

# *Pension* ANALYST

Important Information

Legislation

June 2007



## Pension Protection Act of 2006 Changes Affect Single-Employer Defined Benefit Plans in 2008

This is one of a series of *Pension Analyst* publications providing information on specific aspects of the 2006 pension reform legislation affecting defined benefit plans. This publication focuses on those changes that are effective in 2008 and beyond. An [earlier publication](#) discussed those provisions that became effective in 2007 and prior years. Separate publications discuss the changes affecting multiemployer plans, governmental plans and non-electing church plans in 2008 and beyond.

**WHO'S AFFECTED** These developments affect sponsors of and participants in qualified single-employer defined benefit plans. They do not affect governmental plans or church plans that do not elect to be covered by ERISA (“non-electing church plans”).

**BACKGROUND AND SUMMARY** On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The 1000 pages of this new law contain major provisions for comprehensive pension reform and introduce substantial changes designed to enhance retirement security of American workers and their families.

For defined benefit plans covered by ERISA, PPA establishes new funding requirements, which will typically increase minimum contributions, affect the measurement of plan assets and liabilities, and limit the use of accumulated excess contributions, known as credit balances. PPA also requires enhanced disclosure to participants regarding a plan’s funding status. In addition, PPA introduces a new plan design known as a DB(k) plan, which allows a defined benefit plan and a 401(k) plan to be treated as a single plan, provided certain requirements are satisfied. Finally, PPA allows distributions from a qualified plan to be directly rolled over into a Roth IRA.

This *Pension Analyst* discusses the PPA provisions that apply to single-employer defined benefit plans in 2008 and later years in an effort to help plan sponsors determine the future actions needed to keep their plans in compliance with ERISA and the Internal Revenue Code. Some of the items do not require plan sponsors to make plan amendments. Other provisions require sponsors to amend their plans.

**ACTION AND NEXT STEPS** The PPA provisions affect plan funding, design, and administration. Plan sponsors should carefully read the information contained in this *Pension Analyst* and should discuss the new law’s impact on their plans with their enrolled actuary and legal counsel. Prudential Retirement’s enrolled actuaries are well prepared to respond to your inquiries regarding the effect of the new law on your plan.

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## Funding Requirements

Before PPA was enacted, a single-employer defined benefit plan was required to meet certain minimum funding requirements. The general funding rules required a plan to fund for the successive year's benefit accruals, along with the amortization of any funding shortfall over a period no longer than 30 years. Plans that were significantly underfunded were required to make an additional deficit reduction contribution.

### Minimum Required Contribution

Effective for plan years beginning after 2007, PPA changes the funding rules for defined benefit plans. The previous rules no longer apply. Under PPA, if the plan's assets are less than the "[funding target](#)," the minimum required contribution for the year is equal to the plan's "[target normal cost](#)" plus the amortization of the "[funding shortfall](#)." If the plan's assets equal or exceed the "funding target," the minimum required contribution is the "target normal cost," which is reduced by the plan assets in excess of the funding target.

PPA introduces the following new definitions that apply to the new funding rules:

- **Funding target:** 100% of the present value of all benefit liabilities accrued to date.

- **Target normal cost:** The present value of benefit liabilities expected to accrue during the plan year, including increases in past service benefits attributable to current year increases in compensation.
- **Funding shortfall:** The excess of the plan's funding target over the plan's assets.
- **Funding target attainment percentage:** The ratio of the value of plan assets for the year to the plan's funding target for the year.

An existing plan that has a current funding percentage of at least 90% in 2007 will not be considered to have a funding shortfall through 2010 if the funding percentage is at least equal to the following phase-in levels for each year:

Plan Year Beginning in	Funding Percentage
2008	92%
2009	94%
2010	96%
2011	100%

A plan that is not funded at the applicable phase-in level for that year would have a funding shortfall for that year based upon the difference between the plan's actual funding percentage and the 100% funding target, not the applicable phase-in level. Also, if a plan fails to meet any one of these phase-in targets in a given year, it can no longer benefit from a phase-in target in any later year. Further, PPA decreases the period for amortizing a plan's shortfall from 30 years to 7 years.

To take advantage of these phase-in levels, plan sponsors will need to consult with the plan's enrolled actuary to ensure that the plan has satisfied the 90% funding percentage target in 2007.

### Quarterly Contributions

Under prior law, the plan sponsor was required to make the minimum contribution for the year in four installments if the plan's funded current liability for the preceding plan year was less than 100%.

Under PPA, a quarterly payment requirement applies to plans that have a "funding shortfall" in the preceding plan year. As with previous law, quarterly installments are equal to 25% of the lesser of:

- 90% of the minimum required contribution for the current plan year; or
- 100% of the minimum required contribution for the preceding plan year.

For plans that have calendar plan years, the installment payments are due on April 15, July 15, and October 15 of the plan year and January 15 of the following year. Interest applies to the amount of any underpayment.

### Credit Balances

If a plan has a positive balance in its funding standard account as of the end of 2007, the plan sponsor may elect to maintain all or a portion of that amount as a "funding standard carryover balance." A funding standard carryover balance may be maintained until it is reduced to zero.

Beginning in 2008, a plan sponsor that contributes an amount in excess of the plan's minimum required contribution for the year may elect to maintain all or a portion of that amount as a "pre-funding balance." A plan sponsor may elect to reduce its minimum required contribution for a year by its funding standard

carryover and/or pre-funding balances. However, the funding standard carryover balance must be used before the pre-funding balance.

PPA also contains detailed rules regarding the:

- Use of credit balances;
- Effect of credit balances on plan assets when determining the amount of the funding shortfall;
- Determination of whether the plan is at-risk and whether benefit restrictions apply; and
- Reduction of credit balances.

The funding standard carryover and pre-funding balances are adjusted as of the first day of the plan year to reflect investment performance in the underlying investments. PPA has directed the IRS to issue regulations describing how the adjustment is to be made.

## **Determining Liabilities and Assets**

### **Interest Rates**

For plan years beginning after December 31, 2003, and before January 1, 2006, the Pension Funding Equity Act of 2004 (PFEA) changed the required interest rate used for determining a plan's current liability. For these years, the required interest rate was a weighted average of monthly composite long term corporate bond rates. The use of this rate had been scheduled to expire for plan years beginning on or after January 1, 2006, and would have been replaced with an interest rate based on 30-year Treasury bonds. However, PPA extended the use of the long term corporate bond rate for the 2006 and 2007 plan years.

Beginning in 2008, the interest rate used to determine the present value of liabilities is determined using a segmented yield curve based on a 24-month average of investment-grade corporate bonds of varying maturities that are in the top three quality levels available. Under these new rules, the interest rate is determined by the following time period (i.e., segment) in which benefits are expected to be paid:

- 0-5 years from the first day of the plan year;
- 5-20 years from the first day of the plan year; or
- More than 20 years from the first day of the plan year.

The IRS will publish these rates monthly.

Alternatively, a plan sponsor may choose to determine the present value of liabilities by using either:

- The entire yield curve (also published monthly by the IRS) to discount expected benefit payments; or
- The published rates from any of the four months prior to the beginning of the valuation year.

Once either of these options is selected, they cannot be changed without IRS consent.

For plans in existence before 2008, PPA contains a transition rule that allows a phase-in of the segmented interest rates over 3 years. However, a plan sponsor may make a one-time election to opt out of the phase-in.

### **Mortality Tables**

PPA directs the IRS to publish new mortality tables to be used in determining present value or making funding calculations under the new rules. These tables are to be based on the actual experience of pension

plans and projected trends in such experience. The IRS must also update these mortality tables at least once every ten years. There is no phase-in of the new mortality tables. However, a plan sponsor may use a substitute mortality table that reflects the plan's actual experience, if IRS approval to do so is requested and received. If a plan uses a substitute mortality table, all plans maintained by members of the plan sponsor's controlled group must use the same table.

Recently, the IRS did publish a [new mortality table](#) to be used for determining current liability calculations for plan years beginning on or after January 1, 2007, as well as for the PPA funding liability calculations beginning with 2008 plan years.

### **Valuation of Plan Assets**

Under PPA, plan assets may be valued using any reasonable actuarial method permitted by the IRS regulations. However, asset values cannot be averaged over a period exceeding 24-months and the averaging cannot result in values lower than 90% or greater than 110% of the fair market value of such assets at the time of valuation.

In addition, plans with more than 100 participants must use the first day of the plan year as the valuation date. However, plans with 100 or fewer participants can use any day of the plan year for the valuation date.

### **At-Risk Plans**

PPA creates a new "[at-risk](#)" category with respect to funding for pension plans. Sponsors of at-risk plans must make larger contributions to offset the greater liability of these plans.

A plan is "at-risk" if, for the preceding plan year, the plan is both:

- Less than 80% funded using actuarial assumptions set forth in the general funding rules; and
- Less than 70% funded using special "at-risk" actuarial assumptions.

As with the [standard funding rules](#), there will be a phase-in of the "at-risk" rules. The 80% funding target will be phased-in through 2011.

Plans with 500 or fewer participants are never considered to be "at-risk."

### **Benefit Restrictions**

Effective for plan years beginning on and after January 1, 2008, single-employer defined benefit plans that fail to meet specific funding requirements are subject to certain restrictions. Plans maintained pursuant to collective bargaining agreements ratified before January 1, 2008, have a delayed effective date.

### **Benefit Payments**

Under PPA, a plan may only make benefit payments in the form of a single life annuity for participants with annuity starting dates occurring when:

- The plan has an "[adjusted funding target attainment percentage](#)" of less than 60%; or
- The plan sponsor is in bankruptcy and the plan has an adjusted funding target percentage that is less than 100%.

A plan's "adjusted funding target attainment percentage" is the ratio of the plan's assets to its funding target, with both amounts increased by the total annuity purchase amounts for all participants who were non-highly compensated employees for the preceding two years.

If a plan's adjusted funding target attainment percentage is between 60% and 80%, the plan may generally make one lump sum payment during an entire restricted period. This payment may not exceed the lesser of:

- The present value of the participant's maximum PBGC guaranteed benefit; or
- 50% of the amount of the payment that could otherwise be paid.

Once a plan is no longer subject to this restriction, benefit payments may resume as otherwise provided for in the plan. However, there are still many unanswered questions about how benefit payments may need to be adjusted once the restriction is lifted

### **Shutdown or Contingent Benefits**

Before the enactment of PPA, a plan was permitted to pay benefits for certain unpredictable events, such as plant shutdowns, without any special limitations.

PPA now prohibits the payment of shutdown benefits, or benefits for other unpredictable events, if a plan has an "[adjusted funding target attainment percentage](#)" that:

- Is less than 60%; or
- Would be less than 60% as a result of paying such benefits.

However, this restriction does not apply if the plan sponsor makes additional contributions to the plan or provides security to either:

- Pay for these benefits; or
- Satisfy the 60% funding percentage.

### **Benefit Accruals**

PPA imposes a restriction on benefit accruals that is related to the plan's funding status. If a plan has an "[adjusted funding target attainment percentage](#)" that is less than 60%, the plan must freeze all future benefit accruals as of the valuation date for the plan year.

The restriction on benefit accruals does not apply:

- During a new plan's first five plan years; or
- If the plan sponsor makes contributions to the plan to satisfy the 60% funding level or provides additional security.

A plan may resume benefit accruals once it is no longer subject to the restriction.

### **Benefit Increases**

A plan cannot be amended to increase benefits if the plan is less than 80% funded or would be less than 80% funded taking the amendment in account.

However, this restriction does not apply if:

- The plan sponsor makes contributions (or provides security) to the plan to either completely fund the benefit increase, or satisfy the 80% funding requirement; or
- The plan amendment provides for a benefit increase under a formula that is not based on a participant's compensation and the rate of increase does not exceed the simultaneous rate of increase in average wages of plan participants; or
- The plan (and any predecessor plan) has been in existence for five years or less.

## **Actuarial Certification**

For purposes of determining whether any of the new benefit restrictions apply for a plan year, a plan is considered to have the same adjusted funding target attainment percentage as it had in the prior plan year, until an actuarial certification is completed for the current plan year.

If an enrolled actuary does not certify the adjusted funding target attainment percentage for the current plan year by the first day of the fourth month of the plan year (e.g., by April 1 for a calendar plan year), the percentage is immediately deemed to be 10% lower than the prior plan year's level. Any benefit restrictions resulting from this decrease would apply beginning on this date and would remain in effect until the actuarial certification is completed.

If the actuarial certification is not completed by the first day of the tenth month of the plan year (e.g., by October 1 for a calendar year plan), the plan is immediately deemed to be less than 60% funded. At that point, the applicable benefit restrictions will immediately apply. These restrictions will remain in effect until the actuarial certification is completed for the *next* plan year. It is important that sponsors submit plan information as soon as possible in order for the plan's enrolled actuary to complete the plan valuation and actuarial certification.

If Prudential Retirement does not provide actuarial services but does make benefit payments or provides document services for your plan, plan sponsors will need to make sure that a copy of the actuarial certification is provided to Prudential on a timely basis to ensure that benefits are not unnecessarily restricted.

## **Notice Requirements**

The plan administrator must provide written or electronic notice of the applicable benefit restriction to plan participants and beneficiaries within 30 days of its application. If the plan administrator fails to provide the notice, a civil penalty may be imposed up to \$1,000 per day from the time of the failure.

## **Reporting and Disclosure Requirements**

### **Plan Funding Notice**

Effective for plan years beginning on or after January 1, 2008, PPA requires plan administrators of single-employer plans to provide an annual funding notice, disclosing the plan's funded current liability and the value of plan assets. The notice must be provided to:

- The Pension Benefit Guaranty Corporation (PBGC);
- Participants;
- Beneficiaries; and
- Labor organizations representing participants.

In general, this notice must be provided within 120 days of the end of the plan year to which it relates. In the case of a small plan (i.e., a plan covering less than 100 participants), the notice must be provided by the filing due date of the annual Form 5500 (i.e., within seven months after the end of the plan year, unless the due date for the annual report is extended).

The funding notice must include the following information:

- The number of participants;
- The [funding target attainment percentage](#) for the current and preceding two plan years;
- The level of assets, funding target, and all credit balances reported on the most recent and two preceding Form 5500s;
- A statement of the plan's funding policy and asset allocation (as a percentage of total assets) as of the end of the plan year;
- An explanation of any plan amendment, scheduled benefit increase or reduction, or other known event taking effect in the current plan year and having a material effect on plan liabilities or assets for the year);
- A summary of ERISA's plan termination rules;
- A general description of the PBGC's guaranteed benefits;
- A statement that a copy of the plan's Form 5500 annual report is available upon request, through the Department of Labor's (DOL) website, or through an Intranet website maintained by the plan sponsor; and
- Any additional information that the plan administrator elects or includes that is not inconsistent with the DOL regulations.

The notice must be provided in a manner so as to be understood by the average plan participant. PPA directs the DOL to provide a model notice, satisfying these requirements, by August 17, 2007.

As a result of the expanded annual funding notice requirement, PPA has repealed the requirement that defined benefit plans provide Summary Annual Reports (SARs) to plan participants. The repeal is effective for plan years beginning after December 31, 2007. For plan years beginning before January 1, 2008, SARs are still required.

### **Additional Form 5500 Disclosures**

Effective for plan years beginning on or after January 1, 2008, PPA requires additional information to be included in the Form 5500 annual report where a plan merger or other transfer of liabilities from multiple plans occurred during the year. PPA also requires the actuarial statement filed with the Form 5500 to contain a statement explaining actuarial assumptions and methods used in projecting future retirements and forms of distribution under the plan.

### **Electronic Display of Annual Report**

Effective for plan years beginning on or after January 1, 2008, PPA requires a plan administrator to electronically file plan identification and basic plan information and actuarial information from the Form 5500 filing to the DOL. Within 90 days after filing, the DOL must display this information on its Internet website. Within this same time period, the employer or plan administrator must display this information on its Intranet website. PPA authorizes the DOL to issue regulations regarding this requirement.

The DOL has recently indicated that the requirement to file the Form 5500 electronically will be effective for plan years beginning on or after January 1, 2009, rather than January 1, 2008. It is unclear how this delay will affect this PPA requirement, if at all.

## PBGC Filings

Before the enactment of PPA, sponsors of certain plans were required to file an additional form with the PBGC (“4010 filing”) if the plan’s aggregate unfunded vested benefits exceeded \$50 million or if there were unpaid contributions or unpaid funding waivers in excess of \$1 million.

Effective for plan years beginning on or after January 1, 2008, plan sponsors must make a 4010 filing if any plan within the controlled group has a [funding target attainment percentage](#) at the end of the preceding plan year that is less than 80%. PPA also expands the information required in the 4010 filing. Plan sponsors must now include the following information in the 4010 filing:

- The amount of benefit liabilities under the plan using PBGC assumptions;
- The funding target, determined as if the plan was in at-risk status for at least five years; and
- The funding target attainment percentage.

PBGC may assess a penalty for a failure to provide the required information up to \$1,000 for each day the failure occurs.

## Deduction Rules

For taxable years beginning in 2006 and 2007, PPA provides that the maximum deductible contribution amount for a single-employer defined benefit plan is 150% of the plan’s current liability, minus the value of plan assets, all determined at the end of the year.

However, for taxable years beginning after 2007, the maximum deductible amount is equal to the greater of the:

- Excess, if any, of the sum of the plan’s funding target, the plan’s target normal cost, and a “[cushion amount](#)” for a plan year, over the value of plan assets; and
- Minimum required contribution for the plan year.

The “cushion amount” is equal to the sum of:

- 50% of the plan’s funding target for the plan year; and
- The amount by which the funding target would increase based on future compensation increases (or on expected increases in benefits for certain plans).

There are special deduction rules for at-risk plans.

In addition, for plan years beginning on or after January 1, 2008, PPA eliminates the [combined deduction](#) limit for an employer that sponsors a defined benefit plan which is insured by the PBGC and a defined contribution plan.

## PBGC Premiums

Under prior law, the PBGC variable rate premium was waived for an underfunded plan if the plan made the full funding requirement for the year. The variable rate premium is currently \$9 per \$1,000 of underfunding.

Effective for plan years beginning on or after January 1, 2008, the variable rate premium applies to all underfunded plans, regardless of prior years' funding status. PPA requires the variable rate premium to be calculated using a three-segment rate based on the corporate bond yield curve provided by the IRS.

PPA also makes permanent the termination premium required by the [Deficit Reduction Act](#). The special per participant premium will be assessed on underfunded single-employer plans that terminate after December 31, 2005, in a distress termination or in an involuntary termination by the PBGC. The special premium is \$1,250 per participant and is payable annually for each of the three years beginning the month following the date of termination and each anniversary, or if later, the employer's exit from bankruptcy. This premium is in addition to any other PBGC premiums that are due for the plan year. If the plan termination occurs as part of a bankruptcy reorganization, the special premium applies only if the bankruptcy was filed after October 18, 2005.

## **DB(k) Plan Design**

Effective for plan years beginning in 2010, PPA allows certain employers to establish "eligible combined plans," more commonly known as "DB(k) plans." This plan design is only available to employers with fewer than 500 employees when the plan is established.

Under the new law, a DB(k) plan is:

- Funded through a single trust with a single plan document;
- Required to file just one Form 5500;
- Exempt from the top-heavy rules; and
- Deemed to satisfy the ADP and ACP tests.

Under this plan design, the defined benefit portion must provide either:

- A benefit equal to 1% of final average compensation for each year of service up to a maximum of 20 years; or
- A cash balance plan that increases benefits with the participant's age.

Benefits under the defined benefit portion must be 100% vested after three years of service.

The defined contribution portion must provide:

- Automatic enrollment with a contribution of 4% of pay;
- Employer matching contribution equal to 50% of the first 4% of employee deferrals; and
- 100% immediate vesting for matching contributions.

Nonelective employer contributions to a profit sharing feature in the plan are permitted but not required. However, they must vest after 3 years of service.

## **Additional Distribution Rules**

### **Direct Rollover to Roth IRA**

Prior to January 1, 2008, plan participants may roll over distributions from a tax-qualified retirement plan to a traditional individual retirement arrangement ("IRA"), but not to a Roth IRA. However, distributions from a traditional IRA may be rolled over to a Roth IRA if the taxpayer has a modified adjusted gross income (AGI) of \$100,000 or less.

Beginning January 1, 2008, plan participants may roll over distributions from a tax-qualified retirement plan, directly into a Roth IRA provided the taxpayer's AGI is \$100,000 or less. In 2010, this \$100,000 threshold is repealed as a result of the Tax Increase Prevention and Reconciliation Act.

### **Qualified Optional Survivor Annuity**

Defined benefit plans must provide benefits in the form of a qualified joint and survivor annuity (QJSA). A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50% (and not more than 100%) of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

Effective for plan years beginning on or after January 1, 2008, defined benefit plans must offer a new qualified optional survivor annuity (QOSA) which is a joint annuity with a continuation of either 50% or 75% of the amount payable to the participant. A plan must offer a:

- 75% survivor annuity option if it currently offers a QJSA with less than 75% continuation; and
- 50% survivor annuity option if it currently offers a QJSA with a survivor continuation percentage equal to or greater than 75%.

Collectively bargained plans have a delayed effective date which is the earlier of:

- The later of January 1, 2008, or the last date on which an applicable collective bargaining agreement terminates (without regard to extensions) after August 17, 2006; or
- January 1, 2009.

### **Minimum Lump Sum Value**

PPA requires plans to use an interest rate for determining the minimum value of a lump sum payment and certain other optional forms of payment that is based upon a three-segment, modified yield curve, similar to the rate used for determining liabilities. This interest rate is determined by the period (i.e., segment) in which the lump sum benefit is paid, as follows:

- 0-5 years from the first day of the plan year;
- 5-20 years from the first day of the plan year; or
- More than 20 years from the first day of the plan year.

These new rates are determined without the 24-month averaging that applies to the rate used for determining liabilities and will be phased-in over five years beginning in 2008.

### **Increased Bonding Requirement**

ERISA generally requires every plan fiduciary and plan official who handles funds or other plan property to be bonded. Effective for plan years beginning on or after January 1, 2008, PPA increases the maximum bond amount from \$500,000 to \$1 million in the case of a plan that holds employer securities.

### **Missing Participants**

If the plan administrator of a terminating single-employer defined benefit plan cannot locate a participant after a diligent search, the plan administrator may satisfy distribution requirements only by purchasing an annuity from an insurer or transferring the participant's benefit to the PBGC. If the benefit is transferred to

the PBGC, the agency will hold the benefit as trustee until the PBGC locates the missing participant and distributes the benefit.

PPA now extends the PBGC's missing participants program to include defined benefit pension plans that have no more than 25 active participants and are maintained by professional service employers.

This provision is effective for distributions made after the PBGC issues final regulations.

## Next Steps

Prudential Retirement will continue to monitor the IRS, PBGC and DOL's published guidance regarding these new rules. Several employer groups have recently asked Congress to delay the effective date of the plan funding rules, but for now, we have to assume that plans will have to comply with the new rules beginning in 2008. We will keep you informed as additional guidance is made available that clarifies the PPA provisions discussed in this *Pension Analyst*. Hopefully, any guidance will provide examples illustrating how the new requirements apply in specific situations.

In general, PPA plan amendments do not have to be adopted until the last day of the 2009 plan year. If Prudential Retirement provides document services for your plan, we will work with you to provide your PPA amendment, as well as the related Summary Plan Description.

If you have questions about the new funding requirements, asset and liability determinations, actuarial certifications relating to benefit restrictions, deduction rules or PBGC premium rules, you should contact the plan's enrolled actuary. If you have questions about how the new distribution rules affect your plan and the need for plan amendments, you should contact your document provider or your Prudential Retirement representative. Of course, plan sponsors should always be sure to involve the plan's enrolled actuary when considering *any* plan design changes, since those changes may affect plan funding.

**Summary of Pension Protection Act Provisions  
Effective On or After January 1, 2008  
For ERISA Single-Employer Defined Benefit Plans**

**Changes Effective in 2008**

- Funding requirements
- Actuarial assumptions for determining liabilities and assets
- Benefit restrictions
- Reporting and disclosure requirements
- Deduction rules
- PBGC premium requirements
- Direct rollover to Roth IRA
- Qualified Optional Survivor Annuity (QOSA)
- Minimum lump sum value requirements
- Increased bonding requirements

**Changes Effective in 2010**

- DB(k) plan design

**Pension Analyst by Prudential Retirement**

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