

MEMORANDUM TO CLIENTS

December 19, 2008

RE: Key Provisions of The "Worker, Retiree, and Employer Recovery Act of 2008" – A Bit More Than PPA Technical Corrections

The Worker, Retiree, and Employer Recovery Act of 2008 (H.R. 7327) (the "Act"), was passed by the House of Representatives on December 10, by the Senate on December 11, and has been sent to the President for signature. The Act primarily makes technical corrections to the Pension Protection Act of 2006 ("PPA"), but also provides some relief from required minimum distribution rules and funding difficulties created by the current economic downturn and includes other provisions. This memorandum focuses on the provisions dealing with required minimum distributions, the funding requirements for defined benefit pension plans, and a handful of other provisions likely to be of interest to sponsors and administrators of private pension plans.

A. 2009 Required Minimum Distribution Relief

Qualified retirement plans, including 401(k), 403(b) and 457 plans, and individual retirement accounts and annuities ("IRAs"), are subject to annual required minimum distributions ("RMDs") under Internal Revenue Code section 401(a)(9). For employer-sponsored plans, employees must generally begin taking RMDs by the later of April 1 following the year in which the employee attains age 70 ½ or April 1 following the year of retirement. For traditional IRAs, required minimum distributions must begin by April 1 following the year the IRA owner attains age 70 ½. A RMD for a defined contribution plan or IRA is determined by taking the account balance of the plan or IRA as of December 31 of the previous year and dividing it by a number based on life expectancy of the plan participant or IRA owner. If a RMD is not distributed by the required date, a 50% excise tax is imposed on the shortfall not distributed (sec. 4974).

The current economic downturn has made RMDs particularly burdensome to older retirees in defined contribution plans and IRAs because RMDs for 2008 are based on December 31, 2007 account balances. Since most account balances have significantly declined since that date, distributions for 2008 are likely to be unusually large relative to the current smaller account balances of many retirees. The Act provides relief for the 2009 calendar year for defined contribution employer-sponsored qualified retirement plans (including 403(b) plans and 457(b) plans maintained by a government employer) and IRAs by waiving the RMD requirement for 2009 for participants and beneficiaries. Persons who reach age 70 ½ in 2009 will need to take their first RMD by December 31, 2010. (Those who reached 70 ½ in 2008 still must take their RMD under the normal rules, unless IRS soon waives them.) Beneficiaries taking RMDs under the 5-year rule get an extra year to complete the payments.

The Act does not waive RMDs for 2008, which are generally required by December 31, 2008. Although the Treasury Department and Internal Revenue Service had signaled that they

may issue some form of RMD relief for 2008, the Treasury Department has informed Congress that they will not provide RMD relief for 2008.

Due to the waiver in 2009, distributions that would otherwise be RMDs may become "eligible rollover distributions." The Act provides that the direct rollover notice, written explanation, and 20% income tax withholding requirements are not required to apply to distributions that would otherwise be RMDs in 2009. Rather, plans may or may not offer to handle these as direct rollovers.

Plans and IRAs will be required again in 2010 to comply with the RMD rules and the legislative history to the Act indicates how future RMDs will reflect this one-year waiver. The plan or IRA is not required to be amended to get the RMD relief until the 2011 plan year.

B. DB Funding Relief

The economic downturn has made PPA's tighter funding rules even harder to swallow. The Act provides modest relief, but we expect the new Congress to consider more. The key changes are as follows.

- **"Smoothing" Relief.** The IRS regulations on the valuation of pension plan assets under the new PPA rules did not continue the use of traditional asset smoothing methods, but only allowed averaging over a period up to 24 months. The Act would permit some asset smoothing by allowing plans to take expected earnings into account when determining the value of plan assets. This will result in somewhat smaller underfunded amounts and thus somewhat smaller required contributions. However, the smoothed value of assets still must be within 10% of actual fair market value of plan assets. Due to the dramatic market drop, plan sponsor groups asked Congress to widen this 10% "corridor" (prior law had a 20% corridor), but the Act does not do so.
- **Funding Target Transition Relief.** Under the new PPA funding requirements, if a plan's assets are less than the funding target, the minimum required contribution is the plan's normal cost plus an amortization of the plan's funding shortfall (the difference between the plan's funding target and the plan's assets). This new PPA funding target is phased-in over three years. Plans with a funding target at or below the set phase-in level for the year (*e.g.*, 92% for 2008, 94% for 2009; 96% for 2010) only need to fund up to that percentage limitation. Under the PPA rules, if the plan does not meet those phased-in funding target percentages, the plan would no longer be eligible for the phase-in period, and the employer would have to fund based on 100% of funding target. The Act would eliminate this so-called "cliff" effect of the transition rule, and instead generally require plans that were at least 90% funded in 2007 to fund up to the specified phased-in funding threshold for the 3 transition relief years. This will modestly reduce the contributions that some plan sponsors will have to make to their plans.
- **"Look Back" Period.** Under the PPA funding rules, if a single-employer pension plan is less than 60% funded for a plan year (as certified by the plan's

actuary), the plan sponsor is required to freeze all future benefit accruals for participants. The Act would temporarily allow plans to "look back" to the plan's funding status during the previous plan year to determine whether the plan was at least 60% funded for this purpose. This provision would apply for plan years beginning on or after October 1, 2008 and before October 1, 2009. This would mean that for plan years beginning January 1, 2009, a plan's funded status as of January 1, 2008 would be used for purposes of the rule.

- **"At-Risk" Status Transition Rule.** Under the PPA funding rules, a plan generally is considered "at-risk" if it is (1) less than 80% funded using the general funding actuarial assumptions and (2) less than 70% funded using special "at-risk" actuarial assumptions. The 80% test under the first prong is phased-in over four years (*i.e.*, 65% for 2008, 70% for 2009, 75% for 2010, and 80% for 2011). The Act would also apply the phase-in transitional rule for determining "at-risk" status to the 70% funded test, which will keep some plans out of "at risk" status.
- **Lump Sum Payments.** Under the PPA funding rules, plans that have a funding percentage less than 60%, or where the plan sponsor is in bankruptcy, are not permitted to make any lump-sum payments to participants. The Act provides that lump sum payments of \$5,000 or less (or \$1,000 if the plan lowered the threshold) can be paid even if an underfunded plan is otherwise prohibited from paying lump sums.
- **Target Normal Cost.** The Act would require that plan sponsors include in the calculation of "target normal cost" the amount of plan-related expenses to be paid from plan assets during the year and mandatory employee contributions expected to be made during the year. This change applies to plan years beginning after December 31, 2008. Thus, the inclusion of plan-related expenses and mandatory employee contributions in target normal cost would not affect 2008 minimum contribution requirements. The technical language and legislative history are not clear as to whether investment-related expenses are to be considered plan-related expenses that must be included in target normal cost. However, we understand that Congress did not intend for investment-related expenses to be included in target normal cost and anticipate that a later explanation of the Act, to be prepared by the staff of the Joint Committee on Taxation, will make that intention clear.
- **Multiemployer Plan Relief.** For plan years beginning on or after October 1, 2008 and before October 1, 2009, the Act would permit multiemployer plan sponsors to elect to temporarily freeze their actuarial funding certification of endangered status, critical status or neither based on the previous year's funding level. The Act would also extend the current funding improvement or rehabilitation period for multiemployer plans in "endangered" or "critical" status and that have funding improvement and rehabilitation plans in place in 2008 and 2009 by 3 years, from 10 to 13 years. Seriously endangered plans can extend their 15-year plans to 18 years.

C. Other Notable Provisions

Non-Spouse Rollovers. Under the PPA, individual non-spouse beneficiaries are now allowed to rollover amounts from a tax-qualified plan, 403(b) annuity or governmental 457 plan directly to an IRA beginning in 2007. The IRA is then treated as an inherited IRA for purposes of the minimum distribution rules. The IRS has interpreted the PPA provision as permitting – but not requiring – plans to provide such a rollover opportunity. The technical corrections in the Act would clarify that tax-qualified plans are required to allow non-spouse rollovers and provide direct rollover notices (sec. 402(f)) as a condition of plan qualification. The correction would be effective for plan years beginning after December 31, 2009.

Automatic Enrollment Programs. The PPA included several provisions intended to promote the use of automatic enrollment programs, including a provision allowing a participant in certain arrangements to make a "permissible withdrawal" of automatic contributions within 90 days of the date the first automatic contribution was made on behalf of the participant. One requirement to be an automatic enrollment arrangement eligible for this relief is that the plan has to invest contributions under the arrangement pursuant to the DOL qualified default investment alternative regulations in the absence of a specific investment election by the participant. This requirement would be eliminated. In addition, the permissible withdrawal rule would apply to SIMPLE IRAs and SARSEPs, and a permissible withdrawal would not be taken into account in applying the annual limit on elective deferrals (Code sec. 402(g)(1)), *i.e.*, \$16,500 in 2009.

Combined Deduction Limit for Defined Benefit and Defined Contribution Plans. The PPA included certain changes designed to loosen the impact of the combined plan deduction limit for plan sponsors that maintain both defined benefit plans and defined contribution plans. Under one change, for plan years beginning in 2006 and 2007, the combined plan limit applies only to the extent contributions to one or more defined contribution plans do not exceed 6 percent of compensation of beneficiaries under the plans. In Notice 2007-28, the IRS determined that even if defined contribution plan contributions do not exceed 6 percent of compensation, the combined plan limit still applies to the defined benefit plan. The Act clarifies that the combined plan deduction limit will not apply to either a sponsor's defined contribution or defined benefit plans if contributions to the defined contribution plans do not exceed 6 percent of compensation. In this regard, the Treasury Department previously had informally stated that it would apply the combined deduction limit as if this technical correction had already been enacted. If defined contributions exceed six percent of compensation, only the excess counts toward the combined limit.

Effective Date of Cash Balance Vesting Requirement. In general, the PPA requires cash balance and other hybrid plans to provide for 100 percent vesting after 3 years of service. The Act provides that this requirement only applies with respect to participants with an hour of service after the applicable effective date for a plan. (We note that the proposed cash balance plan regulations issued in December 2007 provide that this 3-year vesting requirement applies to the entire benefit in the case of a plan that includes both a cash balance and traditional formula (e.g., a plan providing for the greater of the two formulas).)

Roth Rollovers. The PPA permits rollovers from a tax-qualified plan, 403(b) annuity or governmental 457 plan directly to a Roth IRA, subject to the following conditions: (1) the rolled-over amount generally must be included in income (except to the extent it represents "basis"), and (2) adjusted gross income limits are imposed on the ability to perform such rollovers in 2008 and 2009 (the limits do not apply in 2010). Under the PPA, these conditions technically apply even in the case of rollovers to Roth IRAs from designated Roth accounts in a 401(k) or 403(b) plan. The Act clarifies that these conditions do not apply to direct rollovers to a Roth IRA from a Roth 401(k) or Roth 403(b).

Extension of PFEA Amendment Date. The Act extends the deadline for amending a defined benefit plan to conform to certain temporary interest assumptions in calculating 2004 and 2005 lump sums for section 415 testing purposes from the end of the 2008 plan year to the end of the 2009 plan year. It also clarifies when the new mortality table may be used for this purpose.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about these matters.

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