

# AdvantEdge

A LEGISLATIVE & TECHNICAL UPDATE FOR OUR CLIENTS

## Pension Reform Becomes Law

On August 17, 2006 the Pension Protection Act of 2006 was signed into law by President Bush. The Act provides for significant changes to pension plan funding and administration.

**Although the Act contains many changes to current pension rules, the majority of the changes do not take place until 2008, and several are phased in over three to four years, delaying their full effective date further.**

This newsletter provides a summary of the key provisions of the Pension Protection Act. This information gives you a start toward understanding the pension reforms which will impact your plans in the coming years.

## Key features of the Pension Protection Act of 2006

As the name implies, the Pension Protection Act of 2006 introduces new rules designed to stabilize the nation's pension system. However, its more than 900 pages of provisions also address other areas, including individual retirement savings.

### Key Provisions Affecting Pension Plans

#### Minimum Funding Requirements for Pension Plans

The Minimum Funding Requirement rules are unchanged for Plan Years beginning in 2006 and 2007. Beginning with the 2008 Plan Year, the Minimum Required Contribution will be equal to the Target Normal Cost plus seven-year amortization of any Funding Shortfall.

The Target Normal Cost is the present value of all benefits expected to accrue during the Plan Year. This includes prior year benefit accruals that increase due to compensation increases in the current year.

The Funding Shortfall is the excess of Plan liabilities over Plan assets.

- Plan liabilities are based on benefits accrued to date (with no provision for future salary increases), and are valued by using an approach which reflects an average of corporate bond rates over the 24 months prior to the valuation month. This "modified yield curve approach" will be phased-in from 2008 – 2011, unless the sponsor elects not to use the phase-in.
- Plan assets may be valued at Market Value, or may use an approach which smoothes assets over two years.
- If Plan assets exceed Plan liabilities, the excess will offset the otherwise determined Minimum Required Contribution.

The Funding Shortfall determination phases in over a four year period. For the 2008 - 2011 Plan Years, a Funding Shortfall exists if Plan assets are less than 92%, 94%, 96%, or 100% of Plan liabilities, respectively. This transition relief will not be available to Plans which have a Deficit Reduction Contribution for the 2007 Plan Year, based on current funding regulations.

Credit Balances, which may be used to offset Minimum Required Contributions, are preserved, but only when the ratio of Plan assets to Plan liabilities is at least 80%. Credit Balances are subtracted from Plan Assets in calculating the Funding Shortfall.

Note that the overall contribution requirements of a defined benefit program are equal to the total benefits provided under the Plan, offset by the plan's investment return. Since the Act does not affect the benefits, nor does it affect the plan's investment return, any effect the Act has on contribution requirements represents a timing difference.

### **At-Risk Plans**

Beginning with the 2008 Plan Year, if a Plan is determined to be at-risk, it will be required to make larger contributions than if the Plan was not in at-risk status. At-risk plans are defined as those which (1) have 500 or more participants, (2) are less than 80% funded for the prior Plan Year, and (3) are less than 70% funded for the prior Plan Year based on alternate retirement assumptions which increase plan liabilities. The 80% threshold is phased in over four years (65%, 70%, 75%, and 80% for Plan Years 2008 – 2011, respectively).

Quarterly Contributions no longer will be required for Plans with less than 100 participants, effective for the 2008 Plan Year. For other plans, quarterly contributions will be required (at the same time as under current regulations) if there is a Funding Shortfall in the prior Plan Year.

### **Maximum Deductible Limits for Pension Plans**

For the 2006 and 2007 Plan Years, the Maximum Deductible Limit is 150% of the Plan's Current Liability, minus the Plan's assets. This is a larger Limit than the one that existed for the 2005 Plan Year.

For Plan Years beginning in 2008 or later, the Maximum Deductible Limit will be the sum of (1) the Target Normal Cost, (2) the Plan's Funding Shortfall, using the assumption that the Plan was at-risk, (3) a funding cushion of 50% of the Funding Shortfall, and (4) an amount to cover future pay increases, minus the Plan's assets.

Also beginning with the 2008 Plan Year, the Maximum Deductible Limit for plan sponsors who maintain both a Defined Benefit and a Defined Contribution Plan will be determined without regard to contributions to any Defined Benefit Plans which are covered by the Pension Benefit Guaranty Corporation ("PBGC"), and without regard to employer contributions to Defined Contribution Plans which are less than 6% of participant compensation. Employee elective deferrals continue to be disregarded in the Maximum Deductible Limit determination.

### **Benefit Restrictions**

Lump Sum payments to participants will not be permitted if the Plan's Funding Level (the ratio of the Plan's assets to the Plan's liabilities) is less than 60%. If the Plan's Funding Level is between 60% and 80%, lump sums will be permitted, but generally will be limited to 50% of the otherwise-payable lump sum; the remaining benefit will be payable as an annuity.

Benefit Accruals will not be permitted for Plans with less than a 60% Funding Level. Benefit Improvements will not be permitted for Plans with less than an 80% Funding Level (as measured after the benefit increase) unless the Plan sponsor funds the greater of the benefit improvement amount or the amount needed to bring the Plan to an 80% Funding Level.

Generally, the Plan's Credit balance is subtracted from the Plan's Assets in determining the above Funding Ratios. The effective date for the Benefit Restrictions above is the first day of the 2008 Plan Year.

### **Lump Sum Interest Rates**

The interest rate basis used for determining Lump Sum distribution amounts will be modified from the 30-Year Treasury Rate to a three-segment Corporate Bond Yield Curve. The change will be phased in over the five year period from 2008 to 2012.

### **Phased Retirement**

A participant who has reached age 62 will be permitted to commence receipt of benefits from the pension plan, even if the plan's normal retirement age is later than age 62. This change is effective with the 2007 Plan Year, assuming that the Plan is amended to accommodate this provision.

### **Restrictions on Non-Qualified Deferred Compensation Plans**

The Act restricts an employer's ability to fund a deferred compensation program covering its highest five executives if the qualified pension plan is in at-risk status.

### **Disclosure**

Beginning with the 2008 Plan Year, Plan sponsors will need to provide annual funding notices to participants, beneficiaries, and the PBGC. The Notice will include information pertaining to the Plan's assets and liabilities; the number of participants; the Plan's funding policy and asset allocation; and other information.

### **Hybrid Plans**

Cash Balance Plans will be allowed, provided they meet certain conditions relating to benefit accruals, interest rate crediting, transition during conversion to cash balance, vesting, and whipsaw rules. Situations where participants become part of a cash balance plan due to a merger or acquisition will be handled via Regulations to be prescribed by the Secretary of the Treasury. The effective date for the interest crediting and vesting provisions is the plan year beginning in 2008; most of the other cash balance plan provisions are effective as of June 29, 2005.

### **Multi-employer Plans**

The Act contains several provisions specific to multi-employer plans. We have not addressed these provisions in this newsletter, as Pentegra has no multi-employer plans. Note that the Pentegra Defined Benefit Plan in which many of you participate is a multiple employer plan, which is similar to, but different than, a multi-employer plan. Therefore, the Pentegra Plan is not affected by any of the multi-employer provisions of the Act. On a separate note, the Act does not change the financial accounting treatment for Pentegra multiple employer plan clients, as the Pentegra Defined Benefit Plan is treated as a multi-employer plan for purposes of FAS87 accounting.

## Key Provisions Affecting Defined Contribution Plans

### **EGTRRA Benefits Extended Permanently**

The Act permanently extends the provisions of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which were due to expire in 2011, including:

- Increased contribution and salary limits;
- Catch-up contributions for participants age 50 and older;
- Faster vesting schedules; and
- The Roth 401(k), established in 2006.

### **Automatic Enrollment**

The Act creates a Safe Harbor design for automatic enrollment, based on enrolling new employees with a salary deferral of 3% of compensation (unless the employee elects not to participate by opting out in writing) and increasing the minimum contribution percentage by 1% per year for the following three years, providing a match of 100% of the first 1% of contributions and 50% of the next 5% of contributions (or a 3% nonelective contribution), and vesting the employer contributions after two years.

### **Investment Advice**

Effective in 2007, the Act permits investment advice which is provided by a “fiduciary adviser” under an “eligible investment advice arrangement”, as approved by an independent fiduciary.

### **Faster Vesting for Defined Contribution Non-Matching Contributions**

Beginning with the 2007 Plan Year, employer non-matching contributions, such as profit sharing or discretionary contributions, would be subject to 100% vesting after three years or 20% vesting per year beginning with the second year.

### **Military Personnel and the 10% Excise Tax**

Military personnel (reservists and National Guardsmen) called up to active duty for at least 180 days after September 11, 2001 will be able to withdraw funds from their retirement savings without incurring the 10% early withdrawal penalty, provided that the funds are replaced into plan accounts within two years after the end of activation.

## Conclusion

Although it is too early to surmise what impact the Act will have on defined benefit plan Minimum Required Contribution levels for 2008 and beyond, we will be continuing to analyze the Act and will keep you updated as to how the Act will affect your program. In the coming months we will be developing software which will enable us to estimate the impact of the Act on your costs for Plan Years beginning in 2008. In the interim, if you have any questions regarding the Act, please contact Richard Rausser, Vice President, Consulting Services, at [rrausser@pentegra.com](mailto:rrausser@pentegra.com), or Jeff Kissel, Chief Actuary, at [jkissel@pentegra.com](mailto:jkissel@pentegra.com), or 800-872-3473.

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