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DECEMBER 1, 2006 VOLUME 2, NUMBER 12

"This newsletter looks to 2007 and highlights effective PPA changes – some of which are already effective, some that become effective January 1, 2007, and some that become effective when your plan's 2007 plan year begins."

Pension Protection Act of 2006: What to do in 2007

by
Matthew J. Eickman
Utz, Miller & Kuhn, LLC
(913) 685-0749
meickman@utzmiller.com

As you likely have heard, President Bush signed into law the Pension Protection Act of 2006 (the "PPA") on August 17, 2006. The PPA makes wide-sweeping changes that affect your company's retirement plans. Although many of those changes do not become effective for some time, there are several important changes that will affect the administration of your plans in 2007. This newsletter looks to 2007 and highlights effective PPA changes – some of which are already effective, some that become effective January 1, 2007, and some that become effective when your plan's 2007 plan year begins.

The newsletter first discusses PPA provisions that affect qualified defined contribution and qualified defined benefit plans in an identical fashion. It then describes PPA changes that affect only defined contribution plans, before moving on to defined benefit plans. Next, it briefly addresses certain PPA provisions that affect cash balance plans, nonqualified deferred compensation arrangements, governmental plans, and company-owned life insurance. It concludes by discussing the deadline for plan amendments. Please note that, for fear that this piece would collapse under its own weight (which is certainly possible with a 907-page law and 376-page joint committee report), we have not addressed every PPA provisions that has already become effective or will before the end of the 2007 plan year. For instance, we have not addressed provisions related to multiemployer withdrawal liability, the termination of plans and their possible maintenance by the PBGC, contribution deduction limits, church plans, charitable contributions by plans, or certain prohibited transaction exemptions (relating to block trades, electronic communication networks, service providers, foreign exchange transactions, and cross trading).

We have, however, described the provisions most likely to impact your company's plans. If you have questions about any of the changes we describe – or do not describe – below, please do not hesitate to contact us. Let's begin by looking at changes that affect qualified defined contribution and defined benefits alike.

I. DC AND DB PLANS

A. **QJSA Explanations and Elections**. As you probably know, if the qualified joint and survivor annuity ("QJSA") rules apply to a plan, it must provide a participant with a written explanation of the QJSA, and the participant then has a period of time during which he or she may waive the QJSA (with spousal consent, when required). That explanation must include certain information, including the participant's right, if any, to defer distribution. Prior to

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Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

the PPA, the explanation was required to be given no less than 30 and no more than 90 days before the date distribution commences. The participant could then waive the QJSA at any time during the 90-day period ending on the date distribution commences.

The PPA changes: (i) the length of the period during which a participant may waive the QJSA; (ii) the required content of the notice; and (iii) the timeframe in which it must be provided. First, the PPA extends the participant's 90-day election period to a *180*-day election period. Second, the PPA directs the Treasury to modify existing regulations to require that the explanation's description of a participant's right, if any, to defer distribution also describe the consequences of failing to defer receipt. Finally, the PPA also directs the Treasury to modify existing regulations to provide that the explanation must be given no less than 30 and no more than *180* days before distribution commences. Although the Treasury is yet to take the steps to publish these last two rules, all three of these changes are effective for plan years starting in 2007. As a result, your company's administrative procedures will need to be changed when your 2007 plan year begins so they reflect these three changes. (At the end of this letter, we will discuss the deadline for the related plan amendment.)

B. **<u>Special Tax Notice</u>**. The PPA directs the Treasury to make one similar change to existing regulations that describe the timeframe in which a Tax Code Section 402(f) notice (special tax notice for eligible rollover distributions) may be given. The Treasury is to revise the regulations to provide that the Section 402(f) notice may be given no less than 30 and no more than 180 days (up from 90 days) before distribution commences. Again, although the Treasury is yet to take the step to finalize this change, it is effective for plan years starting in 2007.

C. **<u>Rollovers</u>**. The PPA makes two favorable rollover changes that become effective in 2007. The first liberalizes the ability to rollover employee after-tax contributions. Prior to the PPA, employee after-tax contributions could be directly rolled over only to a qualified defined contribution plan or an IRA. The PPA, however, allows those contributions to also be directly rolled over to a qualified defined benefit plan or tax-sheltered annuity. This change is effective beginning January 1, 2007.

Second, the PPA allows *non-spousal* beneficiaries to directly rollover amounts from a deceased employee's qualified retirement plan, governmental 457 plan, or tax-sheltered annuity, to an IRA through a trustee-to-trustee transfer. Prior to the PPA, a beneficiary could make such a direct rollover only if he or she were a *spousal* beneficiary. After a non-spousal beneficiary's direct rollover, the IRA to which benefits are transferred will be treated as an inherited IRA of the non-spousal beneficiary, which means the beneficiary may not make contributions to the IRA and cannot rollover any amounts out of the inherited IRA. It also means the amounts are subject to the minimum distribution rules (the age 70½ rules) applicable to beneficiaries, rather than being subject to the minimum distribution rules that would apply to an IRA established by the individual on his or her own. Non-spousal beneficiaries may begin to make these direct rollovers on January 1, 2007.

Please see our comments regarding plan amendments related to these rollover changes in Section V at the end of this newsletter.

D. **<u>In-Service Distributions</u>**. Another PPA provision will allow many participants to receive in-service distributions at an earlier age. Prior to the PPA, a qualified defined benefit plan or money purchase plan could not make in-service

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distributions to participants before their attainment of normal retirement age ("NRA"), which is commonly age 65. Under proposed Treasury regulations, a pension plan would have been permitted to pay a portion of a participant's benefits before his or her NRA under a "phased retirement" program. That would have been a program under which employees who are at least age 59 ½ and eligible for retirement could reduce (by at least 20 percent) the number of hours they customarily work and receive a pro rata portion of their retirement benefits, based on the reduction in their work schedule.

The PPA renders such a phased retirement program unnecessary for employees who have attained age 62. Under the PPA, distribution may be made from any "pension plan" (as that term is defined by ERISA to include both defined benefit and defined contribution plans) to an employee who has attained age 62 and has not separated from employment. Importantly, unlike the proposed phased retirement regulations, a participant need not reduce his or her hours in order to receive this in-service distribution. A plan may (but is not required to) allow these in-service distributions beginning in plan years starting in 2007. As we will describe at the end of this letter, a plan amendment to reflect this in-service distribution feature is not required for some time.

II. DEFINED CONTRIBUTION PLANS

A. Vesting of Non-Matching Contributions. The law (both pre- and post-PPA) requires that employer *matching* contributions vest at least as rapidly as under one of the following two schedules: (1) three-year cliff vesting; or (2) three-to-six-year graded vesting. Prior to the PPA, a plan could provide for slightly slower vesting of *non-matching* employer contributions under either a five-year cliff or three-to-seven-year vesting schedule. The PPA provides, however, that the same minimum vesting requirements apply with respect to matching and non-matching contributions. That is not to say that a plan must use the same vesting schedule for all employer contributions, but the PPA does require that a plan vest all employer contributions at least as rapidly as under a three-year cliff or three-to-six year graded vesting schedule.

Subject to exceptions for plans maintained pursuant to collective bargaining agreements and some ESOPs (discussed below), this change is effective with respect to contributions for plan years beginning in 2007. Importantly, this would allow your company to continue to apply its old vesting schedule for non-matching contributions for plan years that began in 2006 or earlier. For the sake of administrative and communicative simplicity, however, many employers will likely choose to apply the new faster schedule even to contributions made for plan years prior to 2007. This is another plan design change that is not required to be reflected in a plan amendment for a few years (discussed in Section V below).

If a plan is maintained pursuant to a collective bargaining agreement ratified before August 17, 2006, it is not subject to this PPA change until a later date (but no later than plan years beginning in 2009). There is also a special rule for any ESOP that, on September 26, 2005, had outstanding a loan incurred for the purpose of acquiring qualifying employer securities: the faster vesting rules do not apply to any plan year beginning before the earlier of the date on which the loan is fully repaid or the date on which the loan was scheduled to be fully repaid as of September 26, 2005.

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
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Phone: 913.685.7978
Fax: 913.685.1281

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www.utzmiller.com

B. **Investment Advice**. The PPA loosens ERISA's prohibited transaction rules to permit certain investment advisors who are defined contribution plan fiduciaries to provide investment advice to participants, execute trades, and receive compensation, despite the advisor's potential conflict of interest with respect to the investment advice offered. More specifically, the PPA adds a prohibited transaction exemption for the provision of investment advice by a "Fiduciary Advisor" under an "Eligible Investment Advice Arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the Plan or an IRA. The legislative history provides that the exemption is also available with respect to advice given to beneficiaries of health savings accounts, Archer medical savings accounts, and Coverdell education savings accounts. If the PPA's requirements are met, the following acts are exempt from prohibited transaction treatment: (a) the provision of investment advice; (b) an investment transaction pursuant to the advice; and (c) the receipt of fees or other compensation in connection the provision of the advice or an investment transaction pursuant to the advice.

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The exemption becomes available with respect to investment advice given on or after January 1, 2007. Before your company decides whether to allow its plan's participants to receive investment advice from a Fiduciary Advisor, there are important issues to consider. First, the previous paragraph only generally describes the exemption and what is required to rely upon it. Many specific requirements must be met in order for there to be a "Fiduciary Advisor" or an "Eligible Investment Advice Arrangement," and for the exemption to be otherwise available. Second, before the advice is initially provided, the Fiduciary Advisor must provide the eventual recipient of the advice with a written notice (which may be in electronic form) containing various specific items of information. That information must also be maintained in accurate form and provided to the recipient of the investment advice, without charge, on an annual basis, on request, or in the case of any material change. Third, a Fiduciary Advisor must maintain for at least six years any records necessary for determining whether the prohibited transaction exemption's requirements were met. Finally, the exemption does not provide relief from the employer or other plan fiduciary's responsibility under ERISA for the prudent selection and periodic review of a Fiduciary Advisor with whom the employer or plan fiduciary has arranged for the provision of investment advice. Importantly, however, the employer or plan fiduciary does not, however, have a duty to monitor the specific investment advice given by a Fiduciary Advisor.

C. **ERISA Section 404(c): Participant Investment Decisions**. The PPA makes a number of modifications to the ERISA Section 404(c) rules governing liability for investment decisions made by participants under defined contribution arrangements. Two of those are not effective until plan years beginning in 2008 – one of which provides plan fiduciaries a way to avoid liability where there is "mapping" from a replaced investment option to a new option and another that potentially imposes liability on fiduciaries for participants' inability to make investment switches during a blackout. Thus, we will not discuss them further in this newsletter. An additional modification related to participants who simply fail to make investment elections altogether, however, becomes effective for plan years beginning in 2007. We will address this Section 404(c) change.

The Department of Labor's ("DOL's") position has been that when a participant fails to make an affirmative investment election, and the assets in his or her account under a defined contribution pension plan are placed into a default investment, the participant is not considered to have exercised control in the way necessary to prevent plan fiduciaries from being responsible for proper investment of the participant's account. The DOL has taken this position even when participants are timely and properly informed that their account will be invested in

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

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Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

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Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
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Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

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jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

the default option if they do not make an election. Fortunately, the PPA directs the DOL to issue regulations that provide guidance on the appropriateness of certain investments for designation as default investments, including guidance regarding appropriate mixes of default investments and asset classes that the DOL considers consistent with long-term capital appreciation or long-term capital preservation, and the designation of other default investments. These regulations will be of particular importance to Section 401(k) plans that utilize an automatic enrollment feature. If the assets in a participant's account are invested in a default arrangement in accordance with those upcoming DOL regulations, the participant will be treated as exercising control (as required to provide fiduciaries with Section 404(c) protection) until he or she makes an affirmative election.

This PPA change is to be effective for plan years beginning in 2007, but, because we must first receive DOL regulations and then provide participants advance notice, some fiduciaries may not be able to rely on its protection until 2007. The PPA directed the DOL to issue regulations within six months of the date of the PPA's enactment, which was August 17, 2006, and we are currently awaiting those regulations. In order for plan fiduciaries to enjoy Section 404(c) protection with respect to default investments, the PPA requires that a notice (meeting certain requirements) of participants' rights and obligations under the arrangement be provided within a reasonable period *before* each plan year. Additionally, the participant must have a reasonable time after receipt of the notice and before the assets are first invested to make such an election. Let's consider a plan with a calendar year plan year. We will not have the DOL's guidance at a time that will allow notice to be provided a reasonable amount of time before January 1 and allow the participant reasonable time to make an election. Thus, the plan's fiduciaries could not rely on this relief during the 2007 plan year. As a result, this PPA change will offer relief only to fiduciaries whose 2007 plan year starts later in the year.

D. **<u>Benefit Statements</u>**. Prior to the PPA, ERISA required that the administrator of a defined contribution plan furnish a benefit statement only to any participant or beneficiary who requests such a statement in writing and only once during any 12-month period. The PPA requires a defined contribution plan administrator to provide a benefit statement to some participants and beneficiaries *even when not requested*, and increases the frequency at which participants and beneficiaries are entitled to receive statements.

Under the new law, an administrator must provide a statement to a participant or beneficiary who has the right to direct the investment of his or her account, at least quarterly. A participant or beneficiary who has his or her own account, but not the right to direct the investment of that account, must receive a statement at least annually. In addition, any beneficiary not described in the two previous sentences is entitled to receive a statement, upon request, once per 12-month period.

Additionally, the PPA requires that statements include not only the information that was previously required, but also other specific information. <u>Any</u> defined contribution benefit statement must include the value of each investment to which assets in the individual's account are allocated (determined as of the plan's most recent valuation date), including the value of any assets held in the form of employer securities. <u>A quarterly statement</u> provided to an individual who has the right to direct investments must include: (1) an explanation of any limitations or restrictions on any right of the individual to direct an investment; (2) an explanation of the importance, for long-term retirement security, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified; and (3) a notice directing the participant or beneficiary to the Internet website of the DOL for sources of information on individual investing and diversification.

The new statement requirements are generally effective for plan years beginning in 2007. In the case of a plan maintained pursuant to a collective bargaining agreement, they may become effective later (but no later than the 2009 plan year). In Section III.C below, we will address changes to requirements of benefit statements from defined benefit plans.

E. <u>Diversification of Publicly Traded Employer Securities</u>. The PPA changes the rules related to diversification of investments in defined contribution plans that hold *publicly traded* securities. Prior to the PPA, the law gave diversification rights only to *ESOP* participants who had attained age 55 and had at least 10 years of plan participation. The PPA extends diversification rights to an expanded group of participants in other defined contribution plans, such as 401(k) plans, that hold publicly traded employer securities, and modifies current ESOP diversification rules.

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A defined contribution plan holding publicly traded employer securities (defined as an "Applicable Defined Contribution Plan") will be required to permit an "Applicable Individual" to direct that the portion of the individual's account held in certain employer securities be invested in alternative investments. An "Applicable Individual" includes: (a) any plan participant; and (b) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant. Publicly traded employer securities are securities issued by the employer or a member of the employer's controlled group of corporations (using a 50 percent ownership test, rather than the normal 80 percent ownership test for controlled group status) that are readily tradable on an established securities market.

As you can see, the PPA's diversification rules are broader than those that currently apply to ESOPs. For that reason, an ESOP that is subject to the new rules is excepted from present law rules. For example, the new rules – but not the present rules – will apply to an ESOP that holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy special nondiscrimination tests. They will also apply to an ESOP that is part of a plan that holds any amounts that are not part of the ESOP. The legislative history indicates that an ESOP will not be treated as failing to be designed to invest primarily in qualifying employer securities (which is a requirement for ESOPs) merely because the plan provides diversification rights as required – or greater than required – under the PPA.

The new diversification rules apply differently depending on whether investments in employer securities have been made through elective deferrals under a 401(k) plan and employee after-tax contributions, or nonelective employer contributions and employer matching contributions. The rules also require that applicable individuals receive a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risks and return characteristics.

The new diversification requirements are generally effective for plan years beginning in 2007 and later. The PPA provides different effective dates for plans maintained pursuant to a collective bargaining agreement, and for employer matching contributions and nonelective contributions that are invested in employer securities that, as of September 17, 2003, consist of preferred stock and are held within an ESOP and subject to a guaranteed minimum.

F. <u>Notice of Diversification Right</u>. The PPA also requires that a new notice be provided in connection with the right of an Applicable Individual to divest his or her account under an Applicable Defined Contribution Plan of employer securities. Not later than 30 days before the first date on which an Applicable Individual is eligible to exercise his or her diversification rights, the plan administrator must provide the individual with a notice setting forth this right

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

and describing the importance of diversifying the investment of retirement account assets. The Treasury has published a model notice, as directed by the PPA.

This notice requirement is also effective for plan years beginning in 2007 or later. In light of the Treasury's model notice being published late in the year, the Treasury has provided temporary relief from the 30-day advance notice requirement for plans with plan years beginning on or after January 1, 2007, but before February 1, 2007. Those plans are not required to provide a notice until January 1, 2007.

G. Qualified Reservist Distributions. Generally, a 401(k) plan participant is subject to a 10 percent early withdrawal tax on a distribution received prior to his or her severance from employment, attainment of age 59½, death, disability, or financial hardship. The PPA provides an exception from that 10 percent early withdrawal tax in the event a participant receives a "qualified reservist distribution," which is a distribution: (1) from an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar arrangements; (2) made to an individual who, by reason of being a member of the reserves, was ordered or called to active duty for a period in excess of 179 days or for an indefinite period; and (3) made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A 401(k) plan does not violate otherwise-applicable distribution restrictions by reason of making a qualified reservist distribution. An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA in an aggregate amount not exceeding the amount of the qualified reservist distribution, and such contributions will not be taken into account for purposes of dollar limitations applicable to IRA contributions.

This exemption from the 10 percent early withdrawal tax applies to distributions made after September 11, 2001, and before December 31, 2007. The two-year period for making recontributions of qualified reservist distributions does not expire until August 17, 2008 (two years after the PPA's enactment date).

III. Defined Benefit Plans

A. Benefit Limitations. Tax Code Section 415 limits annual benefits payable under a defined benefit pension plan. The Section 415 annual benefit limitations generally assume that payments will be made in a straight life annuity. When a participant receives benefits in the form of "nondecreasing life annuity" at normal age (which includes life annuities and joint and survivor annuities), Section 415 does not require any adjustment to those benefits to determine whether they exceed the annual limitation. When a participant receives any other form of benefit, such as a lump sum or installment payments, Section 415 requires an adjustment to those payments to determine whether they exceed annual limitations. Prior to the PPA, the interest rate used for that adjustment must have been not less than the greater of: (1) the Tax Code Section 417(e)(3) rate; or (2) the plan's rate. In the case of plan years beginning in 2004 or 2005, the interest rate generally could not have been less than the greater of: (1) 5.5 percent; or (2) the plan's rate.

Retroactively effective with respect to distributions made on or after January 1, 2006, the PPA provides newly applicable rules regarding the interest rate assumptions that must be used to calculate that Section 415 adjustment.

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Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

The PPA provides that the interest rate may not be less than the greatest of: (1) 5.5%; (2) the rate that provides a benefit not more than 105% of what would be provided under the Tax Code Section 417(e)(3) rate; and (3) the plan's rate. Assuming that a plan used the correct interest rate for the 2005 plan year (described in the last sentence of the previous paragraph), this change likely will not have any additional effect on lump sum distributions made in 2006. This is because 5.5 percent (which was a rate considered under pre-PPA law) has been greater than the new rate added by the PPA (rate (2)) has been in 2006. It could have an effect in future years, however, if the Tax Code Section 417(e)(3) rate increases. If this change has a practical effect in future years, it would be to *decrease* the maximum amount participants could receive as a lump sum or installment distribution in a year.

The PPA made an additional change to the Section 415 limitations. Effective for plan years beginning in 2006 and later, for purposes of determination average compensation for a participant's high three years, the high three years are the period of consecutive calendar years during which the participant had the greatest aggregate compensation from the employer, without regard to whether the employee was an active participant in the plan at the time he or she received that compensation (as was previously the rule).

"If this change has a practical effect in future years, it would be to decrease *the maximum amount participants could receive as a lump sum or installment distribution in a year."*

B. Funding Rules: Required Interest Rate. Previously, the Pension Funding Equity Act of 2004 provided a special interest rate to be used in determining a single-employer defined benefit plan's current liability for funding purposes in plan years beginning in 2004 or 2005. That rate must be within a permissible range (90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The PPA extends the application of that special interest rate for plan years beginning in 2006 and 2007. Notably, a different rate will then apply beginning with respect to plan years beginning in 2008.

C. Benefit Statements. The PPA also changes the rules related to defined benefit plan benefit statements. First, in addition to the information that was required to be provided in a statement prior to the PPA (the total accrued benefit, and the vested accrued benefit or the earliest date on which benefits will become vested), a benefit statement must also explain any permitted disparity or floor-offset arrangement that may be applied in determining accrued benefits under the plan. Second, a defined benefit administrator must provide a benefit statement or a notice, even in the absence of a request, within certain timelines. A defined benefit plan administrator must furnish either: (1) a benefit statement at least once every three years to each participant who has a vested accrued benefit under the plan and who is employed by the employer at the time the benefit statements are furnished to participants; or (2) a notice, at least annually, to each such participant of the availability of a benefit statement and the manner in which the participant can obtain it. It is intended that the notice of the availability of a benefit statement may be included with other communications to the participant if done in a manner reasonably designed to attract the participant's attention.

This change is generally effective for plan years beginning in 2007 or later. If the plan is maintained pursuant to a collective bargaining agreement, the requirement may become effective later (but no later than plan years beginning in 2009).

D. Variable Rate Premiums. The PPA extends a previously effective rule relating to PBGC variable rate premiums and provides a new limitation on the variable rate premiums paid by small plans. All covered plans

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
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Fax: 913.685.1281

John L. Utz
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Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
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www.utzmiller.com

"The PPA expands the ability of a defined benefit pension plan to transfer excess pension assets to fund the expected cost of retiree medical benefits."

pay a flat per-participant PBGC premium, and underfunded plans are subject to an additional variable rate premium based on the level of underfunding ($9 per $1,000 of unfunded vested benefits). In determining the level of underfunding for plan years starting in 2003 or earlier, the applicable interest rate was 85 percent of the interest rate on 30-year Treasury securities. For plan years beginning in 2004 and 2005, however, the appropriate interest rate was 85 percent of the annual rate of interest determined by the Treasury on amounts invested conservatively in long-term investment-grade corporate bonds for the month preceding the month in which the plan year begins. The PPA extends the 2004 and 2005 rules to apply for plan years beginning in 2006 and 2007. Different rules will later apply for the 2008 and subsequent plan years.

In the case of a small employer, the PPA limits the per-participant variable-rate premium to an amount no greater than $5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. A "small employer" is a contributing sponsor that, on the first day of the plan year, has 25 or fewer employees (taking account all employees of the controlled group). Let's consider the application of this limitation to a plan with 20 participants. Under the PPA limit, the plan's total variable rate premium may not exceed $2,000 (that is, a per-participant limit of $100 (20 x $5) multiplied by the 20 participants). This change becomes effective for the 2007 plan year.

E. Plan Funding Notice. Prior to the PPA, in the case of an underfunded single-employer plan for which PBGC variable rate premiums are required, ERISA required that the plan administrator provide participants an annual notice of the plan's funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded. The PPA repeals that requirement for plan years beginning in 2007. Then, beginning in 2008, single-employer defined benefit plans will be subject to requirements similar to the requirements imposed upon a multiemployer plan.

F. Future Retiree Health Benefits. The PPA expands the ability of a defined benefit pension plan to transfer excess pension assets to fund the expected cost of retiree medical benefits. Before the PPA, a pension plan could provide medical benefits to retired employees through a separate account that is part of the plan, but transfers of "excess assets" could not exceed the amount reasonably estimated to be the amount the employer would pay during the current year for qualified current retiree health liabilities.

If certain requirements are satisfied, the PPA permits transfers of excess pension assets under a single-employer plan to retiree medical accounts to fund the expected cost of retiree medical benefits for the current *and future* years and also allows such transfers in the case of benefits provided under a collective bargaining agreement. Under the PPA, "excess assets" are calculated slightly differently, and transfers must be made for at least a two-year period. These PPA changes are immediately effective with respect to transfers made after August 17, 2006, the date the PPA was enacted. Please contact us if you would like to discuss these PPA changes in greater detail.

IV. MISCELLANEOUS PROVISIONS

In addition to the PPA's impact on qualified defined contribution and defined benefit plan discussed above, the PPA also made important changes to rules relating to cash balance plans (and other "hybrid" plans), nonqualified deferred compensation arrangements, governmental plans, and company-owned life insurance. We will briefly address those changes in this Section. These descriptions are overly simplistic, however, so please contact us for further details.

Utz, Miller & Kuhn, LLC
7285 West 132nd St.
Suite 320
Overland Park, KS 66213

Phone: 913.685.0970
Fax: 913.685.1281

Gregory B. Kuhn
gkuhn@utzmiller.com
Phone: 913.685.0774
Fax: 913.685.1281

Eric N. Miller
emiller@utzmiller.com
Phone: 913.685.8150
Fax: 913.685.1281

John L. Utz
jutz@utzmiller.com
Phone: 913.685.7978
Fax: 913.685.1281

Matthew J. Eickman
meickman@utzmiller.com
Phone: 913.685.0749
Fax: 913.685.1281

www.utzmiller.com

"The PPA clarifies that, effective June 30, 2005, a hybrid plan does not violate age discrimination rules if certain requirements are met with respect to the calculation of participants' benefits."

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Fax: 913.685.1281

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meickman@utzmiller.com
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Fax: 913.685.1281

www.utzmiller.com

A. **Cash Balance Plans**. Cash balance and other hybrid defined benefit plans have been surrounded by uncertainty and embroiled in litigation, particularly with regard to age discrimination and the calculation of lump sum distributions. The PPA clarifies that, effective June 30, 2005, a hybrid plan does not violate age discrimination rules if certain requirements are met with respect to the calculation of participants' benefits. Additionally, effective August 17, 2006, a hybrid plan may distribute a participant's hypothetical account balance or an amount equal to an accumulated percentage of the participant's final average compensation, without determining whether such amount is at least equal to the present value of a life annuity payable at NRA. The PPA makes additional changes to hybrid plans' vesting rules and interest requirements, but those changes do not become effective until the 2008 plan year.

B. **Nonqualified Deferred Compensation**. Under the PPA, an employer that is terminating a defined benefit pension plan, maintains a defined benefit pension plan that is in at-risk status, or is in bankruptcy itself, faces restrictions on the funding of nonqualified deferred compensation plans. These restrictions apply during a "Restricted Period," which includes a period during which: (i) a plan is in at-risk status; (ii) the employer is in bankruptcy; or (iii) the period beginning six months before and ending six months after the date a plan is terminated in an involuntary or distress termination. The restrictions prevent assets from being set aside for "Applicable Covered Employees," which include the CEO, four highest compensated officers, and individuals subject to special reporting requirements under the Securities Exchange Act of 1934. In particular, if, during any Restricted Period, assets are set aside in a trust for purposes of paying deferred compensation of an Applicable Covered Employee, those transferred assets are treated as property transferred in connection with the performance of services under Tax Code Section 83. As a result, participants would be taxed when they vest in those amounts – that is, when they were no longer subject to a substantial risk of forfeiture. The PPA's prohibition on nonqualified deferred compensation funding is effective for transfers or other reservations of assets after August 17, 2006, the PPA's enactment date.

C. **Governmental Plans**. The PPA makes certain changes that do not affect private-sector plans, but do impact governmental plans. For instance, effective as of August 17, 2006, a "qualified safety employee" may avoid the 10 percent early withdrawal penalty tax on any distribution if he or she has separated from service and attained age 50 at the time of the distribution. Prior to the PPA, a participant must separated from service and attained age 55 in order to avoid the 10 percent penalty. Also, beginning with the 2007 plan year, the PPA allows a tax-free distribution of up to $3,000 per year to be made from a governmental plan on behalf of an eligible public safety officer for the purchase of health or long term-care insurance. Further, the PPA expands the definition of "permissive service credit" that employees may purchase with after-tax employee contributions. This change is retroactively effective as if included in the Tax Payer Relief Act of 1997, except some related aspects are effective as if included in EGTRRA (2001).

D. **Company-Owned Life Insurance**. The PPA changes the extent to which proceeds from a company-owned life insurance ("COLI") contract are excludable from the policyholder's income. Under the PPA, the amount excludable from income as a death benefit cannot exceed the premiums and other amounts paid by the policyholder for the contract. Any excess death benefit is included in income, subject to certain exceptions where notice and consent requirements are met *prior to the issuance of the insurance contract*. Those exceptions apply to amounts received: (1) by reason of the death of an insured individual who was an employee of the policyholder at any time during the 12-month period before the insured's death; (2) by reason of the death of an employee who was a director, highly compensated employee, or highly compensated individual when the contract was issued; and (3) amounts received by family members or designated beneficiaries (other than the policyholder) of the insured, a trust established on a family member or designated beneficiary's behalf, or the insured's estate. These new COLI rules generally apply to contracts issued after August 17, 2006, except they do not apply to contracts issued after that date pursuant to a Tax Code Section 1035 exchange. Importantly, keep in mind that the employee must receive notice and give consent to being insured *before* the contract is issued in order for the policyholder to rely upon any income inclusion exception.

V. PLAN AMENDMENTS

A plan amendment made pursuant to the changes made by the PPA or regulations issued thereunder may be retroactively effective and will not violate anti-cutback rules if the amendment is made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan). This applies, of course, only if the plan was properly operated in a manner consistent with the amendment during the period beginning with the date the amendment is effective and ending the date it is adopted.

We look forward to discussing any questions you might have regarding those issues or any other issues described in this newsletter.

"[P]lan amendment[s] . . . may be . . . made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan)."

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