H.R. 2830
The Pension Protection Act
(as approved by the House Education and the Workforce Committee on 6/30/05)

Single-Employer Plans

Minimum Funding Rules

In General

The bill replaces the current funding rules with new funding rules. Generally, these new rules require contributions equal to the "target normal cost" of the plan for the plan year and require amortization of any underfunding over a 7-year period. This is substantially shorter than current law normal funding rules. The bill eliminates the higher deficit reduction contribution required for underfunded plans, but the benefit liability amount that plans have to fund is increased for plans that are less than 60 percent funded.

Determination of Funding Target and Annual Contributions: The bill changes the current law concept of a funding standard account. If a plan’s assets equal its "funding target," the minimum required contribution for the year is equal to its target normal cost. The funding target is equal to the present value of all benefit liabilities accrued to date, including early retirement subsidies or similar benefits. The target normal cost is equal to the present value of all benefits accrued or earned during the plan year, including increases in benefits attributable to increases in compensation. If a plan’s assets exceed its funding target, the target normal cost is accordingly reduced by the excess (in certain instances the minimum required contribution may be zero). If a plan’s assets are less than its funding target, additional contributions are required to amortize that shortfall over 7 years (unlike current law where amortization periods differ based on the source of the shortfall and could be as long as 30 years). There will be a year-by-year determination of shortfall amounts and the related amortization periods; consequently, there could be up to 7 different shortfalls being amortized at once. If a plan's assets exceed the funding target in future years, then all of the shortfall amortizations are cancelled.

Under the bill, the funding target is equal to 100 percent of the plan’s accrued liability. In order to ease the burden of meeting the 100 percent funding target, the bill phases in the funding requirement ratably over 5 years. Thus, the funding target in 2006 would be 92 percent of a plan’s accrued liability, 94 percent in 2007, 96 percent in 2008, 98 percent in 2009, and 100 percent in 2010.

If a plan sponsor elects to maintain a "funding standard carryover balance" or "pre-funding balance," the plan's assets are reduced by such balances for purposes of determining the plan's minimum required contribution for the year (and for certain other purposes). (See below for a broader discussion regarding "funding standard carryover balances" and "pre-funding balances" and the implications of their use).

Valuation Date: For purposes of determining annual funding amounts, all large plans must use the first day of the plan year as the valuation date. Plans with 500 or fewer participants can continue to choose the valuation date.

Interest Rates: The bill requires that the interest rate used in determining the funding target (i.e., present value of all benefit liabilities) be based on a modified yield curve of corporate bonds to reflect the duration of the liabilities that are to be valued. Unlike the Administration's proposal, which would require a separate interest rate for each payment date, the bill requires that the durations of the liabilities be segregated into three broad categories: those liabilities payable within 5 years of the valuation date, liabilities payable after 5 years and before 20 years of the valuation date, and liabilities payable thereafter. The Treasury Department has much discretion in determining the rates for each category. The bill provides that each rate is based on a 3-year weighted average of these rates (as compared to a 90-day "spot" rate in the Administration's proposal). The weighting will be determined so that the most recent year will be weighted 50 percent, the next most recent year will be weighted 35 percent, and the second most recent year will be weighted 15 percent. The use of this modified yield curve will be phased-in over 3 years.

Mortality Tables: The mortality table used in determining these benefit liabilities would be based on the RP-2000 Combined Mortality Table, with Treasury to update the tables at least every 10 years. Treasury is instructed to issue regulations that phase-in ratably the change in the mortality table over 5 years. The bill would also allow a plan sponsor to request to use a different mortality table (for not more than 10 years) if the plan sponsor can demonstrate to Treasury that (i) the RP-2000 Combined Mortality Table does not reflect the actual experience of the plan and projected trends in such experience and (ii) the table is significantly different from the RP-2000 Combined Mortality Table. If Treasury does not otherwise disapprove of the use of the different table within 180 days of the request, its use shall be effective for the following plan year

Determination of Asset Values: The bill continues the current methodology of determining the actuarial value of assets. That means that the values can be determined under any reasonable actuarial method that is permitted under Treasury Department regulations. However, the bill imposes two restrictions on the valuation methodology. The first restriction is that the smoothing of asset values cannot be for more than 3 years

(instead of 5 years under current law). The second restriction is that the result of this smoothing cannot provide results which are lower than 90 percent (instead of 80 percent under current law) or greater than 110 percent (instead of 120 percent under current law) of the fair market value of such assets at the time of the valuation. The Administration's proposal would eliminate smoothing and instead require the use of the market value of assets.

Credit Balances: One of the major concerns raised by employer groups regarding the Administration's proposal was the loss of the use of credit balances in determining annual funding amounts. The bill addresses that concern in part by permitting plan sponsors to elect to maintain a "pre-funding balance" which may be used to reduce a plan's minimum required contribution for the year. Under a transition rule, pre-2006 plans that were pre-funded are permitted to maintain a "funding standard carryover balance," which may also be used to reduce a plan's minimum required contribution. Plan sponsors may elect to reduce the amounts held in the funding standard carryover or pre-funding accounts in an attempt to minimize any reduction in plan assets (discussed below), although the mechanics are unclear. The funding standard carryover balance must be used before the pre-funding balance may be used under all circumstances. As of a plan's valuation date, the pre-funding and funding standard carryover balances would be adjusted to reflect investment performance in the underlying plan assets (i.e., marked to market).

The bill, however, would impose the following rules and restrictions on the use of pre-funding and funding standard carryover balances:

- If a plan is less than 80 percent funded for a plan year, the plan may not elect to use its funding standard carryover or pre-funding balance to reduce the minimum required contribution for the year. For purposes of applying the 80 percent limitation, a plan sponsor is required to reduce its plan assets by its pre-funding balance (but not the funding standard carryover balance).

- Consistent with the current deficit reduction contribution rules, plan assets must be reduced by the funding standard carryover and pre-funding balances for purposes of determining the minimum required contribution for the year.

- Significantly, plan assets must also be reduced by the funding standard carryover and pre-funding balances for certain other purposes, including the application of the benefit restrictions and the "at-risk" rules under the bill (described below). If a plan is 100 percent funded (i.e., the plan's assets equal or exceed its funding target), the plan's assets would not have to be reduced for the purposes of determining whether the benefit restrictions apply.

- If a plan sponsor elects to use its pre-funding balance to reduce its minimum required contribution for the year, the plan's assets must be reduced by a corresponding amount for purposes of determining whether any scheduled shortfall amortization payments may be cancelled.

At-Risk Plans: The bill requires additional funding for plans in "at-risk" status. A plan is in "at-risk" status based solely on whether the plan's assets are less than 60 percent of the funding target (as stated above, a plan's assets are reduced by its credit balances for purposes of determining whether a plan is "at-risk"). The underlying financial health of the company (as determined by its credit rating) is not considered. This differs from the Administration's proposal, which looks to both the credit status of the plan sponsor as well as the funding status of the plan to determine whether the "at-risk" requirements apply. Under the bill, if a plan is in "at-risk" status, the value of plan benefits is determined as if all participants elect benefits that will result in the highest present value of benefits (e.g., lump-sums at the "most subsidized" age). In addition, a load factor of $700 per participant and 4 percent of the funding target would be added, which is intended to reflect the higher costs involved in terminating a plan. These changes will result in a higher funding target and higher contributions being made to plans in "at-risk" status. This higher funding requirement for "at-risk" plans is phased in over 5 years from when a plan is first determined to be in "at-risk" status.

Other Rules: Many of the current pension funding rules (e.g., timing of contributions, quarterly contributions and security requirements) generally follow current law. However, there are a number of small changes in the ways the current rules work that reflect the overall change in the funding rules. For example, the bill makes changes relating to section 420 transfers of assets in an overfunded plan to a section 401(h) account to pay for the current year's retiree medical expenses. Under current law, the assets transferred to the 401(h) account are still counted for purposes of determining the funded status of the plan; however, the transferred amount is treated as a net experience loss, which must be amortized over 5 years. Under the bill, the assets transferred will not be treated as assets of the plan for purposes of determining whether the plan has met its funding target. In addition, since there is no funding standard account under the bill, there is also no need for any amortization of the transferred amount.

Benefit Restrictions

Shutdown Benefits and Unpredictable Contingent Event Benefits: The bill prohibits pension plans from offering shutdown benefits and other unpredictable contingent event benefits that currently can be provided under these plans. These benefits are benefits that are payable upon an event other than the attainment of any age, performance of any service, receipt of any compensation, or the occurrence of death or disability, or which is

an event that is reasonably and reliably predictable. Plant shutdown benefits (even if reasonably predictable) and severance benefits could not be paid from a pension plan. These restrictions would become effective for events occurring after 2006, with a delayed effective date for benefits offered under a plan maintained pursuant to a collective bargaining agreement.

Benefit Restrictions Based on Funding: Like the Administration's proposal, the bill includes restrictions on increasing benefits, paying lump sums, or accruing new benefits if the plan falls below a certain funded percentage.

Benefit Increases: A pension plan cannot be amended to increase benefits if the plan is less than 80 percent funded (determined as if the amendment was adopted). However, the amendment would be allowed if the plan sponsor made contributions to the plan to pay for the increase or that would result in the plan satisfying the 80 percent threshold. This restriction would not apply to a plan for the first 5 years the plan (or a predecessor plan) is in effect.

Benefit Payments: A pension plan cannot make payments in a form other than a life annuity if the plan is less than 80 percent funded. The plan administrator must notify participants of this restriction within 30 days after the plan has become subject to the restriction. Failure to notify could result in a penalty imposed by the DOL up to $1,000 per day. If a plan subsequently becomes 80 percent or more funded, a plan must be amended in order to resume other forms of distributions (e.g., lump sum distributions). This restriction would not apply to a plan that is frozen as of June 29, 2005.

Benefit Accruals: All future benefit accruals must cease under a pension plan if the plan is less than 60 percent funded. The plan sponsor can provide for a resumption of benefit accruals after the plan assets exceed 60 percent of its funding target; however, the plan must be amended to provide for the resumption of benefit accruals. This restriction would not apply to a plan for the first 5 years the plan (or a predecessor plan) is in effect.

Credit Balances: As discussed above, a plan's assets must be reduced by its funding standard carryover and pre-funding balances for purposes of determining whether the benefit restrictions apply. However, if a plan is 100 percent funded (i.e., the plan's assets equal or exceed its funding target), the plan sponsor is not required to reduce its plan assets by such balances. Thus, under the general rule, a plan sponsor maintaining a plan that is 85 percent funded may fall below the 80 percent or 60 percent thresholds if it maintains a large funding standard carryover or pre-funding balance. On the other hand, a plan that is 100 percent funded would not be subject to the benefit restrictions under the bill, regardless of whether the plan sponsor maintains these balances (because the plan's

assets will not be reduced to a level where the plan falls below the 80 percent or 60 percent thresholds).

Effective Date for Restrictions: These restrictions would become effective for plan years beginning after 2006, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement.

Increase in Deduction Limitations

The bill would increase the amount of contributions a sponsor of a single-employer plan may deduct to an amount equal to the greater of (i) 150 percent of the funding target plus target normal cost, or (ii) in the case of a plan that is not at-risk, the sum of the plan's funding target and target normal cost determined as if the plan was at-risk for the plan year, less the plan's assets for that year. The bill also provides that the combined plan deduction limitation would not apply to the extent contributions to one or more defined contribution plans does not exceed 6 percent of compensation.

Deferred Compensation Restrictions

The bill amends the new deferred compensation restrictions in Code section 409A to provide that if a pension plan is determined to be "at-risk" (i.e., the plan is less than 60 percent funded), then any amounts (i) set aside (directly or indirectly) to fund deferred compensation (or otherwise restricted to pay such benefits) or (ii) will be set aside upon attainment of "at-risk" status (or other similar financial triggers) will be considered to be a taxable transfer to the individual and such amounts will be subject to the penalties under Code section 409A. The bill is unclear on what it means for amounts to be "set aside," but transfers to rabbi trusts would be covered under this provision and corporate-owned life insurance policies used to fund these arrangements might be covered. The bill does not limit this provision to executives or key employees; any individual who has "deferred compensation," as defined in section 409A, would be covered by this provision. If enacted, this provision should put more pressure on the IRS and Treasury Department to provide exceptions for various broad-based arrangements from the application of Section 409A.

PBGC Premium Increases

<u>Flat-Rate Premiums</u>: Under the bill, the flat-rate premium will increase from $19 per participant to $30 per participant starting in plan years after 2006. The premium increase will be phased in over 5 years if the plan is 80 percent or more funded and over 3 years if the plan is less than 80 percent funded. The $30 per participant amount will be indexed annually to reflect increases in wages.

Risk-Based Premiums: Unlike the originally introduced bill, the risk-based premium factor of $9.00 for each $1,000 of unfunded vested benefits will not be adjusted annually to reflect increases in wages.

Lump Sum Distributions

The bill revises the interest rate used to determine the value of lump sum distributions. Under current law, that interest rate is the Treasury Department-determined rate of interest on 30-year Treasury securities. Under the bill, plans must use the 3-segment, modified yield curve interest rate used to determine liabilities under the plan (discussed above). The new rates are determined using spot rates (i.e., on a "snap-shot" basis). In addition, the bill generally requires plans to use a mortality table based on the RP-2000 Combined Mortality Table, although plan sponsors may request the use of a substitute mortality table (also discussed above). The bill phases-in the use of the interest rate over 5 years beginning in 2006.

Multiemployer Plans

The bill generally changes the amortization periods from 30 years to 15 years for (i) net increases or decreases in unfunded past service liability arising from plan amendments, and (ii) net losses or gains resulting from changes in actuarial assumptions. The bill increases the maximum deductible limit to 140 percent of current liability, as determined based upon a 4-year weighted average of 30-year Treasury rates. The bill also changes the rules for receiving an extension of amortization periods from the Secretary of Treasury, and increases the interest rate applicable to any such amortization period extension.

In addition, the bill creates new categories of troubled multiemployer plans: (i) "endangered plans," defined as plans that have a funded percentage of less than 80 percent or are projected to have an accumulated funding deficiency within 7 plan years; and (ii) "critical plans," defined as plans that fall within a series of triggers. Endangered plans are generally required to come up with a funding improvement plan that, among other things, will increase the plan's funded percentage by one-third within 10 years. Under an amendment adopted during the Committee mark-up, alternative benchmarks apply to endangered plans that are less than 70 percent funded and to certain plans more than 70 percent but less than 80 percent funded.

Critical plans are generally required to develop a rehabilitation plan that provides for a combination of measures to permit the plan to exit "critical" status within 10 years. Under another amendment adopted during the mark-up, employers currently contributing to a plan would be required to make 5-10 percent surcharge contributions until the next

collective bargaining agreement is adopted. In addition, the trustees of plans in critical status would be provided additional tools to cut certain types of non-core benefits with respect to participants not in pay status for a year and benefit increases in the last 60 months.

Disclosure Requirements for All Plans

Application of Annual Disclosure Requirements to all Pension Plans: The funding notices that currently have to be sent annually to participants, beneficiaries and labor organizations in a multiemployer plan will have to be provided by all defined benefit plans. The notice must be provided within 90 days after the end of the plan year. Among other things, the notice must provide (i) whether the plan's funding status is at least 100 percent; (ii) a summary of the rules governing plan termination; (iii) the value of plan assets and projected liabilities and the ratio of these two amounts; (iv) the ratio of active participants to inactive participants in the plan; and (v) the plan's funding policy and asset allocation. These new requirements would be effective for plan years beginning after December 31, 2005.

Additional Information in the Annual Form 5500: Under the bill, annual Form 5500 disclosure must be expanded to include (i) the ratio of inactive participants to active participants in the plan, and (ii) the effect of plan mergers during the plan year on the plan's funded ratio. The actuarial statement will be required to include a statement explaining the actuarial assumptions and methods used in projecting future retirements and distributions under the plan.

Distribution of Summary Annual Reports: Summary annual reports (SARs) will now have to be provided to participants within 15 days of the due date for filing the Form 5500. For calendar year plans, that means that a SAR must be provided to participants by August 15. In addition, SARs must set forth the total assets and liabilities of the plan for each of the past 3 plan years.

4010 Information: Under current law, the sponsor of plans with over $50 million in unfunded vested benefits (on a controlled group basis) is required to provide the PBGC with information about the assets and liabilities of the plan, as well as the sponsor's audited financial statements and other financial information. This information is currently not available to the public (but Congress may request to see that information).

The bill would amend current law to require a plan sponsor whose plan(s) are less than 60 percent funded (on a controlled group basis) to file the section 4010 information with the PBGC. A plan sponsor whose plan(s) are less than 75 percent funded and who the PBGC determines is in an industry in which there is substantial underemployment or

unemployment and sales and profits are depressed or declining must also file the section 4010 information with the PBGC.

The sponsor would also be required to provide notice to participants within 90-days containing information regarding (i) how many plans maintained by the plan sponsor are in an "at-risk" status; (ii) the value of the assets for each plan that is in "at-risk" status; (iii) the funding target for each plan and percentage to which assets support the funding target; and (iv) the aggregate of the above numbers for all plans maintained by the plan sponsor, regardless of whether they are in "at risk" status. This notice must also be submitted to Congress (i.e., the House Committee on Education and the Workforce and the Senate Health, Education, Labor, and Pensions Committee).

Investment Advice

The bill would add a new statutory exemption from ERISA's prohibited transaction rules allowing regulated financial institutions to provide investment advice to plans and plan participants where the institution's (or an affiliate's) products are among those available under the program. The exemption expressly covers the sale, acquisition, and holding of assets pursuant to such advice, and the payment of fees to advisers for such advice. The exemption does not regulate the fees that advisers are permitted to receive, but imposes significant disclosure conditions consistent with securities laws, and limits the exemption to arm's-length transactions in which the adviser receives no more than reasonable compensation. The disclosure requirements include fees received and the relationship of the adviser to the available investments (e.g., shares of an affiliated mutual fund).

The Prohibited Transaction Rules and Other Related Amendments

During the mark-up, a majority of the Committee agreed to an amendment providing for changes to ERISA's prohibited transaction rules and changes to the regulations defining whether an entity that ERISA plans invest in is deemed to hold ERISA plan assets. The amendment would create new exemptions from the prohibited transaction rules for (i) "block" trading securities under certain conditions, (ii) investing and "blind" trading of plan assets via electronic or alternative trading systems, and (iii) the purchase or sale of securities on a foreign exchange by a bank or broker-dealer, provided certain requirements are met. Under the amendment, plan fiduciaries could correct a prohibited transaction involving a security or commodity within 14 days. In addition, ERISA's bonding requirements would not apply to brokers or dealers who agree to handle (and be liable for) the investment of plan assets. Finally, certain entities (such as partnerships) in which ERISA plans invest would no longer be deemed to hold ERISA plan assets unless 50 percent of the equity interests in the entity are held by benefit plan investors (including ERISA plans and IRAs, but not including governmental or foreign plans).

Hybrid Pension Plans

Under the bill, whether a pension plan violates the age discrimination provisions under ERISA and the Code would be determined by examining the terms of the plan to see if a similarly situated younger employee would receive a greater benefit than an older worker. For example, if a cash balance plan's interest credit is 3 percent for a 50-year old participant and 5 percent for a 30-year old, the plan would be age discriminatory. In making this determination, early retirement subsidies are not taken into account. In addition, the bill makes it clear that pre-retirement indexing of a benefit does not violate the age discrimination rules.

The bill also solves the "whipsaw" problem. Under current law, whipsaw occurs when a plan sponsor offers an interest rate credit under the plan that is greater than the 30-year Treasury rate. If the plan's interest rate exceeds the 30-year Treasury rate, the plan must pay a lump-sum benefit that is greater than the participant's account balance. The bill cures the whipsaw problem by permitting plan sponsors to use a "market rate" of interest instead of the 30-year Treasury rate and still pay a lump sum benefit equal to the participant's account balance. The market rate of interest is not clearly defined in the bill. Therefore, it appears that Treasury and the IRS will need to define it in guidance.

The bill would be effective for plan years beginning on or after June 29, 2005 (i.e., the provisions would be effective on a prospective basis only). The bill does not specifically address cash balance or hybrid conversions.