HIGHLIGHTS OF

THE PENSION PROTECTION ACT OF 2006

By

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I. **Introduction.** On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 ("PPA"). The primary focus of the PPA was to amend the minimum funding requirements in such a way as to shore up funding of defined benefit plans. In addition, PPA attempts to sure up the financial status of the Pension Benefit Guaranty Corporation ("PBGC"). However, in addition to those objectives, PPA contains significant provisions covering defined contribution plans, new disclosure requirements applicable to both defined benefit and defined contribution plans, new rules governing plan fiduciaries and changes to certain tax deduction rules applicable to qualified plans.

II. **Principal Changes Affecting Defined Contribution Plans and Individual Retirement Accounts.**

A. **Automatic Enrollment in 401(k) Plans.**

1. **Federal Preemption.** PPA blesses automatic enrollment provisions in 401(k), 403(b) and 457(b) governmental plans, by preempting state wage withholding laws as they affect these plans (e.g. New York Labor Law §193). This preemption is effective as of the date of enactment (August 17, 2006).

2. **Design.** The automatic enrollment provision allows an employer to design the plan to require participation in elective deferrals at the employer's pre-set levels, unless the employee (within 90 days after first entering the plan) elects a different deferral percentage or to not participate at all. Deferrals made after that 90-day period may be returned and will be taxed to the employee in the year of distribution, but not be subject to the 10% early distribution tax.

3. **Investments.** Absent an employee election to direct the investment of those deferrals, they must be placed in a default investment fund permitted under Department of Labor regulations. Recently proposed regulations identify managed accounts, balanced funds and life cycle funds as appropriate default investments, but money market accounts are expressly unacceptable default investments.

4. **Application.** The automatic enrollment provisions may be applied to all newly eligible participants, and may be applied to anyone who has not affirmatively elected out of participation in the plan, but cannot apply to anyone who has made an affirmative election to participate.

5. **ADP/ACP Safe Harbor.** In addition, effective for plan years beginning after December 31, 2007, a 401(k) plan can avoid ADP/ACP testing by using a modified safe harbor that borrows from the existing 401(k) safe harbor rules.

   a. Specifically, employers can avoid ADP/ACP testing if the plan contains a "qualified automatic contribution account" ("QACA") and an ACP safe harbor match provision. Each eligible employee must be treated as electing to make elective contributions in an amount equal to a "qualified percentage" of compensation. The qualified percentage must be no more than 10% of compensation and must comply with the following schedule:

Years of Participation	Percentage of Compensation
1	3%
2	4%
3	5%
4 and After	6%

   This does not prevent the employer from allowing greater deferral percentages to be elected by participants.

   b. The plan must provide an employer non-elective contribution of either 3% of pay or a matching contribution equal to:

Percentage of Pay Contributed	**Matching Contribution Rate (as a % of the Contribution)**
1%	100%
>1%, no more than 6%	50%

c. The employer contributions must fully vest after two years (compare this with the current safe harbor rules which require immediate vesting of the non-elective contribution).

6. **Notice Requirement.** Employees must receive notice that explains his or her right to elect not to have elective contributions made, and how contributions will be invested if no investment election is made. That employee must also have a reasonable time period after receipt of the notice but before the first elective contribution is made to make an affirmative election.

7. **Safe Harbor Comparisons.**

a. Plans already using the 3% fixed or 4% match contribution safe harbor lose nothing by adopting the automatic enrollment provision. Those with the 3% fixed contribution satisfy the top heavy test, and if safe harbor (provided there are no additional employer contributions), it is exempt from the top heavy rules. Even those plans that have additional employer contributions (e.g. cross-tested defined contribution plans with a supplemental defined benefit plan) will not face issues by excluding the safe harbor during 2007, and not utilizing a safe harbor in years thereafter.

b. Compare the following in analyzing the QACA safe harbor vs. a traditional ADP safe harbor:

- 3% non-elective contribution is the same amount.
- QACA has a lower match formula, although there may be more deferrals to match.
- two-year cliff vesting vs. immediate vesting.
- minimum automatic contribution vs. no minimum in the traditional safe harbor plan.

8. **Extended Correction Period.** Note that by adopting the automatic contribution account (and assuming the arrangement is not "qualified"),

the employer gets 6 months to distribute excess contributions to meet the ADP/ACP tests, vs. 2½ months under traditional 401(k) plans.

B. **New Vesting Rules.** Effective for plan years beginning after December 31, 2006, all employer contributions to defined contribution plans (not merely matching contributions) must vest under either a 3-year cliff schedule or a 6-year graded schedule (20% after the second year of service). This applies only to contributions made for plan years beginning after December 31, 2006, and only with respect to employees who complete at least one hour of service in any such plan year. However, maintaining separate vesting schedules for pre- and post-PPA contributions may unnecessarily complicate administration.

C. **Default Investments for Automatic Enrollment in Other 404(c) Plans.** Automatic enrollment creates fiduciary liability concerns for those amounts contributed without investment direction by the participant. While this is not a concern for accounts that are not individually directed and for which ERISA §404(c) protection is sought, for all other plans the liability remains with the fiduciary. To avoid this, PPA provides that §404(c) protection is available with respect to those amounts invested pursuant to Department of Labor regulations. This also requires notice to the participants before each plan year explaining the employee's right to direct the investment of their accounts, including those under automatic enrollment provisions.

Recently, Department of Labor issued regulations specifying that the use of balanced funds, life cycle funds, and managed accounts are appropriate investments, but specifically explaining that money market accounts and other investments which seek capital preservation (primarily) are inappropriate.

D. **EGTRRA Permanence.**

1. The increase in contribution limits and other rules under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") were set to expire in 2011. PPA nullifies the sunset rule. With respect to defined contribution plans and IRAs, these changes are now permanent:

   a. The permissible maximum contribution on behalf of a participant in a defined contribution plan is $40,000, subject to COLAs ($44,000 for 2006; $45,000 for 2007).

   b. The maximum compensation that may be taken into account for any plan participant is $200,000, subject to COLAs ($220,000 for 2006; $225,000 for 2007).

c. Maximum deferrals to a 401(k) plan, 403(b) annuity and 408(k) SAR SEPs are $15,000, subject to COLAs ($15,500 for 2007).

d. Maximum deferrals to a simple IRA or simple 401(k) are $10,000 in 2006, subject to COLAs ($10,500 for 2007).

e. Catch up contributions for individuals age 50 or over to 401(k), 403(b), SEPs and 457(b) plans are $5,000 in 2006, subject to COLAs ($5,000 for 2007). For SIMPLE plans, the limit is $2,500, subject to COLAs ($2,500 for 2007).

f. The percentage of compensation limitation for contributions to defined contribution plans, 403(b) plans and 457 plans is 100% of compensation.

g. The multiple use test for 401(k) plans is repealed.

h. The deduction limits for defined contribution plans is 25% of covered compensation. For this purpose, elective deferrals are excluded. The maximum deductible contribution to an IRA is $4,000, to increase to $5,000 for 2008 and thereafter, with a $1,000 catch up available. COLAs are to apply after 2008.

i. Roth contributions may be made under a 401(k) or 403(b) plan.

j. A plan loan may be made to Subchapter S owners, partners and sole proprietors without triggering the excise tax imposed under §4975(f)(6).

k. Expansion of the rollover rules among plans and IRAs, including rollover of after-tax contributions.

l. Modification of the top heavy rules to simplify the definition of key employees and to take into account matching contributions.

m. Employer's credit for eligible employers who adopt a qualified plan for the first time. Eligible employers may utilize tax credits up to $500 for start-up costs for each of the first three years during which a plan is maintained (Code §45E).

n. The "savers credit" is made permanent. Code §25B allows low and middle income tax payers a non-refundable credit for contributions made to 401(k), 403(b) and 457 plans.

E. **Hardship Distributions for Beneficiaries**. Current 401(k) regulations allow hardship distributions to cover medical, funeral and educational expenses for the participant, the participant's spouse and his or her dependents. The IRS is directed under PPA to expand this rule to include a participant's designated beneficiary for 401(k), 403(b), 457(b) and non-qualified deferred compensation plans governed by Code §409A.

F. **Adjusted Gross Income Limits for IRA Contributions.** The applicable limits that apply to individuals who wish to make deductible contributions to IRAs are now subject to COLA adjustments effective for calendar years after 2006, in multiples of $500.

G. **Qualified Reservists Distributions.** Distributions may be made from an IRA, or amounts attributable to elective deferrals under a 401(k), 403(b) or 457 plan, that will only be subject to regular income tax and not the early distribution tax, if paid to a Reservist or National Guardsman who is called to active duty for a period in excess of 179 days. This provision is retroactive. Distributions made after September 11, 2001 are subject to this exception; refunds may be claimed, even if otherwise prevented under statute of limitations or other rule of law but provided the claim is made before August 17, 2007.

H. **Rollovers by Non-Spouse Beneficiaries.**

1. **Disadvantage to Non-Spouse Beneficiaries.**

a. The coordination between (i) language in a tax-qualified pension, profit sharing or 401(k) plan, and 403(b) tax-exempt and 457(b) governmental plans, that controls distributions from the plan, and (ii) the minimum distribution rules under Code §401(a)(9), have resulted in innumerable occasions when non-spouse beneficiaries have been forced to receive accelerated distributions from the plan following the participant's death. In an effort to simplify distribution administration, qualified plan sponsors often provide for an immediate single sum distribution of the participant's account to the designated beneficiary and, oftentimes, limit distributions to only a single sum payment.

b. For surviving spouses, this poses no immediate adverse tax consequence in view of the spouse's rights to roll over the distribution to an individual retirement account in the spouse's name, or to the spouse's own retirement plan. Thereafter, the minimum distribution rules will apply to the surviving spouse as if

the spouse were the employee. That is, distributions can be delayed until the spouse attains age 70½, and the annual distributions can be based upon the spouse's use of the Uniform Lifetime Table under Regs. §1.401(a)(9)-9. That "stretch-out" is further enhanced by the spouse's right to designate a beneficiary. Following the spouse's death after her "required beginning date", the payout period can be based on the remaining life expectancy of the designated beneficiary.

c. In contrast, if the participant named a non-spouse beneficiary (for example, a child, civil union partner or significant other), the plan's requirement for immediate lump sum distribution would trigger an immediate tax burden upon the designated beneficiary that cannot be avoided by a rollover.

2. **New Rule – Rollover Permitted.**

a. Effective for distributions occurring after December 31, 2006, this result can now be avoided. Under Section 829(a) of the Pension Protection Act, non-spouse beneficiaries will have the right to immediately rollover the lump sum distribution to an individual retirement account or individual retirement annuity (Code §402(c)(11)(A)). Although not clear under the statute (which refers to "any portion of a distribution from a retirement plan" as eligible) arguably the same limitation will apply here as with distributions to spousal beneficiaries, – that portion of the account that must be distributed as a "minimum required distribution" cannot be rolled over. Hence, delaying a rollover distribution beyond the year of the participant's death will may complete the transfer somewhat.

b. The rollover can be made with respect to distributions from "any eligible retirement plan" (defined in Code §402(c)(8)(B) to include individual retirement accounts, individual retirement annuities, qualified plans, qualified annuities, tax shelter annuities, and eligible governmental plans under §457(b)). The rollover must be accomplished by a direct trustee-to-trustee transfer to an individual retirement account or individual retirement annuity (only) established for the purpose of receiving that distribution. In other words, distributions cannot be rolled over to an IRA maintained by the beneficiary, but instead must be designated as the decedent's account for the benefit of the designated beneficiary.

c. The rollover account is treated as an inherited individual retirement account (within the meaning of Code §408(d)(3)(C)). Therefore, the beneficiary cannot make further rollover distributions from that account to any other qualified plan or account. Of course, this will not prevent the beneficiary from effecting trustee-to-trustee transfers to other custodians or trustees.

d. Because the IRA is treated as the IRA of the decedent, the minimum distribution rules for post-death distributions, as applied to the decedent, will apply to the beneficiary. Hence, distributions must begin by the end of the year following the year of death, and will be based either on the beneficiary's life expectancy or, if the decedent had reached his "required beginning date" (April 1 of the year following the year he attained age 70½) and the beneficiary was older than the decedent, on the remaining life expectancy of the decedent. Under those rules, if the non-spouse beneficiary dies before fully depleting the account balance, payments over the remaining life expectancy period for the deceased beneficiary may continue to that beneficiary's designated beneficiary.

3. **Trusts as Designated Beneficiaries.** New Code §402(c)(11)(B) also provides that a trust that is named as a beneficiary may qualify for this new rollover treatment, to the extent provided in regulations to be issued. Prior to issuance of those regulations, caution should be applied in anticipating the breadth of those regulations.

I. **Rollovers from Retirement Plans Directly to Roth IRAs.**

1. Commencing with distributions made after December 31, 2007, direct rollovers can be made from tax-qualified retirement plans, tax sheltered annuities and 457 plans to Roth IRAs.

2. The rollover is not available to individuals that have adjusted gross income of $100,000 ro more until after December 31, 2009.

3. The rollover amount is subject to tax in the year of the rollover.

4. The benefit of a direct rollover to a Roth IRA – it will no longer be necessary to roll into a traditional IRA and then roll out of that IRA into the Roth IRA.

J. **Charitable Rollovers.**

1. **Distributions to Public Charity.** For years 2006 and 2007, distributions from an IRA or a Roth IRA directly to a Qualified Charity[1], to wit:

   a. public charity (IRC §170(b)(1)A)); or

   b. private conduit foundation (§170(a)(1)(A))

   do not have to be included in the taxable income of the "donor".

   BUT, the charitable deduction is not available.

2. **Benefit.**

   a. Not having to report the income and not being able to deduct the charitable contribution is significantly more advantageous than current law, which requires the distribution to be included on your tax return.

   b. "Qualified Charitable Distribution" (IRC §408(d)(8) means a direct transfer from the IRA to an organization described at IRC §170(b)(9)(A) but not one described in §509(a)(3).

   Concerns:

   - Limitation of $100,000 in 2006 and $100,000 in 2007 only (IRC §408(d)(8)(A)); and

   - Transfer must be made directly from the IRA to the charity.

3. **Eligibility.**

   a. Persons that have attained the age of 70½ or older

   b. The donee charity must be a public charity or a conduit private foundation.

   c. The provision applies only with respect to IRAs (both traditional and Roth), but not 401(k)s or SEPs, etc.

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[1] organization described at IRC §170(b)(9)(A) but not one described in §509(a)(3).

d. The contribution must be otherwise deductible under IRC §170 and §1201(c).

Be Careful! While a direct distribution to the charity is permitted, an administrator cannot be compelled to actually make the distribution. Thus, the owner of the IRA could make a request to the administrator and the administrator could refuse to do so.

4. **Who Benefits?** Individuals age 70½ or older who have charitable intent because:

   a. you avoid inclusion of the IRA funds in taxable income;

   b. the distribution satisfies a minimum distribution requirement for that year (either all or in part, but then again, the amount required to be distributed and the amount of charitable distribution may be different);

   c. non-deductible, voluntary contributions would not be taxable to the beneficiary. Thus, the new law directs that the distributions directly to the qualifying charity be made first from the taxable portion of the IRA and not the non-taxable portion;

   d. all taxpayers who do not itemize;

   e. donors who would have taxable social security income; and

   f. those in states that do not allow charitable deductions such as New Jersey, Ohio, etc.

5. **Additional Benefits.**

   a. A charitable contribution is an itemized deduction. Thus, it is subject to the 50% of the contribution base (basically, adjusted gross income) or other limitations. Therefore, both itemizers who are subject to the 2% haircut (base) and non-itemizers benefit. Similarly, as itemized deductions are phased out, the benefit becomes more important. This allows donors to make additional contributions from other assets.

b. Those wishing to make additional contributions from other sources are not restricted or limited by the direct transfers (IRC §408(d)(8)(D).

c. Withholding is not required.

d. The transfer fully or partially satisfies the required minimum distribution for the year.

e. Prior year carryovers are available for current year gifts from other assets.

f. Residents of states with income tax.

6. **Be Careful!**

a. Donor-advised funds and private foundations (except "conduit private foundations) (IRC §4965(d)2) and supporting organizations (IRC §509(a)(3)) are not eligible beneficiaries. The contribution must be made after reaching age 70½. Thus, the distribution could not be made until after the date in the year in which the person reaches age 70½ (as defined at IRC §509(a)(3)).

In addition, split interest charitable transfers are not qualified charities. Thus, gifts to charitable lead or remainder trusts, pooled income funds and/or charitable gift annuities do not qualify.

b. There cannot be a quid pro quo benefit to the donor - purely incidental benefits are OK. If received, the distribution is includable in taxable income of the donor.

c. Donation must be substantiated by the charity.

7. **Issues.** Will administrators comply? This will require a great deal of administrative paperwork such as:

a. How to report on Form 1099R;

b. Will administrators investigate the qualification of a charity?

c. Must the administrator indicate who the donor was?

d. Can the direct transfer be in securities instead of cash?

e. What about spousal rollover IRA's? Not specifically mentioned, but why not? IRC §408(d)(8) does not prohibit this.

K. **Phased Retirement.**

1. **Tax Qualification Rule for Pension Plans.** To achieve tax-qualification status under Section 401(a) of the Internal Revenue Code, pension plans must (among other things) be structured to provide systematically for the payment of definitely determinable benefits to employees over a period of years after retirement (Regs. §1.401-1(b)(1)(i)). Unlike profit sharing or 401(k) plans, in-service distributions to pension plan participants who have not attained the normal retirement age expressed under the plan are not permitted (Rev. Rul. 74-254, 1974 C.B. 91). However, once an employee attains normal retirement age (whatever age that might be), payment of the annual benefit (in whole or in part) may be paid to the participant, even if the employee has not yet left service (Rev. Rul. 71-24, 1971-1 C.B. 114).

2. **Alternative Work Scenarios.** In view of the lengthening in life expectancies, employees have grown concerned that they will outlive their retirement benefits, or at the very least, receive retirement benefits in their later years that will not meet their financial needs. At the same time, many employers desire to encourage older, more experienced workers to stay in the work force and have begun to design their plans to offer a kind of "phased retirement". Those arrangements generally provide employees who are at or near eligibility for retirement with the opportunity for a reduced schedule or workload, thereby providing a stream of current income for current services. But to make up for the reduction in pay (but not lifestyle), employees have sought ways to receive a portion of their qualified plan retirement benefits that have accrued from prior service and even to continue to accrue benefits under the plan.

   IRS recognized these needs and, in Notice 2002-43(2002-2 C.B. 38), requested comments on various issues, including:

   a. Whether permitting distributions from a defined benefit plan before the employee attains normal retirement age would be consistent with Regs. §1.401-1(b)(1)(i).

   b. If there *were* situations that were consistent with that rule, how would additional benefits be calculated while the employee continues in service?

c. How would the nondiscrimination requirement that applies to a plan's benefits, rights and features be tested with respect a phased retirement program within the defined benefit plan?

d. How would the qualified joint and survivor annuity rules apply to a phased retirement feature.

In contrast to the complexity of the issues involved with defined benefit plans, and to a lesser degree, money purchase pension plans, phased retirement poses no significant problem with respect to 401(k) and profit sharing plans. This is primarily because distributions from those plans (except with respect to elective deferrals to a 401(k) or typical 403(b) arrangement) may be distributed within a relatively short period of time after the contributions have been made and compensation deferred (see, for example, Rev. Rul. 73-553, 1973-2 C.B. 130, which states that a passage of time of only two years after a contribution is made to a profit sharing plan to effectively defer the recognition of income with respect to that contribution). Furthermore, other specified events (e.g. circumstances that constitute a hardship) may intervene to allow an even earlier distribution.

3. **Proposed Regulations.** In response to comments, IRS issued proposed regulations in November 2004. Those proposed regulations would allow plans to permit distribution of a pro rata share of an employee's accrued benefit at any time after age 59½, based on the extent to which the employee has reduced service hours to the employer. To qualify, the reduction in hours must be at least 20% from the full-time hours experienced by the employee. Furthermore, no lump sum distribution would be allowed, rather benefits would have to be paid in the form of an annuity or joint and survivor annuity, applying the qualified joint and survivor annuity rules of Code §§401(a)(11) and 417.

The employer's phased retirement program would require a monitoring of actual hours performed in comparison to projected hours, and adjustments made in the amount of the phased retirement benefit if the actual hours worked exceeded a certain threshold. This was to prevent abuse of the program as a subterfuge for early distribution of retirement benefits.

Finally, the regulations prevented a plan from setting a normal retirement age earlier than the "earliest age reasonably representative of a typical age for the covered workforce". Again, this was to prevent abuse in arranging

the phased retirement program to, in effect, pay retirement benefits before a customary retirement age.

4. **Liberalized Phased Retirement Under PPA.** Before these regulations could be finalized, Congress enacted new Code §401(a)(36) as part of PPA, which, on its face, appears to provide a very simple and flexible rule. Specifically, the new rule states that a pension plan shall not be disqualified solely because the plan provides that "a distribution" may be made from the pension trust to an employee who has attained age 62 and who has not yet separated from employment. Note the following:

   a. The rule applies to pension plans and not to profit sharing, 401(k), stock bonus or 403(b) annuity contracts (as noted above, those plans may already be designed to allow in-service distributions).

   b. There appears to be no restriction on the form of benefit to be paid (contrast to the proposed regulations). For example, a single sum distribution which could be rolled over to an individual retirement account or other retirement plan will qualify, if so designed under the terms of the pension plan. Of course, the plan must still comply with the qualified joint and survivor annuity rules (and waiver thereof) under Code §§401(a)(11) and 417.

   c. There appears to be no reduced service thresholds to qualify for the benefit.

   d. There appears to be no adjustments required if initially reduced service schedules later change to increased hours.

   e. Query: What will be the impact on those plans using a substantially younger "normal" retirement age? Will IRS continue with its proposed regulations project as an alternative to Code §401(a)(36)?

L. **Qualified Joint and Survivor Annuity Rules.** With respect to money purchase and target benefit plans, PPA extends the notice and consent rules from 90 days to 180 days before the annuity starting date. In addition, the Act requires adoption of a qualified joint and 75% annuity if the normal form is a 50% survivor's annuity, and (in reverse) a 50% survivor annuity if the plan currently provides only a 75% survivor's annuity.

M. **Simplified Reporting.** PPA directs regulations to be issued allowing a one-participant plan with assets of $250,000 or less not having to file an annual return.

In addition, the Department of Labor is directed to issue a simplified annual report for retirement plans with fewer than 25 employees provided that: (1) the plan meets the minimum coverage requirements without aggregation; (2) the plan does not cover a business that is a member of an affiliated service group, controlled group or group of businesses under common control; and (3) the plan does not cover a business that leases employees.

N. **New Notice and Disclosure Requirements.** For defined contribution plans, annual statements must be prepared on an annual basis and distributed to participants (old law merely required distribution upon request by the participant/beneficiary). In addition, for those plans which have any account, or portion thereof, subject to individual investment direction, quarterly statements will be required. These rules go into effect for plan years beginning after December 31, 2006. The benefit statements must reflect the total account balance, vested account balance, the date on which 100% vesting is achieved, and the various investments that comprise the individual's account. For those plans that have both a daily valuation and balance forward valuation, the IRS will be issuing guidance to determine whether quarterly valuations will be required.

O. **Investment Advice.** PPA adds a new prohibited transaction exemption for the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries under a defined contribution plan who direct the investment of their accounts. PPA creates a new category of advisors referred to as "fiduciary advisors" and clarifies the role of the plan's sponsor in the case of such arrangements. The two new prohibited transaction exemptions are: (1) one which provides that any fees including commissions or other compensation received by the fiduciary advisor for investment advice, or with respect to an investment transaction concerning plan assets, do not vary depending upon the basis of any investment option selected, and (2) investment advice based on computer modeling. PPA contains a series of requirements that apply in order to qualify for the exemption, especially with respect to the computer modeling option. Requirements include annual audit, followed by a written report concerning the fiduciary advisor's activities. Notwithstanding this exemption, the prudent person rule applies in the selection of the fiduciary advisor and monitoring of that person's activities.

III. Principal Provisions of PPA Affecting Single-Employer Defined Benefit Pension Plans.

A. **EGTRRA Permanence.** The defined benefit plan limits under Code §415 have been made permanent, resulting in a maximum annual benefit beginning at age 62 of $175,000 or 100% of average pay, whichever is less. The dollar limitation is subject to COLAs ($180,000 in 2007).

B. **Cash Balance and Other Hybrid Plans.** Prior to the passage of PPA, employers had been opting to convert existing traditional defined benefit plans to cash balance or other "hybrid" pension plans, or to simply adopt cash balance plans in lieu of the traditional plan. For various reasons, hybrid plans were seen as a major advance in the pension field, especially so for small employers. These hybrid plans, which in most cases offered the simplicity of separate "hypothetical accounts", were better understood by employees and employers, and could be tailored to meet specific needs within the workforce.

However, employees had raised issues concerning age discrimination in connection with these plans. Although the IRS had seen cash balance plans as a favorable concept, plaintiff's attorneys were successful in a few cases in the age discrimination claims (most notably, in *Cooper vs. IBM*).

PPA provides that cash balance and other hybrid pension plans will not be subject to age discrimination claims, provided that certain standards are met, including the use of an interest crediting rate that is no greater than the "market rate" in effect at the time. Regulations will be issued to describe the concept of "market rate" for this purpose. In addition, the "whipsaw" effect which employers had been subject to in the past will be avoided by the use of this market rate. Finally, existing traditional plans can be converted to a cash balance plan provided that the total accrued benefit that a participant earns under the plan equals the sum of (a) the accrued benefit earned under the traditional plan up to the date of conversion, plus (b) the hypothetical account balance earned under the plan from the date of conversion forward.

New cash balance plans adopted after June 29, 2005 must provide for 100% vesting after 3 years; existing plans must accelerate vesting beginning in plan years starting after December 31, 2007.

PPA also introduces the concept of a DB/(K) plan which consists of both a cash balance defined benefit plan and a 401(k) plan, within one plan arrangement. The requirements under this arrangement are such that few, if any, employers will adopt this plan. Currently, it would require a varying rate of compensation to be credited for each participant to the cash balance portion of the plan based on age, and a 401(k) provision that provides safe harbor employer contribution requirements. Congress will probably undertake further changes to the concept to make it more palatable to employers.

C. **Combined Plan Tax Deduction Limit Increased.** For employers who maintain both a defined contribution and a defined benefit plan where at least one participant actively participates in both plans, the tax deduction limit has

effectively been 25% of covered payroll. Effective immediately, this rule has changed as follows:

1. If the employer makes a contribution not exceeding 6% of covered payroll to the defined contribution plan (disregarding elective deferrals), the amount deductible by the employer will be the sum of the employer contribution made to the defined contribution plan, and the targeted normal cost under the defined benefit plan.

2. Effective for plan years beginning in 2008 and thereafter, if the defined benefit plan is covered by PBGC (Title IV of ERISA), the limit is 25% of covered payroll plus the targeted normal cost under the defined benefit plan. This significantly increases the deduction limits in planning opportunities for many small employers.

D. **Minimum Required Contributions in Funding Shortfalls.** The public focus of PPA was directed towards the increase in required contributions to be made to underfunded pension plans. Basically, Congress has reworked the calculation of required minimum contributions, much to the consternation of actuaries who will need to take these new rules into account beginning in 2007. One point of note is that Congress is encouraging significant funding to pension plans, even those that are not underfunded in 2006 and 2007. Allowable funding may increase by as much as 50% compared to prior levels.

E. **Restriction on Funding - Rabbi Trusts.** PPA includes a new restriction applicable to non-qualified deferred compensation plans that utilize trusts to "fund" the promised benefits under those plans. Funding of those plans is prohibited during a "restriction period" that applies if the plan sponsor is bankrupt, or if the qualified defined benefit plan is "at risk" (i.e. at only 80% or less in funding of pension liabilities), or during the 12-month period that straddles the termination date of the underfunded defined benefit pension plan.

F. **Lump Sum Equivalents.** In calculating lump sum equivalents of the promised pension benefit, new interest rates and new mortality tables will have to be used beginning with distributions occurring after 2007. The new rate essentially moves away over a 4-year transition period from the 30-year U.S. Treasury rate and applies a modified yield curve. New mortality tables are to be issued reflecting increased longevity. It is estimated that the change in mortality tables will itself increase benefit liabilities from 3% to 7%.

G. **New Disclosure Rules.** With respect to defined benefit plans, the summary annual report ("SAR") will be replaced with a new notice to participants that must

be issued within 120 days after plan year end describing the funding status of the plan (among other things).

IV. **Miscellaneous Items.**

A. **Plan Amendments.** All qualified plans will need to be modified to incorporate these changes under PPA. Plans will have until the end of the plan year beginning in 2009 to amend their plans. We expect regulations to be issued over the course of the next few years and, if past history is any indication, this 2009 deadline will be deferred to later dates.

B. **EPCRS.** Since 1990, the IRS has maintained a correction program that has evolved into a multifaceted program allowing plan sponsors of tax qualified plans, 403(b) annuities and governmental plans to correct either form or operational errors. In some cases, correction may be done without notifying the IRS, but in many cases, the IRS must be informed and made a party to the correction process. PPA essentially blesses this program and enhances it by giving the IRS the authority to waive income, excise and other taxes that may be associated with any errors that would apply. This is a welcomed enhancement to this program.

C. **Direct Deposit of Tax Refunds.** PPA directed the IRS to make available forms on which individuals may elect to have a portion of their tax refund deposited directly to an IRA effective for tax years beginning after December 31, 2006.

D. **COLI/BOLI Arrangements.** Under prior law, business entities could maintain life insurance policies on key executives and others, and enjoy income-tax free death benefits under those policies. PPA provides that the employer will have to recognize income on the net death benefit (benefit in excess of premiums paid) unless the amount is received by reason of the death of an insured individual who, with respect to the policy holder, is an employee at any time during the 12-month period before the insured's death or, who at the time the contract was issued, was either: (1) a director, (2) a highly-compensated employee (defined under Code §414Q), or (3) a highly-compensated individual (defined under Code §105(h)(5)) who is in a group of the highest paid 35% of all employees.