



## Economic Stimulus Bill Provides Funding Relief for Defined Benefit Plans and Technical Corrections to EGTRRA

**WHO'S AFFECTED** The new law affects participants in and sponsors of qualified defined benefit and defined contribution plans, including governmental plans. It also affects participants in and sponsors of tax-sheltered annuity (403(b)) programs and section 457 plans.

**BACKGROUND AND SUMMARY** On March 9, 2002, President Bush signed into law the economic stimulus bill, formally known as the Job Creation and Worker Assistance Act of 2002 (JCWAA). This legislation includes temporary funding relief for defined benefit plans and technical corrections to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Defined Benefit plans are required to satisfy specific funding requirements. Funding calculations are based on the interest rate on 30-year Treasury Securities. This rate has significantly decreased over the past two years. This lower rate has, in some cases, caused defined benefit plans to appear underfunded or has increased the current funding liability of an underfunded plan. JCWAA provides temporary relief to this interest rate problem by setting new interest rate ranges and ceilings to be used in these calculations for 2002 and 2003 plan years. EGTRRA included many provisions that affect retirement plans and IRAs. For a review of these provisions, please refer to our [June 2001 Pension Analyst](#) titled "[The 'Economic Growth and Tax Relief Reconciliation Act of 2001' Makes Significant Changes to Retirement Plans and IRAs](#)". JCWAA includes a number of technical corrections to various EGTRRA provisions. Some of the corrections are meant to clarify certain provisions while others modify the original provisions.

**ACTION AND NEXT STEPS** Plan sponsors should review this publication to identify the items that may apply to their plans and participants. In some situations, plan sponsors may want or need to adopt additional EGTRRA plan amendments. If you have questions about how these provisions affect your plan, please contact your Prudential representative.

\*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

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## Funding Relief for Defined Benefit Plans

Defined benefit plans must satisfy specific funding requirements. Plans that do not meet certain funding thresholds must make quarterly contributions. An underfunded plan must pay additional Pension Benefit Guaranty Corporation (PBGC) premiums (variable rate premiums) based on the amount of the plan's unfunded vested benefits. All of these calculations are based on the interest rates on 30-year Treasury securities.

However, the Treasury Department no longer issues 30-year Treasury securities. Nevertheless, the IRS continues to issue a monthly 30-year Treasury bond rate, which has significantly decreased over the past two years. This lower rate has caused some plans to become underfunded or has increased the current funding liability of some already-underfunded plans.

As a temporary solution to this interest rate problem, JCWAA has set new interest rate ranges and ceilings to be used in these calculations. *These rules are effective for 2002 and 2003 plan years only*, in anticipation of a permanent solution being developed by 2004.

## Current Liability Calculation

The interest rate used to determine a defined benefit plan's current liability for funding purposes must be within a "permissible range." The Internal Revenue Code defines the permissible range to be 90% to 105% of the weighted average of the interest rate on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. JCWAA expands this permissible range to be *90% to 120%* of the weighted average of 30-year Treasuries, as

described above.

### **Deficit Reduction Contribution**

A defined benefit plan with more than 100 participants is generally required to make additional contributions under a special funding rule if the plan assets are less than 90% of the current liability in the current plan year. The amount of the required additional contributions is based on the unfunded current liability in the current plan year.

Expanding the permissible current liability interest rate ceiling to *120%* of the weighted average of 30-year Treasuries may enable some plans that had anticipated making required additional contributions under this special funding rule to reduce the required amount or to completely avoid the requirement to make them.

### **Quarterly Contribution Requirement**

The determination of whether a defined benefit plan must make quarterly contributions is partially based on whether the plan's assets exceeded its current liability in the prior year. When making this determination for 2002, a plan's *2001 current liability can be recalculated using the 120% ceiling* described above. As a result, plans that had anticipated making quarterly contributions in 2002 may not have to make them or may be able to make smaller payments.

### **PBGC Variable Rate Premium**

For purposes of determining a plan's variable rate PBGC premium, the plan's unfunded vested benefits are calculated using an interest rate of 85% of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins. JCWAA increases this rate to *100%* of the interest rate on applicable 30-year Treasury securities.

### **Calculations Not Affected by This Relief**

It is important to note that these temporary changes *do not* apply to the rules for determining the interest rate used to value minimum lump-sum benefits or to determine if they can be involuntarily cashed-out. In addition, JCWAA *did not* amend the permissible range of interest rates used to determine a plan's full funding limit. This range of interest rates remains 90% to 110% of the weighted average of Treasury securities.

If CIGNA provides actuarial services for your plan, the funding calculations will reflect this relief where it is applicable. If you wish to discuss how this relief affects your plan's funding, please contact the plan's enrolled actuary.

### **EGTRRA Technical Corrections**

JCWAA includes a number of technical corrections to pension related EGTRRA provisions. Some of the corrections are meant to clarify certain provisions while others modify the original provisions. All of the changes are effective as if they were originally included in EGTRRA.

## **Increase in Benefit Limit for Defined Benefit Plans**

EGTRRA increased the annual benefit limit for defined benefit plans effective for limitation years ending after December 31, 2001. If a defined benefit plan document defines this limit by referencing the applicable Internal Revenue Code section this increased limit becomes effective automatically, resulting in unintended and perhaps unwanted benefit increases. By the time plan sponsors with 2001 limitation years ending in early 2002 realized what was happening, it was often too late to do anything about it. Either there was not enough time to provide ERISA 204(h) notices before the desired amendment effective date, or the plan's 2001 limitation year had already ended and the increase could not be removed retroactively without violating protected benefit rules.

JCWAA adds an exception to the protected benefit rules to allow plan sponsors to retroactively amend their plans to reflect the pre-EGTRRA limits. This *amendment must be adopted no later than June 30, 2002*, and only applies to plans that define the limit by referencing the applicable Internal Revenue Code section.

Sponsors of defined benefit plans with a non-calendar limitation year ending before July 1, 2002, and a benefit limit provision that references section 415 of the Internal Revenue Code, should contact the plan's enrolled actuary to determine if a plan amendment is needed. Note that amendments may also be needed for plans that have calendar limitation years or 2001 limitation years ending on or after July 1, 2002, but any amendments made after June 30, 2002, will be subject to the standard protected benefit timing and notice rules.

## **Cash-Out Rules**

EGTRRA allowed most plan sponsors to amend their plans to disregard a participant's rollover balance when determining whether the value of the participant's vested accrued benefit is below the plan's cash-out threshold. However, EGTRRA did not make similar amendments to the qualified joint and survivor annuity (QJSA) requirements. Therefore, the IRS's EGTRRA Model Amendments took the position that a plan that is subject to the QJSA rules could not adopt this provision.

JCWAA now allows a plan that is subject to the QJSA rules to be amended to disregard the participant's rollover balance. Since most defined benefit plans do not accept rollover contributions, this is mainly an issue for money purchase pension plans and profit sharing plans that are subject to the QJSA rules.

Plan Sponsors that wish to adopt this provision should contact their document provider. If you use Prudential's document services, please contact your Prudential representative to obtain an amendment. If you do not use Prudential's document services but you amend your plan to take advantage of this new provision, please forward a copy of the signed amendment to your Prudential representative so that we can appropriately administer your plan.

## Top Heavy Rules

JCWAA clarifies that distributions made after severance from employment (rather than separation from service) are taken into account for only one year in determining top heavy status.

Therefore, a distribution made to an employee due to a severance from employment that is not considered to be a separation from service, as a result of the application of the "same desk rule," is only counted for top heavy purposes for one year.

## Deemed IRAs

Effective January 1, 2003, "qualified employer plans" may accept voluntary participant contributions, which are placed in a separate account that is deemed to be an IRA.

The new law clarifies that for purposes of these "deemed IRAs," the term "qualified employer plan" includes the following types of plans maintained by a governmental employer:

- Qualified retirement plans under section 401(a);
- Qualified annuity plans under section 403(a);
- Tax-sheltered annuity programs under 403(b); and
- Governmental section 457 plans.

## Small Business Tax Credit for New Retirement Plan Expenses

JCWAA clarifies that the small business tax credit for certain new retirement plan expenses applies to plans that are first *effective* after December 31, 2001, even if they were adopted before that date.

## Nonrefundable Credit for Elective Deferrals and IRA Contributions

Under EGTRRA, eligible taxpayers who make contributions to certain retirement plans and IRAs are eligible for a nonrefundable tax credit. The amount of contributions taken into account when determining the available credit is reduced by certain distributions received by the individual and his or her spouse (if a joint return is filed).

The new law clarifies that the amount of contributions taken into account to determine the credit is reduced only by the amount of those distributions that is includible in income or that consists of after-tax contributions. Any distributions that are rolled over to another retirement plan do not affect this calculation.

## Catch-up Contributions

JCWAA clarifies the catch-up contribution rules as follows:

- An individual who will reach age 50 by the end of a tax year (usually, the calendar year) is eligible to make catch-up contributions as of the beginning of that tax year, even if the plan does not have a calendar plan year or the individual has not yet actually reached age 50. This is consistent with the proposed regulations that were issued to provide administrative guidance on catch-up contributions.

- An eligible participant in a governmental section 457 plan may make catch-up contributions equal to the greater of the amount permitted under the new catch-up rules or the amount permitted under the existing special catch-up rule for these plans.
- A plan acquired in a business transaction is not taken into account when determining whether the universal availability requirements are satisfied until the end of the plan year following the plan year in which the transaction occurred.

## **Rollovers**

The new law clarifies that after-tax contributions in a qualified retirement plan may be rolled over as a *direct rollover* to

- A *qualified defined contribution plan* that agrees to accept, and separately account for, after-tax amounts; or
- A traditional IRA.

In addition, if a *rollover distribution* includes both pretax and after-tax amounts, the pretax dollars are considered to be the first dollars rolled-over. This way, if any portion of the distribution is not rolled over, the participant can minimize the taxation on that amount.

## **ERISA 204(h) Notice**

If a defined benefit plan or a money purchase pension plan is amended to provide for a significant reduction in the future rate of benefit accruals or the reduction or elimination of an early retirement-type subsidy, affected participants must be notified before the amendment effective date. This notice is typically referred to as the "ERISA 204(h) Notice."

JCWAA clarifies that this notice requirement only applies to qualified plans. Also, if the amendment reduces or eliminates an early retirement benefit or retirement-type subsidy, notice is required only if the reduction or elimination was "significant."

## **ESOP Dividends**

The new law clarifies that dividends that are reinvested in employer stock at the election of the participant or beneficiary may be deducted from the employer's federal income taxes for the tax year in which the later of the following occurs:

- The dividends are reinvested in employer stock; or
- The participant makes an election to have the dividend paid to the plan and reinvested in employer stock.

In addition, reinvested dividends must be 100% vested.

## **Defined Benefit-Defined Contribution Combined Deduction Limits**

The new law clarifies that the combined contribution deduction limit of 25% when at least one employee participates in both a defined benefit plan and a defined contribution plan sponsored by the employer does not apply if the only contributions made to the defined contribution plan are elective deferrals.

## **Definition of Compensation for 457 Plans**

The definition of “includable compensation” used in applying the contribution limits in a section 457 plan has been updated to reflect the definition of compensation used to determine the annual additions limit under qualified defined contribution plans. Compensation will now include 457(b) plan deferrals when applying the 100% of compensation limit.

## **Application of Annual Additions Limit to 403(b) Programs**

The new law clarifies that contributions under a 403(b) program will count towards the annual additions limit in the year contributed, rather than the year the amounts become vested.

## **Contributions to 403(b) Programs for Former Employees**

Contributions may be made to a 403(b) program for up to five years after retirement based on the participant's includable compensation for the last year of service before retirement.

## **Defined Benefit Plan Valuation Timing**

The new law clarifies that defined benefit plans may use a valuation date in the prior plan year if the value of the plan assets is *100%* of the plan's current liability. This is a decrease from the previous 125% threshold and is based on the prior plan year valuation date.

### **Pension Analyst by Prudential Retirement**

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