

Sweeping Pension Reform Bill Passed

August 7, 2006

Late on Thursday, August 3, 2006, the U.S. Senate passed the Pension Protection Act of 2006 (PPA), a comprehensive bill making significant changes in the federal laws governing traditional single-employer defined benefit pension plans, multiemployer pension plans, “cash balance” and pension equity plans, 401(k) and other defined contribution plans, and individual retirement accounts (IRAs). The U.S. House of Representatives had previously passed the PPA, and President Bush has announced that he will sign the bill into law shortly.

The PPA makes significant changes in many provisions of ERISA and the Internal Revenue Code (as well as other laws like ADEA); the bill itself runs some 907 printed pages. Over the next week, we will be providing more detailed analyses of specific subparts of the PPA; in this LawFlash, we will provide a brief general overview of the most significant changes made by the PPA.

Single-Employer Plan Pension Funding

- Creates new minimum funding rules applicable to all plans, effective in the 2008 plan year, similar to the deficit reduction contribution (DRC) rules applicable under current law to certain plans; new rules would generally require amortization of all unfunded current liabilities over 7 years (with a delayed effective date for plans not subject to DRC rules in 2007 that meet certain funding thresholds in 2008–2010).
- Mandates use of new interest rate assumptions for funding calculations, beginning in the 2008 plan year, based on A-AAA rated corporate bonds and a “yield curve” methodology taking into account the duration of the plan’s liabilities. (Current temporary corporate bond rate interest rules are extended for 2006 and 2007.)
- Limits (but preserves) the use of “credit balances” to offset funding obligations beginning in 2008.
- Creates new accelerated funding requirements for certain “at-risk” plans (those that fall below a specified “at-risk” funding threshold) beginning in 2008.

- Imposes restrictions and limitations on certain types of benefit payments (e.g., lump-sum payments) and benefit increases for plans that are less than fully funded (phasing in with less than 92% funded plans beginning in 2008 and fully applicable in 2011).
- Increases deduction limits for contributions to fully funded plans beginning in 2006.
- Mandates additional or expanded PBGC and participant disclosures regarding plan funding.
- Provides special relief or delayed application for certain commercial airline companies, large defense contractors, plans rescued from distress termination through PBGC settlement, automobile manufacturers and automotive parts suppliers, and multiple employer plans sponsored by certain rural cooperatives.

Cash Balance and Other “Hybrid” Plan Designs

- Establishes prospectively from June 29, 2005 that cash balance and other hybrid plan designs (e.g., pension equity formulas) do not violate age discrimination prohibitions; no inference regarding prior law. (However, the primary adverse decision on age discrimination in cash balance plans, *Cooper v. IBM*, was just reversed by the Seventh Circuit Court of Appeals, in a thoughtful, well-reasoned opinion, which bodes well for other pending cases.)
- Requires hybrid plans to provide full vesting in no more than three years beginning in 2008.
- Permits cash-balance plans to treat the account balance as the participant’s accrued benefit (rather than requiring conversion to an annuity at normal retirement and then discounting to present value), so long as the plan credits interest on account balances at a “market” rate. Applicable to distributions after date of enactment.
- Provides rules for conversion of traditional plans to hybrid plan design; conversions after June 29, 2005 comply only if (i) conversion used “A + B” method (total accrued benefit equals accrued benefit at conversion under old formula plus future accruals under new formula), with no “wearaway,” and (ii) value of early retirement subsidies on old accrued benefit is added to the account at termination if the participant has satisfied the applicable eligibility requirements.

Defined Contribution Plan Changes

- Establishes an “automatic enrollment safe harbor” for 2008 and later years (relief from ADP/ACP testing and top-heavy rules) for 401(k) plans that automatically enroll new hires at a mandated minimum level (3%), increase the level annually thereafter up to at least 6% after four years of participation (maximum 10%), and contain safe-harbor matching or nonelective contributions similar to current law.
- Provides relief under ERISA Section 404(c) where default investment fund for auto-enrollment contributions is selected in accordance with criteria to be established in DOL regulations. Also makes clear that state wage payment laws purporting to limit auto-enrollment are preempted by ERISA (effectively immediately).

- Mandates the provision of certain diversification rights for participants in plans with company stock as an investment, generally beginning in 2007.
- Requires that participants in plans with participant-directed investments receive account statements at least quarterly that include information regarding the importance of diversification.
- Requires faster vesting of employer nonelective contributions (similar to current matching contribution vesting rules).
- Provides 404(c) protection for “mapping” of participant investments if certain requirements met.
- Permits plan service providers to furnish plan participants with individualized investment advice, without the occurrence of a prohibited transaction, so long as the advice is based solely on a computer model developed by an independent third party.

Other Provisions

- Makes a number of changes to ERISA’s **fiduciary duty and prohibited transaction (PT)** provisions (e.g., relaxing certain aspects of the “plan asset” regulations applicable to pass-through investments; providing exemptions from PT rules for certain cross-trading activities; permitting self-correction of certain PTs without penalty).
- Limits employers’ exclusions from income for death benefits paid to the employer under a **corporate-owned life insurance (COLI) policy**, with specified exceptions; applicable to contracts entered into after date of enactment.
- Allows **tax-free IRA distributions to charities**, subject to specified limitations, in 2006 and 2007.
- Enacts a number of special funding and other rules for underfunded **multiemployer pension plans** beginning in 2008.
- Continues and expands rules permitting excess pension funding to be used for **retiree medical benefits**.
- Makes a number of **EGTRAA tax-savings provisions permanent** (e.g., catch-up contributions, Roth 401(k) contributions, “529” college tuition plans).
- Permits **limited phased retirement** by allowing in-service withdrawals under pension plans to begin at age 62, rather than 65 as under current law, beginning in 2007.

As noted, we will shortly provide more comprehensive analyses of various parts of PPA in subsequent LawFlash alerts. In the interim, if you have any questions regarding how PPA will affect your

company, please feel free to contact any of the following individuals or any Morgan Lewis Employee Benefits and Executive Compensation lawyer with whom you work.

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