective in 2008, provided that Roth IRA conversion rules are satisfied, plan distributions may be rolled over directly to a Roth IRA.
- **Missing Participants.** Benefits of missing participants in a terminating DC plan may be transferred to the PBGC (effective after final regulations implementing these provisions are issued).
- **Form 5500.** A simplified Form 5500 will be available for plans with 25 or fewer participants and one-participant plans with less than $250,000 in assets are exempt from filing.
- **Benefit Statements.** Benefit statements must be provided quarterly for participant-directed plans and annually for all other defined contribution plans.

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Effective Dates of the Principal Provisions of the Pension Protection Act

Provisions Effective Retroactively

- Rules for cash balance and hybrid plans (plans effective on or after June 29, 2005 and age discrimination relief for all plans)

Provisions Effective August 17, 2006

- EGTRRA permanency – revisions made under EGTRRA which were set to expire 12/31/10 are now permanent.
- PBGC premiums – current rate continues in effect for 2006/2007 and modifications to premium rates are effective for plan years beginning after 12/31/07
- PBGC missing participant program (upon publication of regulations) – plans other than those covered by the PBGC may transfer the benefit of missing participants to the PBGC for payment.
- Increased deduction limits for defined benefit plans
- Restrictions on executive deferred compensation based on defined benefit plan funding
- Cash balance and hybrid plans whipsaw provisions

Provisions Effective in 2007

- Vesting under defined contribution plans
- Inflation adjustments for IRAs
- Investment advice for defined contribution plans
- Phased retirement distributions

Provisions Effective in 2008

- Defined benefit plan funding and related deduction rules (transition relief through 2010)
- Benefit limitations based on plan funding
- Funding notice requirement
- Direct rollovers to Roth IRAs
- Calculation of variable rate PBGC premiums
- Joint and 75% survivor annuities
- Minimum lump sum distribution interest rate (phased in through 2012)
- Automatic 401(k) plan enrollment
- Permissive withdrawals of erroneous automatic contributions

This newsletter is general in nature and is not intended to provide specific advice.
Consult legal or tax counsel before taking action with respect to any topics discussed.