



The Pension Protection Act of 2006

On August 17, 2006, President Bush signed H.R. 4, the new Pension Protection Act, arguably the most far-reaching pension reform since ERISA was enacted in 1974. There are several items of importance to NCTR and other public systems, as well as a number of other provisions of interest. Below is a brief overview of the new law's primary impact on private sector single-employer defined benefit (DB) plans; a summary of the major provisions affecting the public sector; and other items of note.

In General

Current funding rules for private-sector plans are replaced with stricter standards for minimum required contributions. Generally, the required amount will depend on a comparison of the value of the plan's assets with the plan's "funding target," which is equal to 100 percent of the present value of all benefit liabilities to date, and its "target normal cost," (the present value of benefit liabilities accruing during the plan year). This new funding target will be phased in over 4 years, beginning in 2008 at 92 percent. If a plan has a funding shortfall, it must be amortized over 7 years (current law allows up to 30), except for airlines, which are given up to 17 years. The 30-year Treasury rate to determine current liability is replaced with the corporate bond rate.

There are new "at risk" rules for private-sector plans that require a larger contribution from a plan sponsor whose plan is both less than 80 percent funded under general rules as well as less than 70 percent funded using new "at risk" actuarial assumptions. The 80 percent level is phased in over 4 years, beginning with 65 percent for 2008. The automotive industry gets special rules, and small plans (under 500 participants) are exempt.

The PBGC's flat rate premiums for private-sector plans (increased in 2005) are unchanged, but there would no longer be an exemption from the PBGC's variable rate premiums for fully funded plans, and the surcharge premium of \$1,250 per participant for employers whose plans are terminated in bankruptcy (otherwise set to expire in 2010) is made permanent.



An exemption from the prohibited transaction rule is created for investment advice provided to private-sector employer-sponsored plans through a computer model that is certified by an independent party. An exemption for advice provided by an adviser whose compensation does not vary with the investments selected would also be available to both employer-sponsored plans and Individual Retirement Accounts (IRAs).

Provisions Affecting Public Sector Plans

Purchase of Service Credits: Current law is modified to make clear that credits could be purchased for periods for which there is no performance of service (e.g. air time), and in order to qualify for an increased benefit (e.g. a higher tier/formula in the same plan). In addition, (1) trustee-to-trustee transfers of 403(b) and 457 funds into a governmental defined benefit plan to purchase service credit does not need to be tested under the 415(n) limits on after-tax contributions to the plan; (2) once 403(b)/457 funds are transferred to a governmental DB plan, they take on the distribution rules of such a plan; and (3) transfers need not be made solely between plans maintained by the same employer.

Exception to 10% Early Withdrawal Penalty: Distributions from a governmental DB plan to a qualified public safety employee who separates from service on or after age 50 would be exempt from the 10% early withdrawal tax; current law sets the limit at age 55.

Pre-tax Payments of Retiree Health/Long-term Care Insurance: A retiree who separates from service as a public safety officer due to disability or the attainment of normal retirement age will be able to have tax-free distributions of up to \$3,000 annually from his or her retirement plan, 403(b) annuity, or 457(b) plan used to purchase health or long-term care insurance. The premiums must be deducted from the distributions from the retirement plan and paid directly to the insurer. The program, which is permissive, is authorized to begin in 2007.

Clarification of Minimum Distribution Rules: Governmental plans are to be treated as complying with the minimum distribution rules if they are using a reasonable, good faith interpretation of the regulations. Treasury is directed to draft regulations that would apply this standard retroactively.

Local Educational Agencies Early Retirement Incentive, Employee Retention Plans: Certain voluntary early retirement incentive plans of public boards of education and



other local educational agencies, as well as those of section 501(c)(5) or (6) education associations (such as teachers' unions), will be treated as bona fide severance plans and therefore will not be subject to the section 457 limits and will be exempt from the Age Discrimination in Employment Act (ADEA). In addition, certain payments from employee retention plans will not be required to be included in income until paid.

Cash Balance/Hybrid Plans. Amends ADEA without troublesome cross-references to ERISA vesting rules for public plans. Generally, if, under the terms of the plan a participant's accrued benefit is equal to or greater than a similarly situated younger person, then there will not be a violation of ADEA. A plan must provide an interest credit no greater than a market rate of return, which could be applicable to refunds of contributions and interest to terminating participants of contributory DB plans.

EGTRRA Permanency. The pension provisions of the Economic Growth Tax Relief Reconciliation Act of 2001 ("EGTRRA") are made permanent. These far-reaching changes, otherwise set to expire in 2011, include increasing the limits on contributions, benefits, and compensation; repealing coordination requirements for deferred comp plans; permitting elective deferrals to not have to be taken into account for purposes of deduction limits; and establishing catch-up contributions for individuals age 50 and older.

Other

Withdrawals for Guardsmen and Reservists: The 10% early distribution penalty is waived for reservists/national guardsmen who are called to active duty for at least 180 days, and allows such distributions (made during active duty) to be repaid to the pension plan within 2 years without regard to the annual limits.

Executive Deferred Comp: Generally, if a plan sponsor is bankrupt, has an "at-risk" plan (generally less than 80 percent funded) or has a plan that has terminated without having sufficient assets to pay all benefits, then the current and former chief executive officer and the top four highest compensated officers cannot have amounts set aside or reserved to fund deferred compensation plans. If they do, then the amounts will be considered a taxable transfer to the individual, subject to an additional 20 percent tax and interest. Nor can employers, in such circumstances, receive a deduction for "gross ups" intended to cover penalties incurred by prohibited funding of nonqualified arrangements.



Excess Pension Assets for Retiree Health Benefits: Excess pension assets may be transferred to a separate account in the pension plan to be used to pay retiree health liabilities for not less than 2 and not more than 10 years.

Smoothing: For ERISA plans, the "smoothing" of asset values cannot be for more than a two-year period, and cannot result in values that are lower than 90 percent or greater than 110 percent of the fair market value of such assets at the time of valuation. Current limits are 5 years for assets and 4 for liabilities.

In-Service Distributions: Pension payments may be made to a participant who is age 62 and continues in employment. Current law is based on a normal retirement age of 65.

DB/K Plan: Beginning in 2010, a new hybrid plan will be available to smaller employers (500 employees or fewer) that is essentially the combination of a defined benefit plan and a 401(k) plan. The DB portion must provide a minimum benefit of 1 percent of final average compensation per year of service up to 20 years, fully vested in 3 years, whether or not the participant makes a contribution under the 401(k) portion of the plan. The 401(k) portion of the plan must provide for automatic enrollment at a rate of at least 4 percent of compensation and a matching fully-vested contribution equal to at least 50 percent of the employee's contribution up to 4 percent of compensation.

Indian Plans: The definition of a governmental plan is expanded to include a defined benefit plan established or maintained by an Indian tribal government for its employees performing governmental functions (i.e., a teacher in tribal school) and not commercial activities (employees of a hotel, casino, service station, convenience store operated by a tribal government). Under the provision, the special benefit limitations applicable to employees of police and fire departments of a State or political subdivision (Code sec. 415(b)(2)(H)) apply to such employees of an Indian tribe or any political subdivision thereof. In addition, the rules relating to pick up contribution under governmental plans (Code sec. 414(h)) and special benefit limitations for governmental plans (sec. 415(b)(10)) apply to tribal plans treated as governmental plans under the provision.