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The Pension Protection Act of 2006

Be Aware... Be Prepared!

Introduction

- PPA was signed by President Bush in August.
- Most extensive pension reform since ERISA in 1974.
- Reform influenced by recent series of events:
 - Stock market slump (2000-2003)
 - Low interest rate environment
 - 9-11-01
 - Subsequent economic slowdown
 - Airline failures
 - Corporate corruption
 - PBGC deficits
 - Hurricane Katrina

Agenda

- Defined Benefit Pension Plan Provisions
- Automatic Enrollment 401(k) Plans
- Investment Advice to Plan Participants
- Cash Balance Pension & Other Hybrid Plans
- EGTRRA Permanency
- Other Noteworthy Provisions



Defined Benefit Pension Plan Provisions

Completely New Funding Rules

- Old funding methods no longer apply.
- New funding rules are keyed solely to the plan's funded status.
- Funded status - a comparison of the value of plan assets to the present value of the benefit obligations at their valuation date.
- Plans with more than 100 employees use 1st day of plan year.
- Smaller plans may select a different date.

Determining Benefit Obligations

- Using reasonable actuarial assumptions both individually and in the aggregate.
- Interest and mortality assumptions are set by the Act.
- Plans are required to use different interest rates to value benefits, depending on when pension payments will begin.

Determining Benefit Obligations

- Benefit obligations are grouped in three “segments”:
 1. Benefits expected to be paid within 5 years,
 2. Benefits expected to be paid after 5 years but within 20 years,
 3. Benefit expected to be paid after 20 years.
- The “segment rates” are based on a corporate bond yield curve averaged over 2 years.
- Plans may elect to use a single “blended” interest rate based on the yield curve.

Determining Benefit Obligations

The corporate bond yield method will be phased in beginning in 2008, with full implementation in 2010.

Measuring Plan Assets

- Plan Assets are valued at fair market value as of the Valuation Date.
- The Act allows a two-year average value to reduce the effect of market fluctuations.
- However, the average value used, must lie between 90% and 110% of fair market value.

Determining Funded Status

- The ratio of plan assets to benefit obligations determines whether the plan is classified as:
 - Over Funded
 - Under Funded
 - At-Risk
- The funded status directly affects the amount of required contribution!

Determining Annual Contributions

The minimum required contribution equals the sum of two parts:

1. “Target Normal Cost” - the present value of benefits accrued during the plan year.
2. “Shortfall Amortization Installments” - a funding shortfall exists if during any plan year, plan assets are less than 100% of the present value of the benefit obligations. The funding shortfall is amortized in level installments over the next 7 years.

Determining Annual Contributions

The Act does provide some transition relief.

For purposes of determining whether a funding shortfall exists, the following ratios apply respectively:

- Plan Year 2008 - 92%
- Plan Year 2009 - 94%
- Plan Year 2010 - 96%

Special Rules for “At-Risk” Plans

“At-Risk” plans are of special concern because their status threatens the loss of benefits to participants and increased liabilities for the already financially strapped PBGC which has already racked up deficits of \$22.8 billion.

To combat these possibilities, the Act includes special rules that *increase contributions* for such plans and *impose additional reporting* requirements to the PBGC.

Special Rules for “At-Risk” Plans

A plan is “at-risk” if its funded percentage for the preceding year is:

1. less than 80%, determined *w/o regard* to the “at-risk” rules, and
2. less than 70%, determined *with regard* to the “at-risk” rules.

Transition rules reduce the 80% threshold to:

- 65% for 2008
- 70% for 2009
- 75% for 2010

Special Rules for “At-Risk” Plans

Determining the increased contribution requirement.

- Assumes all employees eligible for benefits payable within 10 years:
 1. Will retire at the earliest possible date and,
 2. Elect the most valuable form of benefit payment.
- Further, if the plan was also “at-risk” in 2 of prior 5 years the “target normal cost” is increased by 4% and,
- The value of liabilities used to calculate funding shortfalls is also increased by 4%, *plus*
- There is a \$700 loading factor per participant.

Other Rules for Under-Funded Plans

Benefit restrictions apply for poorly funded plans.

- Prohibitions for plans less than **80%** funded,
 1. No amendments are allowed which would:
 - Increase benefits,
 - Establish completely new benefits,
 - Change the rate of benefit accrual,
 - Change the rate of vesting.
 2. Lump-sum distributions are restricted to the lesser of:
 - 50% of the value of the accrued benefit, or
 - The actuarial equivalent the maximum permissible benefit guaranteed by the PBGC.

Other Rules for Under-Funded Plans

Benefit restrictions apply for poorly funded plans.

- Prohibitions for plans less than **60%** funded,
 1. All of the above restrictions, plus
 2. No lump-sum distributions are allowed.
 3. All benefit accruals must cease until the first plan year in which the funding is brought up to 60% level.
 4. Benefits payable on account of an unpredictable contingent event (i.e., plant shutdown) cannot be paid.

Other Restrictions Apply

The Act restricts an employer's ability to fund non-qualified deferred compensation plans for the company's top five executive officers.

- Funding restrictions apply during any such period:
 1. When the defined benefit pension plan is considered at-risk.
 2. When the employer is in bankruptcy.
 3. The 12-month period beginning six months before the termination of an unfunded plan .

New Deduction Limits

Existing plan contribution deduction limits are now obsolete!

- To facilitate faster funding before the new rules take effect, the deduction limits for 2006 and 2007 are increased to 150% of the plan's unfunded current liability as calculated under pre-Act law.
- Beginning in 2008 the new deduction limit is:
 1. The target normal cost, plus
 2. The amount to fully fund plan liabilities using "at-risk" standards, plus
 3. 50% of the unfunded liability, plus
 4. An additional cushion based upon future anticipated benefit increases, minus,
 5. The value of plan assets.

Changes to Lump-Sum Payments

Changes in the interest rate used in calculation will reduce the value of lump-sum payments.

- Determining lump-sum equivalents will now be based on the corporate bond yield curve similar to the funding rules.
- Corporate bond yield curve rates are generally higher than the 30-year Treasury rate.
- Higher interest rate assumptions generate lower lump-sum amounts.
- “Segment interest rates” will apply.
- The “segment interest rate” will depend on *when the benefit would have been payable* had the participant delayed payment until the plan normal retirement age.

Opinions

- Is this the end of DB plans?
- Freeze? Terminate? Convert to a cash balance plan?
- The way is cleared for increased conversions to Cash Balance plans & you can count on it happening.
- Generally, required DB plan contributions will increase
- Re-think investment strategy: Fixed income investment strategies highly correlated to the liability structure will reduce volatility of contributions.



Automatic Enrollment 401(k) Plans

ERISA Pre-Emption

The Act protects auto-enrollment plans against states' claims of violation of local payroll withholding laws.

In addition, it requires that the enrollment:

1. Provide notice to participants explaining the right to elect out of the plan, or
2. To change the rate of contribution,
3. Define the time periods for making elections, and
4. Explain how contributions will be invested in the absence of any other such election by the participant.

Nondiscrimination Safe Harbor

An optional safe harbor is created to satisfy the non-discrimination rules for elective deferrals and matching contributions.

1. Minimum employer match of 100% of employees' elective deferrals up to 1% of compensation, plus
 2. 50% of elective deferrals between 1% and 6% of compensation, or
 3. Non-elective 3% employer contribution.
- A plan qualifies for the auto-enrollment safe harbor only if the contribution rate for auto-enrollees is at least:
1. 3% in the first year of participation,
 2. 4% in the second,
 3. 5% in the third, and
 4. 6% thereafter.

Nondiscrimination Safe Harbor

- Vesting would have to be 100% after two years.
- Current law nondiscrimination safe harbor continues to be available for all 401(k) plans, including auto-enroll plans.

Other Auto-Enrollment Rules

- 404(c) protection will be provided to such plans if the default investment option for participants invests in multiple asset classes as to be further defined by DOL guidance.
- An auto-enrolled employee has a 90 day window to elect out of the plan and get his money (and related earnings) back; although the distribution will be taxable, the 10% early withdrawal tax will not apply.
- For auto-enrollment plans not relying on the safe harbor rules who make corrective refunds for violations, such refunds may be made up to six months after plan year end. (prior law allowed 2 1/2 months).
- Corrective distributions will be taxed in the year of distribution.
- Auto-enrollment plan provisions are effective in 2008.

Other DC Plan Rules

- Two other refund related changes which apply to such refunds from all 401(k) Plans:
 - First, gap-period earnings need only be added through the end of the preceding plan year if the refund is made within the six month window,
 - Second, all refunds, regardless of when made, will be taxed in the year of distribution.
- Top-heavy vesting rules will apply beginning in 2007 for all defined contribution plans as follows:
 - 3 -Year Cliff - 100% after 3 years, or
 - 6 -Year Graded - 20% after 2 years, then 20% per year thereafter.

Combined DB & DC Deduction Limits

- The combined tax-deduction limit will not apply if the contribution to the DC plan is 6% or less (elective deferrals are disregarded for such purposes).
- If the contribution exceeds 6%, only the excess will be counted toward the combined limit.
- Generally, this means the new combined deduction limit (where DC plans contribute 6% or less) will be the greater of:
 - The amount necessary to bring the DB plan to a 150% funded level, or
 - 25% of covered payroll.

Opinions

- The Act has set the course for things to come.
- You will see dramatic & innovative changes in service offerings among 401(k) service providers.
- Proceed with caution!
- Record-keeping systems will need to catch-up.
- Need to look for guidance from the DOL regarding investment options for automatically enrolled employees.
- Auto-enrollments will present communications challenges for it to be effective.



Investment Advice to Plan Participants

A New Prohibited Transaction Exemption

The Act permits “Fiduciary Advisers” to be compensated for providing investment advice to participants

- A “Fiduciary Adviser” may be:
 1. A registered investment adviser,
 2. A bank,
 3. An insurance company,
 4. A registered representative of a broker-dealer.
- Investment advice must be provided under an “Eligible Investment Advice Arrangement” which mandates two safeguards:
 1. Fees charged for the advice does not vary based on the investment options chosen by participants, or,
 2. Advice is based upon a computer-based asset allocation modeling program which is certified by an independent third party.

Investment Advice

- Both “Eligible Investment Advice Arrangements” must be audited annually.
- Participant disclosures include:
 - ✓ The fiduciary adviser’s fee arrangement.
 - ✓ The adviser’s relationship with the development of the computer model.
 - ✓ Certain investment performance statistics.
 - ✓ An acknowledgement of ERISA fiduciary status.
 - ✓ Other prescribed information (DOL to issue a model form).
- This is for advice rendered beginning in January 2007.

Note: While the Act provides limited liability protection regarding *participant* investment advice, employers are still required to *prudently select* and *prudently monitor* their investment advice provider.

Opinions

- This is not intended to circumvent existing guidance (e.g., Sun America DOL Advisory Opinion Letter).
- This applies to participant advice; Plan level advice is a separate issue.
- Emphasizes the need of employers to prudently select and monitor the Fiduciary Advisers to employees.
- Will broker-dealers acknowledge fiduciary status and allow their registered representatives to take on the role of Fiduciary Adviser?
- Requires a careful study of consultant's services agreement and limitation of liability clauses.



Cash Balance Pension & Other Hybrid Plans

Green Light for Cash Balance Plans

Uncertainties surrounding age-discrimination issues of pension conversions to cash balance plans are clarified!

- Cash Balance Plans (defined benefit type plans) are not age discriminatory so long as:
 - ✓ Benefits are fully vested after three years of service and,
 - ✓ The interest credits to account balances do not exceed a market rate of return, and
 - ✓ Any participant's accrued benefit is not less than any "Similarly Situated" younger employee's accrued benefit,
- "Similarly Situated" means that employees are identical in every respect (i.e., service, compensation, position, etc.) except age.

Cash Balance Plans

Other cash balance issues are clarified.

- Employers are prohibited from reducing or cutting any earned vested benefits during a conversion to a cash balance plan.
 - Effective for conversions after June 29, 2005.
- Whipsaw problems are eliminated by allowing the lump-sum distribution to be equal to the “hypothetical” account balance.
 - Effective for distributions made after the enactment.
- Benefits have to be 100% vested in no more than three years.
 - Effective for plan years beginning in 2008.

DB(k) Plans

An Eligible Combined Plan would be permitted to contain component features of a 401(k) Plan and a DB Plan.

- Each component would be subject to its respective rules.
- This plan design is limited to employers with less than 500 employees.
- The DB component will have to be either:
 - A 1% of final average pay formula up to 20 years, or
 - A cash balance formula that increase with the employee's age.
- The 401(k) component would have to include an automatic enrollment feature providing for:
 - A 4% automatic enrollment rate, and
 - Provide a 50% match on the first 4%.
 - Non-elective contributions would be permitted.

DB(k) Plans

- All employer-derived benefits under the DB component and all non-elective contributions under the DC component would have to be vested in no more than three years of service.
- 100% vesting will be applied to matching contributions.
- ADP/ACP test will be deemed to be satisfied.
- One form 5500 filing.
- Nondiscrimination and coverage testing would have to be satisfied:
 - without regard to contributions or benefits under another plan, and
 - without regard to permitted disparity.
- Effective for plan years beginning in 2010.

Opinions

- In the mid to late 90s the adoption of and conversion to cash balance plans was gaining traction.
- Litigation, unfavorable court decisions and an IRS moratorium on determination letters abruptly ended the trend.
- Clarity in regards to the age discrimination issue eliminates the controversy and should have a positive impact for cash balance plans.



EGTRRA Permanency

EGTRRA's Key Provisions

Economic Growth and Tax Relief Reconciliation Act of 2001 will not “sunset” in 2010 as was scheduled.

- Increased the amounts individuals could contribute to tax-favored IRAs, SIMPLE plans, 401(k), 403(b) and 457 retirement plans.
- Increased other limits on contributions, covered compensation amounts and pension benefits.
- Permitted “catch-up” contributions to IRAs and employer sponsored plans for individuals age 50 and older.
- Permitted Roth contributions to 401(k) plans and 403(b) plans.
- Enhanced portability of retirement benefits by expanding rollover options.

EGTRRA's Key Provisions

Economic Growth and Tax Relief Reconciliation Act of 2001 will not “sunset” in 2010 as was scheduled.

- Qualified distributions from 529 plans will continue to be TAX-FREE after 2010.
- Saver's Tax Credit set to expire 12-31-06 made permanent.

Opinions

- Significance can not be overstated.
- Signals a clear change in attitude and policy in Washington towards private pensions compared to late eighties.
- This EGTRRA permanence adopted in concert with the other provisions of PPA, provides strong support for the private pension system which is needed to supplement the ailing Social Security system.



Other Noteworthy Provisions

Other Noteworthy Provisions

- Effective for distributions after 2006, a non-spouse beneficiary may roll their inherited retirement plan distribution into an IRA rather than being cashed out and taxed.
- Effective in 2008, direct rollovers from a qualified plan, 403(b) plan or governmental 457 plan may be made to an IRA.
- Treasury Dept. to issue regulations for Hardship distributions for a person who is the participant's beneficiary under the plan and experienced an unforeseen emergency (think of Katrina).
- IRAs and 401(k) plans will be able to make distributions to Qualified Reservist called up to active duty for a minimum period and would be exempt from the 10% premature distribution penalty.

Other Noteworthy Provisions

- A DB plan will be permitted to allow for in-service distributions to participants who have attained age 62 even if the NRD is later.
- The Act expands the ability to transfer excess assets within a defined benefit pension plan to fund retiree health benefits.
- Retirement Plan benefit statements would be required:
 1. Quarterly for participant-directed DC plans,
 2. Annually for DC plans and
 3. Every three years for DB plans.
- The Act requires any DC plan that hold publicly traded employer securities to permit participants to diversify account balance invested in those securities (think Enron & WorldCom).

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Thank you !



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