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Summary of the Pension Protection Act of 2006

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Summary

On July 28, 2006, the House of Representatives passed H.R. 4, the Pension Protection Act, by a vote of 279-131. The bill was passed by the Senate on August 3 by a vote of 93-5 and was signed into law by the President as P.L. 109-280 on August 17, 2006. The Pension Protection Act is the most comprehensive reform of the nation's pension laws since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA, P.L. 93-406). It establishes new funding requirements for defined benefit pensions and includes reforms that will affect cash balance pension plans, defined contribution plans, and deferred compensation plans for executives and highly compensated employees.

Prompted by the default in recent years of several large defined benefit pension plans and the increasing deficit of Pension Benefit Guaranty Corporation (PBGC), the Bush Administration in January 2005 advanced a proposal for pension funding reform, which was designed to increase the minimum funding requirements for pension plans and strengthen the pension insurance system.

In 2005, major pension reform bills were introduced in both the Senate and the House of Representatives. In the Senate, Senator Charles Grassley, Chairman of the Finance Committee, introduced S. 1783, the Pension Security and Transparency Act. In the House, Representative John Boehner, then Chairman of the Committee on Education and the Workforce, introduced H.R. 2830, the Pension Protection Act, which subsequently was renumbered as H.R. 4. The legislation ultimately passed by the House and Senate and signed into law by the President on August 17, 2006, was based mainly on these two bills, with the final version being the result of conference negotiations between the House and Senate that began in March 2006 and continued through July.

This report summarizes the main provisions of the Pension Protection Act (PPA) as they affect single-employer defined benefit plans, multiemployer defined benefit plans, and defined contribution plans. It will not be updated.

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Prompted by the default in recent years of several large defined benefit pension plans and the increasing deficit of Pension Benefit Guaranty Corporation (PBGC), the Bush Administration in January 2005 advanced a proposal for pension funding reform, which was designed to increase the minimum funding requirements for pension plans and strengthen the pension insurance system. The Administration pointed out several weaknesses of the rules that were then in place:

- Sponsors of underfunded plans were not required to make additional contributions — called *deficit reduction contributions* — as long as their plans were at least 90% funded.

- Because the interest rates used to calculate current pension plan liabilities were averaged over a four-year period and asset values used to calculate minimum funding requirements could be averaged over five years, neither plan assets nor liabilities were measured accurately.

- Plans that were underfunded were sometimes able to amortize their funding shortfalls over periods as long as 30 years.[1]

- Some sponsors of underfunded pensions were able to avoid making contributions to their plans for several years because they had made contributions beyond the required minimum in the past. The use of these so-called "credit balances" led to greater underfunding of pension plans, according to the Administration's analysis.

The possibility that the termination of defined benefit pension plans with large unfunded liabilities might eventually lead to the insolvency of PBGC — created by

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[1] Liabilities arising from plan amendments that increased benefits under the plan could be amortized over 30 years.

Congress in 1974 to insure defined benefit pension plans of private-sector employers — lent a particular urgency to the effort to mandate improved pension plan funding. Although the PBGC receives no appropriations from Congress, it is generally acknowledged that if the agency were to become financially insolvent — threatening the retirement income of the 44 million Americans who have earned benefits under defined benefit pension plans — Congress would have little choice but to step in and engineer a financial bailout of the agency.[2] In 2000, the PBGC recorded a $9.7 billion surplus, but several years of falling interest rates and declining stock prices and the termination of several large, underfunded pension plans led to a rapid deterioration in the PBGC's financial position. Nine of the ten largest pension plan claims for PBGC insurance occurred between 2001 and 2005. (See **Table 1**.) These nine claims accounted for 63% of the total dollar value of claims made on the PBGC since the agency began operating in 1975. By 2005, the PBGC had a funding deficit of $22.7 billion, only slightly lower than the record deficit of $23.3 billion that the agency posted in 2004.

Table 1. Ten Largest Claims Against the PBGC, 1975-2005

Name of firm	Year of termination	Claim, in millions	Vested participants	Percentage of all PBGC claims
United Airlines	2005	$7,094	122,541	22.7%
Bethlehem Steel	2003	3,654	97,015	11.5
U.S. Airways	2003, 2005	2,862	58,823	9.0
LTV Steel	2002-2004	1,960	80,961	6.2
National Steel	2003	1,161	35,404	3.7
Pan American Air	1991, 1992	841	37,485	2.7
Weirton Steel	2004	690	9,196	2.2
Trans World Airlines	2001	668	34,257	2.1
Kemper Insurance	2005	566	12,221	1.8
Kaiser Aluminum	2004	566	17,591	1.8
Top 10 claims (total)		**$20,062**	**505,494**	**63.3%**
All other claims (total)		**11,646**	**1,178,762**	**36.7**
All claims on PBGC		**31,708**	**1,684,256**	**100.0**

Source: Pension Benefit Guaranty Corporation, *Pension Insurance Data Book, 2005*, p. 32.

In 2005, major pension reform bills were introduced in both the Senate and the House of Representatives. In the Senate, Senator Charles Grassley, Chairman of the Finance Committee, introduced S. 1783, the Pension Security and Transparency Act.

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[2] The PBGC receives revenue mainly from the premiums paid to it by companies that sponsor defined benefit pensions and investment returns on the assets in its trust fund.

In the House, Representative John Boehner, then Chairman of the Committee on Education and the Workforce, introduced H.R. 2830, the Pension Protection Act, which subsequently was renumbered as H.R. 4. The legislation ultimately passed by the House and Senate and signed into law by the President on August 17, 2006, was based mainly on these two bills, with the final version being the result of conference negotiations between the House and Senate that began in March 2006 and continued through July. This report summarizes the main provisions of the Pension Protection Act (PPA) as they affect single-employer defined benefit plans, multiemployer defined benefit plans, and defined contribution plans.

Single-Employer Plans

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, federal law has required companies that sponsor defined benefit pension plans for their employees to prefund the pension benefits that the plan participants earn each year. If a plan is underfunded, the plan sponsor must amortize (pay off with interest) this unfunded liability over a period of years. The Pension Protection Act (PPA) establishes new rules for determining whether a defined benefit pension plan is fully funded, the contribution needed to fund the benefits that plan participants will earn in the current year, and the contribution to the plan that is required if previously earned benefits are not fully funded. In general, the new rules become effective in 2008, but many provisions of the law will be phased in over several years.

Minimum funding standards for single-employer plans. Pension plan liabilities extend many years into the future. Determining whether a pension is adequately funded requires converting a future stream of pension payments into the amount that would be needed today to pay off those liabilities all at once. This amount — the "present value" of the plan's liabilities — is then compared with the value of the plan's assets. An underfunded plan is one in which the value of the plan's assets falls short of the present value of its liabilities by more than the percentage allowed under law. Converting a future stream of payments (or income) into a present value requires the future payments (or income) to be discounted using an appropriate interest rate. Other things being equal, the *higher* the interest rate, the *smaller* the present value of the future payments (or income), and vice versa.

Beginning in 2008, the PPA introduces new funding requirements for single-employer defined benefit pension plans. The law establishes new rules for calculating plan assets and liabilities, and it eliminates deficit-reduction contributions for underfunded plans. When it is fully phased in, the law will require plan funding to be equal to 100% of the plan's liabilities. Any unfunded liability will have to be amortized over seven years. Sponsors of severely underfunded plans that are at risk of defaulting on their obligations will be required to fund their plans according to special rules that will result in higher employer contributions to the plan. Plan sponsors will continue to be allowed to use credit balances to offset required contributions, but only if the plan is funded at 80% or more. The value of credit balances will have to be adjusted to reflect changes in the market value of plan assets since the date the contributions that created the credit balances were made.

Under the PPA, a plan sponsor's minimum required contribution will be based on the plan's *target normal cost* and the difference between the plan's *funding target* and the value of the plan's assets. The plan's target normal cost is the present value of all benefits that plan participants will accrue during the year. The funding target is the present value of all benefits, including early retirement benefits, already accrued by plan participants as of the beginning of the plan year. If a plan's assets are less than the funding target, the plan has an *unfunded liability*. This liability, less any permissible credit balances, must be amortized in annual installments over seven years. The plan sponsor's minimum required annual contribution is the plan's target normal cost for the plan year, but not less than zero. The 100% funding target will be phased in at 92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011 and later years. The phase-in will not apply to plans that are already underfunded to the extent that they are subject to the deficit reduction contribution rules in 2007. Those plans will have a 100% funding target beginning in 2008.

Federal law prescribes the interest rate that pension plans must use to calculate the present value of plan liabilities. The PPA requires plans to discount future liabilities using three different interest rates, depending on the length of time until the liabilities must be paid. The interest rates correspond to the length of time until the obligations are due to be paid. A short-term interest rate will be used to calculate the present value of liabilities that will come due within five years. A mid-term interest rate will be used for liabilities that will come due in 5 to 15 years, and a long-term interest rate will be applied to liabilities that will come due in more than 15 years. The Secretary of the Treasury will determine these rates, which will be derived from a "yield curve" of investment-grade corporate bonds averaged over the most recent 24 months.[3] The yield curve requirement will be phased in over three years beginning in 2007. It will replace the four-year average of corporate bond rates established under Pension Funding Equity Act of 2004 (P.L. 108-218), which expired on December 31, 2005.[4]

"At risk" plans. The PPA introduces a new concept to be applied in determining a plan sponsor's required contribution to the plan. Pension plans that are determined to be at risk of defaulting on their liabilities will be required to use specific actuarial assumptions in determining plan liabilities that will increase the plan sponsor's required contributions to the plan. A plan will be deemed at-risk if it is unable to pass either of two tests. Under the first test, a plan is deemed to be at-risk if it is less than 70% funded under the "worst-case scenario" assumptions that (1) the employer is not permitted to use credit balances to reduce its cash contribution and (2) employees will retire at the earliest possible date and will choose to take the most expensive form of benefit. If a plan does not pass this test, it will be deemed to be at-risk *unless* it is at least 80% funded under standard actuarial assumptions. This latter test will be phased in over four years, with the minimum funding

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[3] A yield curve is a graph that shows interest rates on bonds plotted against the maturity date of the bond. Normally, long-term bonds have higher yields than short-term bonds because both credit risk and inflation risk rise as the maturity dates extend further into the future. Consequently, the yield curve usually slopes upward from left to right.

[4] The PPA extends the interest rates permissible under P.L. 108-218 through 2007 for purposes of the current liability calculation.

requirement starting at 65% in 2008 and rising to 70% in 2009, 75% in 2010, and 80% in 2011. If a plan passes either of these two tests, it will not be deemed to be at-risk; however, it will still be required to make up its funding shortfall over no more than seven years. Plans that have been in at-risk status for at least two of the last four years also will be subject to an additional "loading factor" of 4% of the plan's liabilities plus $700 per participant, which will be added to the plan sponsor's required contribution to the plan. Plan years prior to 2008 will not count for this determination. Plans with 500 or fewer participants in the preceding year would be exempt from the at-risk funding requirements.

Mortality tables. To estimate a pension plan's future obligations, the plan's actuaries use mortality tables to project the number of participants who will claim benefits and the average length of time that participants and their surviving beneficiaries will receive pension payments. Under the PPA, the Secretary of the Treasury will prescribe the mortality tables to be used for these estimates. Large plans may petition the IRS to use a plan-specific mortality table.

Valuation of plan assets. Under prior law, a plan sponsor could determine the value of a plan's assets using actuarial valuations, which can differ from the current market value of those assets. For example, in an actuarial valuation, the plan's investment returns could be "smoothed" (averaged) over a five-year period, and the average asset value could range from 80% to 120% of the fair market value. Averaging asset values over a period of years is permitted because pension plans are considered long-term commitments, and averaging reduces volatility in the measurement of plan assets that can be caused by year-to-year fluctuations in interest rates and the rate of return on investments. Averaging asset values therefore reduces the year-to-year volatility in the plan sponsor's required minimum contributions to a defined benefit pension plan. The PPA narrows the range for actuarial valuations to no less than 90% and no more than 110% of fair market value, and it reduces the maximum smoothing period to two years. Plans with more than 100 participants will be required to use the first day of the plan year as the basis for calculations of plan assets and liabilities. Plans with 100 or fewer participants can choose another date.

Plan contributions and credit balances. Within certain limits, plan sponsors will continue to be able to offset required current contributions with previous contributions. However, these so-called "credit balances" can be used to reduce the plan sponsor's minimum required contribution to the plan only if the plan's assets are at least 80% of the funding target, not counting prefunding balances that have arisen since the new law became effective. Existing credit balances and new prefunding balances must both be subtracted from assets in determining the "adjusted funding target attainment" percentage that is used to determine whether certain benefits can be paid and whether benefit increases are allowed. Credit balances also have to be adjusted for investment gains and losses since the date of the original contribution that created the credit balance. Credit balances must be separated into two categories: balances carried over from 2007 and balances resulting from contributions in 2008 and later years.

Benefit limitations in underfunded plans. The PPA places limits on (1) plan amendments that would increase benefits, (2) benefit accruals, and (3) benefit

distribution options (such as lump sums) in single-employer defined benefit plans that fail to meet specific funding thresholds.

Shutdown benefits. Shutdown benefits are payments made to employees when a plant or factory is shut down. These benefits typically are negotiated between employers and labor unions, and usually they are not prefunded. The PPA prohibits shut-down benefits and other "contingent event benefits" from being paid by pension plans that are funded at less than 60% of full funding unless the employer makes a prescribed additional contribution.[5] The PBGC guarantee for such benefits will be phased in over a five-year period commencing when the event occurs, but this provision is not applicable for the first five years of a plan's existence.

Restrictions on benefit accruals. The PPA requires benefit accruals to cease in plans funded at less than 60%. Once a plan is funded above 60%, the employer — and the union in a collectively bargained plan — must then decide how to credit past service accruals. This provision does not apply during the first five years of a plan's existence, or if the employer makes an additional contribution prescribed by the statute.

Restrictions on benefit increases. Plan amendments that increase benefits are prohibited if the plan is funded at less than 80% of the full funding level, unless the employer makes additional contributions to fully fund the new benefits. Benefit increases include increases in the rate of benefit accrual or a change in the rate at which benefits become vested. This provision is not applicable for the first five years of a plan's existence.

Restrictions on lump-sum distributions. Lump-sum distributions are prohibited if the plan is funded at less than 60% of the full funding level or if the plan sponsor is in bankruptcy and the plan is less than 100% funded. If the plan is funded at more than 60% but less than 80%, the plan may distribute as a lump sum no more than half of the participant's accrued benefit.

Nonqualified deferred compensation. Executives and other highly compensated employees are sometimes covered under employer-sponsored retirement plans that are separate from those that cover rank-and-file employees. Because the benefits under these plans often exceed the limits prescribed by ERISA, they do not qualify for the favorable tax treatment that most pensions covering rank-and-file employees are qualified to receive. Thus, these deferred compensation plans for executives are commonly referred to as "nonqualified plans." Provided that they meet certain requirements under the Internal Revenue Code (IRC), nonqualified plans are sometimes permitted to set aside funds to prefund deferred compensation for executives without the funds being treated as income to the plan participants in the

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[5] In 2004, the 6th U.S. Circuit Court of Appeals ruled that the PBGC could set a plan termination date that would prevent the agency from being liable for shutdown benefits. In March 2005, the U.S. Supreme Court declined to hear the case, leaving the Circuit Court's decision in place.

year that the contribution to the trust is made.[6] The PPA establishes rules for taxing amounts set aside to prefund nonqualified deferred compensation for executives during a "restricted period." A restricted period occurs if (1) the plan sponsor's defined benefit plan is in at-risk status, (2) the plan sponsor is in bankruptcy, or (3) the plan sponsor's defined benefit plan is terminated in an involuntary or distress termination. Amounts set aside to prefund nonqualified deferred compensation for the plan sponsor's chief executive officer and four highest-compensated officers during a restricted period will be treated as taxable income to these individuals and will be subject to a 20% excise tax.

Notice to participants. The PPA requires plan sponsors to notify participants of restrictions on shutdown benefits, lump-sum distributions, or suspension of benefit accruals within 30 days of the plan being subject to any of these restrictions. The restrictions on benefits in underfunded plans are effective in 2008, but not before 2010 for collectively bargained plans.

Calculating lump-sum distributions. Federal law requires defined benefit pensions to offer participants the option to receive their accrued benefits in the form of an annuity — a series of monthly payments guaranteed for life. Many defined benefit plans also offer participants the option to take their accrued benefits as a single lump sum at the time they separate from the employer. The amount of a lump-sum distribution from a defined benefit pension is inversely related to the interest used to calculate the present value of the benefit that has been accrued under the plan: the higher the interest rate, the smaller the lump sum, and vice versa. Under prior law, lump-sum distributions were calculated using the average interest rate on 30-year Treasury bonds. The PPA replaces the 30-year Treasury bond interest rate as the interest rate for calculating lump-sum distributions from defined benefit plans.[7]

Beginning in 2008, plan sponsors must calculate lump-sum distributions using a three-segment interest rate yield curve, derived from the rates of return on investment-grade corporate bonds of varying maturities. Plan participants of different ages will have their lump-sum distributions calculated using different interest rates. Other things being equal, a lump-sum distribution paid to a worker who is near the plan's normal retirement age will be calculated using a lower interest rate than will be used for a younger worker. As a result, all else being equal, an older worker will receive a larger lump sum than a similarly situated younger worker. The interest rates used to calculate lump sums will be based on *current* bond rates rather than the three-year *weighted average* rate used to calculate the plan's funding target. The new rules for calculating lump sums will be phased in over five years. Plans funded at less than 60% will be prohibited from paying lump-sum distributions. Plans funded at 60% to 80% can pay no more than half of an accrued benefit as a lump-sum distribution.

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[6] Unlike the pension trusts established for qualified plans, which are protected from the claims of creditors if the plan sponsor enters bankruptcy, trusts established to prefund nonqualified deferred compensation arrangements usually are not protected in bankruptcy.

[7] This is also sometimes referred to as the "417(e)" rate after IRC §417(e).

The PPA also establishes a new interest rate floor for testing whether a lump sum paid from a defined benefit plan complies with the limitations under IRC §415(b). In general, IRC §415(b) limits the annual single-life annuity payable from a defined benefit plan to the lesser of 100% of average compensation or $175,000 (in 2006). Benefits paid as a lump sum or other optional form must be converted to an equivalent annuity value for purposes of applying this limit. The PPA requires plans making this calculation to use an interest rate that is no lower than the highest of (1) 5.5%, (2) the rate that results in a benefit of no more than 105% of the benefit that would be provided if the interest rate required for determining a lump-sum distribution were used, or (3) the interest rate specified in the plan documents. This provision is effective for plan years beginning after 2005.

Cash balance plans and other hybrid plans. The PPA clarifies that cash balance plans do not discriminate against older workers as long as benefits are fully vested after three years of service and interest credits do not exceed a market rate of return.[8] The law also provides that the age discrimination test is met if a participant's accrued benefit is not less than the accrued benefit of any other employee similarly situated in all respects except age.[9] The accrued benefit can be tested on the basis of an annuity payable at normal retirement age, a hypothetical account balance, or the current value of the accumulated percentage of the employee's final average pay. The law prohibits *wear-away* of benefits accrued before the conversion of a plan to a cash balance plan if the conversion occurred after June 29, 2005.[10] Earlier conversions may still be subject to legal challenge under the laws in effect at the time of the conversion. These provisions are effective beginning in 2008.

Under prior law, there were circumstances under which the employer that sponsored a cash balance plan was required to pay a departing employee an amount that exceeded the nominal value of the employee's cash balance account.[11] The PPA eliminates this requirement (called "whipsaw") by allowing lump-sum distributions from cash balance plans to be equal to the hypothetical account balances. This is effective for distributions made after the date of enactment. Beginning in 2008, cash balance plans and other hybrid plans would be required to fully vest participants in their accrued benefits after no more than three years of service. With respect to cash

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[8] See CRS Report RL30196, *Pension Issues: Cash-Balance Plans*, by Patrick Purcell, and CRS Report RS22214, *Cash Balance Pension Plans: Selected Legal Issues and the Pension Protection Act of 2006*, by Erika Lunder and Jennifer Staman.

[9] To be "similarly situated" means that the employees are identical with respect to length of service, compensation, and other factors that would affect accrued pension benefits.

[10] A "wear-away" period or "benefit plateau" occurs if a plan participant accrues no new benefits for a period of time after the conversion to a cash balance plan. This can occur if the employer establishes the employee's initial benefit under the cash balance plan at an amount that is less than the value of the benefit he or she had accrued prior to the conversion. If the employee terminates service prior to the end of the wear-away period, he or she is entitled to the benefit amount accrued before the conversion if it exceeds the nominal value of the employee's cash balance account.

[11] This occurs when the interest rate credited to amounts in the cash balance plan is higher than the interest rate required for calculating lump-sum distributions under IRC §417(e).

balance plans and other hybrid plans, the PPA is prospective only and would not affect the legal status of hybrid plans established before the law was enacted.

Pension Benefit Guaranty Corporation. The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to insure pension benefits under private-sector defined benefit pension plans. The PBGC receives no appropriations from Congress. It is funded by premiums paid by plan sponsors and investment returns on the assets held in its trust fund. The PBGC does not have the legal authority to set its own premiums, which are set in law by Congress. The PBGC receives two types of premiums from plans sponsored by individual employers: a per-capita premium that is charged to all single-employer defined benefit plans and a variable premium charged to underfunded plans equal to $9 per $1,000 of underfunding (0.9%). The Deficit Reduction Act of 2005 (P.L. 109-171) increased the per capita premium from $19 per year to $30 per year, beginning in 2007. Future premiums will be indexed to average national wage growth. The flat-rate premium for multiemployer plans is $8 per person and will be indexed to wage growth in future years.

Under prior law, an underfunded plan was exempted from the variable-rate premium of $9 per $1,000 of underfunding if it was not underfunded in any two consecutive years out of the previous three years. Under the PPA, the variable premium will be assessed on all underfunded plans, regardless of the plan's funding status in earlier years. For employers with 25 or fewer employees, the variable premium is capped at $5. The variable-rate premium must be computed using a three-segment yield curve beginning in 2008. The PPA makes permanent a surcharge premium for certain distress terminations, which was added by the Deficit Reduction Act of 2005 and was to expire in 2010. A surcharge of $1,250 per participant will be assessed for three years against any firm that terminates an underfunded pension plan during bankruptcy if it later emerges from bankruptcy. The PPA also authorizes the PBGC to pay interest on overpayment of premiums, effective upon enactment.

The PPA requires the director of the Pension Benefit Guaranty Corporation to be appointed by the President, subject to confirmation by the Senate Committee on Finance and Senate Committee on Health, Education, Labor and Pensions.

Limit on tax deductions for employer contributions. Beginning in 2008, the maximum deductible employer contribution to a defined benefit plan will be (1) the plan's target normal cost plus (2) 150% of the funding target plus (3) an allowance for future pay or benefit increases minus (4) the value of the plan's assets. In 2006 and 2007, the deduction limit will be to 150% of the plan's current liability minus the value of the plan's assets. Contributions in excess of this limit are subject to a 10% excise tax. The PPA also repeals the alternative maximum deductible contribution as determined using an interest rate of 90% to 105% of the four-year weighted average rate on 30-year Treasury bonds.

Combined limit under IRC §404(a)(7). Section 404(a)(7) of the Internal Revenue Code establishes limits on employer tax deductions for contributions made in connection with one or more defined contribution plans *and* one or more defined benefit plans. One effect of these limits is that large contributions to a defined benefit plan can result in the employer's contributions to the defined contribution

plan being nondeductible for that year. The PPA revises the law such that the combined contribution limit under §404(a)(7) will be determined without regard to defined benefit plans that are insured by the PBGC. In addition, only employer contributions to a defined contribution plan that exceed 6% of participant compensation will be subject to the limit. Employees' elective deferrals will continue to be disregarded from the deduction limits.

Multiemployer Plans

Multiemployer plans are collectively bargained plans maintained by several employers — usually within the same industry — and a labor union. Multiemployer defined benefit plans are subject to funding requirements that differ from those for single-employer plans. Most of the funding requirements for multiemployer plans that were in effect before enactment of the PPA remain in effect under the new law. The PPA establishes a new set of rules for improving the funding of multiemployer plans that the law defines as being in "endangered" or "critical" status. These new requirements will remain in effect through 2014.

The PPA establishes new requirements for multiemployer plans that are seriously underfunded. A plan's actuaries will have 90 days after the start of the plan year to certify the funding status of the plan for that year and to project its funding status for the following six years. If the plan is underfunded, it will have 30 days after the actuarial certification to notify participants and approximately eight months to develop a funding schedule to present to the parties of the plan's collective bargaining agreement. The schedule must be designed to meet the statutory funding requirements before the end of the funding improvement period. For multiemployer plans in "critical status," the law makes changes in the *anti-cutback rules* of ERISA to give plans the right to eliminate or reduce some benefit payment options and early retirement benefits for plan participants who have not yet retired. The law also establishes new disclosure requirements for multiemployer plans.

Funding requirements for multiemployer plans. The PPA requires plans to amortize over 15 years (rather than 30 years, as under prior law) any increases in plan liabilities that are due to benefit increases or to changes in the actuarial assumptions used by the plan. Amounts already being amortized under the old amortization schedule need not be recalculated.

The PPA increases the limit on tax-deductible employer contributions to multiemployer plans to 140% of the plan's current liability (up from 100%), and it eliminates the 25%-of-compensation combined limit on contributions to defined benefit and defined contribution plans. These provisions are effective beginning with the 2006 tax year. The law will allow the Internal Revenue Service (IRS) to permit multiemployer plans that project a funding deficiency within 10 years to extend the amortization schedule for paying off its liabilities by five years, with a further five-year extension permissible. It requires such plans to adopt a recovery plan and to use specific interest rates for plan funding calculations.

Requirements for underfunded multiemployer plans. The PPA establishes mandatory procedures, effective through 2014, to improve the funding of seriously underfunded multiemployer plans. Under the PPA, a plan is considered

to be *endangered* if it is less than 80% funded *or* if the plan is projected to have a funding deficiency within seven years. A plan that is less than 80% funded *and* is projected to have a funding deficiency within seven years is considered to be *seriously endangered*. An endangered plan has one year to implement a "funding improvement plan" designed to reduce the amount of under-funding. Endangered plans have 10 years to improve their funding. They must improve their funding percentage by one-third of the difference between 100% funding and the plan's funded percentage from the earlier of (1) two years after the adoption of the funding improvement plan or (2) the first plan year after the expiration of collective bargaining agreements that cover at least 75% of the plan's active participants.

Seriously endangered plans that are less than 70% funded will have 15 years to improve their funding. They must improve their funding percentage by one-fifth of the difference between 100% funding and the plan's funded percentage from the earlier of (1) two years after the adoption of the funding improvement plan or (2) the first plan year after the expiration of collective bargaining agreements that cover at least 75% of the plan's active participants. A plan that is endangered or seriously endangered may not increase benefits. If the parties to the collective bargaining agreement are not able to agree on a funding improvement plan, a default funding schedule will apply. This schedule would reduce future benefit accruals. Additional contribution requirements will apply only if they are needed to achieve the funding improvement required by the law. A plan is not endangered in any plan year in which the required funding percentages are met.

A multiemployer plan is considered to be in *critical status* if (1) it is less than 65% funded and has a projected funding deficiency within five years or will be unable to pay benefits within seven years; (2) it has a projected funding deficiency within four years or will be unable to pay benefits within five years (regardless of its funded percentage); or (3) its liabilities for inactive participants are greater than its liabilities for active participants, its contributions are less than carrying costs, and a funding deficiency is projected within five years. A plan in critical status has one year to develop a rehabilitation plan designed to reduce the amount of underfunding. The plan sponsors will not be required to make "lump-sum" contributions that normally are required to meet the minimum funding standard when a plan has an accumulated funding deficiency. Employers will not be subject to an excise tax if a funding deficiency occurs as long as the plan is meeting its obligations under the rehabilitation plan and under the collective bargaining agreements negotiated to improve plan funding.

Reductions in adjustable benefits. In general, ERISA prohibits reductions in accrued, vested benefits. These provisions of ERISA are commonly called "anti-cutback" rules. The PPA changes the ERISA anti-cutback rules so that plans in critical status are permitted to reduce or eliminate early retirement subsidies and other "adjustable benefits" to help improve their funding status *if* this is agreed to by the bargaining parties. Benefits payable at normal retirement age *cannot* be reduced, and plans are not permitted to cut any benefits of participants who retired before they were notified that the plan is in critical status. Adjustable benefits include certain optional forms of benefit payment, disability benefits, early retirement benefits, joint and survivor annuities (if the survivor benefit exceeds 50%), and

benefit increases adopted or effective less than five years before the plan entered critical status.

The plan must notify all affected parties within 30 days after a determination is made that the plan is in critical status. Beginning 30 days after this notification, a 5% employer surcharge will apply to keep plan funding from deteriorating while the rehabilitation plan is being developed. This surcharge increases to 10% in the second year and stays in effect until the rehabilitation plan has been approved. During this period, increases in benefits and reductions in contributions are prohibited. The surcharge is no longer required beginning on the effective date of a collective bargaining agreement that includes a rehabilitation plan.

A plan has 10 years to move out of critical status from the earlier of (1) two years after adoption of the rehabilitation plan or (2) the first plan year after the beginning of collective bargaining agreements covering 75% of active participants. If the parties to the collective bargaining agreements fail to agree on a funding improvement plan, a default schedule will apply that assumes no increases in contributions — unless necessary to exit critical status — after benefit accruals and adjustable benefits have been reduced to the extent permitted by law. A plan exits critical status if it no longer projects a funding deficiency within 10 years.

Disclosure requirements. The PPA requires annual funding notices to be sent out 120 days after the end of the plan year, rather than within 11½ months after the end of the plan year, as under prior law. The Department of Labor will post information from plans' annual reports on its website, and plans will be required to provide certain information to participants on request. For plans in endangered or critical status, the plan actuary must certify that the funding improvement is on schedule. Annual reports must contain information on funding improvement plans or rehabilitation plans. Notification must be provided to participants, beneficiaries, bargaining parties, the PBGC, and the Secretary of Labor within 30 days after the plan determines that it is in endangered or critical status.

Defined Contribution Plans

Economic Growth and Tax Relief Reconciliation Act of 2001. The PPA makes permanent the higher benefit limits in defined benefit plans, higher contribution limits for individual retirement accounts and defined contribution plans, and catch-up contributions for workers 50 and older that were included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). These provisions had been scheduled to expire on December 31, 2010.

Coverage and nondiscrimination. Federal law prohibits tax-qualified retirement plans from discriminating in favor of highly compensated employees (HCEs) with regard to coverage, amount of benefits, or availability of benefits. A "highly compensated employee" is defined in law as any employee who owns 5% or more of the company or whose compensation exceeds $100,000 (indexed to inflation). An employer can elect to count as HCEs only those employees who rank in the top 20% of compensation in the firm, but it must include all 5% owners.

To be tax-qualified, a §401(k) plan must satisfy one of two tests: either the proportion of non-highly compensated employees (NHCEs) covered by the plan must be at least 70% of the proportion of highly compensated employees (HCEs) covered by the plan, or the average contribution percentage for NHCEs must be at least 70% of the average contribution percentage for HCEs.[12] Contributions to a plan cannot discriminate in favor of HCEs. Plans that have after-tax contributions or matching contributions are subject to the "actual contribution percentage" (ACP) test, which measures the contribution rate to HCE accounts relative to the contribution rate to NHCE accounts. Some §403(b) plans are subject to nondiscrimination rules; §457 plans generally are not. The actual contribution percentage of HCEs in a §401(k) plan generally cannot exceed the limits shown in **Table 2**.

Table 2. Maximum Average 401(k) Contributions for Highly Compensated Employees

Non-highly compensated employees (NHCEs)	Highly compensated employees (HCEs)
Maximum average deferral and match	*Maximum average deferral and match*
2% of pay or less	NHCE percentage x 2
2% to 8% of pay	NHCE percentage + 2%
8% of pay or more	NHCE percentage x 1.25

Note: "Deferral and match" equals the sum of employer and employee contributions.

Any of three "safe-harbor" designs are deemed to satisfy the ACP test automatically for employer matching contributions (up to 6% of compensation):

- The employer matches 100% of employee elective deferrals up to 3% of compensation, and 50% of elective deferrals between 3% and 5% of compensation, and all employer matching contributions are fully vested.

- Employer-matching contributions can follow any other matching formula that results in total matching contributions that are no less than under the first design. All employer-matching contributions vest immediately.

- The employer automatically contributes an amount equal to at least 3% of pay for all eligible NHCEs. Employer contributions vest immediately.

All §401(k) plans must satisfy an "actual deferral percentage" (ADP) test, which measures employees' elective-deferral rates. The same numerical limits are used as

[12] For the purposes of the latter test, the average contribution percentage is defined as all employer contributions divided by total compensation. A third test — that at least 70% of NHCEs must be covered by the plan — will automatically satisfy the first test listed above.

under the ACP test. Three "safe-harbor" designs, similar to the safe-harbor designs for the ACP test, are deemed to satisfy the ADP test automatically. In addition, "cross-testing" allows defined contribution plans to satisfy the nondiscrimination tests based on projected account balances at retirement age, rather than current contribution rates. This permits bigger contributions for older workers. Because higher-paid employees receive proportionally smaller Social Security benefits relative to earnings than lower-paid workers, employers are permitted to make larger contributions on earnings in excess of the Social Security wage base ($94,200 in 2006). Regulations limit the size of the *permitted disparity* in favor of workers whose earnings are above the wage base.

Automatic enrollment "safe harbor". The PPA creates a "safe harbor" from nondiscrimination testing for plans that adopt automatic enrollment, provided the plans meet certain requirements. The requirements include notifying employees of the amount of pay to be deferred, the investments into which the deferrals will be deposited, and that the employee has the right to change the amount deferred or the investments into which the money is deferred or to opt out of the arrangement altogether.[13] A plan with automatic enrollment will be deemed to satisfy the nondiscrimination rules for elective deferrals and matching contributions if it provides a minimum matching contribution of 100% of elective deferrals up to 1% of compensation, plus 50% of elective deferrals between 1% and 6% percent of compensation.

The nondiscrimination safe harbor that existed prior to the PPA (described above) will continue to be available for all §401(k) plans, including those with automatic enrollment. To qualify for the automatic enrollment safe harbor, the contribution rate for automatic enrollees must be at least 3% during the first year of participation, 4% during the second year, 5% during the third year, and 6% thereafter. The plan may specify a higher contribution up to a maximum of 10%. The automatic enrollment arrangement will not have to apply to employees already participating in the plan. Employees must be fully vested in employer contributions after no more than two years, rather than the immediate vesting rule for other safe harbor §401(k) plans. The distribution restrictions under IRC §401(k)(2) also will apply to automatic contribution plans.

An employee who is automatically enrolled will have 90 days to opt out of the plan and withdraw any contributions made on his or her behalf, plus the earnings on those contributions. These amounts will be taxed in the year the employee receives them, but they will not be subject to the 10% extra tax that ordinarily would apply to distributions received before age 59½. This rule also will apply to §403(b) plans and §457(b) plans that adopt automatic enrollment.

Plans that opt for automatic enrollment must choose a set of default investments for participants who have not designated their specific investment choices. Under the PPA, an automatic enrollment plan will be granted protection from fiduciary

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[13] Specifically, a plan with an automatic enrollment feature would be deemed to satisfy the average deferral percentage (ADP) and average contribution percentages (ACP) tests. Qualified automatic enrollment plans also would be deemed not to be "top heavy" plans.

liability under ERISA §404(c) for its default investments, provided that automatic contributions are invested in accordance with regulations to be issued by the Department of Labor and that the plan notifies employees of their right to change the investments or to opt out of the plan. The PPA clarifies that ERISA preempts any state law that would prohibit automatic enrollment, provided that the plan notifies affected employees annually of their rights in the plan.[14] The automatic enrollment provisions of the PPA are effective for plan years starting in 2008, except the ERISA preemption of state law, which is effective on the date of enactment.

Investment advice. The PPA permits certain fiduciaries of a retirement plan to receive compensation in exchange for providing investment advice to plan participants without violating the ban on "prohibited transactions" established by ERISA. Different rules for investment advice will apply for employer-sponsored plans and individual retirement accounts (IRAs). A fiduciary that is a registered investment company, bank, insurance company, or registered broker-dealer will be allowed to provide investment advice to participants without engaging in a prohibited transaction, provided that the advisor charges a flat fee or if its recommendations are based on a computer model that has been certified by an independent third party. An annual audit of the investment advice arrangement will be required. The advisors must disclose their fee arrangements to plan participants and inform them of their affiliations with investments they recommend and with the developer of the computer model. These provisions of the PPA will be effective after December 31, 2006.

With respect to individual retirement accounts, investment advice that is based on a computer model will be exempted from the prohibited transaction rules only if the model complies with guidelines to be developed by the Department of Labor. If the Secretary of Labor determines that no suitable computer models exist, he or she is directed to write regulations that will allow investment professionals to provide objective and unbiased investment advice to IRA owners.

Hedge funds. The PPA provides that investment funds and limited partnerships (including hedge funds) will not be treated as plan fiduciaries under ERISA if investments by ERISA-covered plans account for less than 25% of assets of the investment fund or limited partnership. Investments of governmental and foreign plans, which are not subject to ERISA, will not be taken into account in this calculation, as they were under prior law.[15]

Miscellaneous Provisions

"DB(k)"plans. Beginning in 2010, the PPA authorizes a new "eligible combined plan" for employers with fewer than 500 employees that would contain a 401(k) component and a defined benefit component. The defined benefit component must provide either a benefit equal to 1% of final average pay for each year of service

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[14] This preemption applies only to ERISA plans. Since state and local plans are not subject to ERISA, they remain bound by any state laws prohibiting automatic payroll deductions.

[15] The PPA adds §3(42) to ERISA adopting a 25% threshold to determine if the underlying assets of an entity are plan assets subject to Title I of ERISA. Certain interests held by foreign or governmental plans are excluded when determining if the 25% threshold is met.

up to 20 years or a cash balance plan that increases its benefit with the participant's age. The 401(k) component must include automatic enrollment with a contribution of 4% of pay and a fully vested employer matching contribution equal to 50% of the first 4% of employee pay deferred. Nonelective employer contributions will be permitted but are not required. Benefits under the defined benefit component and nonelective employer contributions under the defined contribution component would have to be vested after no more than three years of service, and matching contributions would have to be 100% vested immediately. Coverage and nondiscrimination tests would have to be satisfied without regard to contributions or benefits under any other plan and without regard to the permitted disparity between highly compensated employees and non-highly compensated employees. The ACP and ADP tests would be deemed satisfied for these plans. Cash balance plans would also have to meet the vesting requirements for those types of plans under IRC §411(a)(13)(B) and the interest credit requirements under IRC §411(b)(5)(B)(I), as added to the tax code by the PPA.

Spousal protections. The PPA directs the Department of Labor to issue regulations to clarify that a court order does not fail to be a Qualified Domestic Relations Order (QDRO) merely because of the time it was issued, or because it modified a prior court order or QDRO. The PPA also requires plans to offer a 75% survivor annuity option if the plan's survivor annuity is less than 75%, and to offer a 50% survivor annuity option if the plan's survivor annuity is greater than 75%.

Rollovers of accrued benefits. Effective in 2008, plan distributions can be rolled over directly to a Roth IRA. Any taxable portion of the rollover amount will be taxed at the time of the rollover. Rollovers are subject to the Roth IRA conversion rules, which restrict conversions of traditional IRAs to Roth IRAs to taxpayers with adjusted gross income of no more than $100,000, whether single or married filing jointly. Effective in 2007, the PPA permits a non-spouse beneficiary of a qualified plan to roll over benefits to an IRA so that the IRA can satisfy the minimum distribution requirements applicable to inherited IRAs. The law also expands the portability of after-tax amounts by allowing rollovers between different types of employer-sponsored plans. The PPA also permits after-tax contributions to a qualified plan to be rolled over into another qualified plan or into a §403(b) plan.

The EGTRRA of 2001 accelerated the vesting schedule of employer matching contributions to defined contribution plans so that they must be fully vested in no more than three years under cliff vesting or no more than six years under graded vesting. The PPA applies these same vesting schedules to all employer contributions made in plan years after 2006 for employees who have at least one hour of service after the effective date.

Permissive service credits. Employees of state and local governments sometimes are permitted to purchase service credit in a public employee pension plan. By making a contribution to the pension plan, they are granted credit for a period of service under the plan, just as if they had contributed to the plan during that period. These contributions to fund the benefit attributable to the period of service are in addition to any regular employee contributions under the plan. The PPA expands the provisions of the Internal Revenue Code regarding permissive service credits under state and local governmental plans to include the purchase of additional

credits for years where service credit already has been given and for other periods, regardless of whether service was performed.

Reporting and disclosure. The PPA requires all single-employer defined benefit plans to distribute an annual funding notice to participants no later than 120 days after the end of the plan year. Small plans with 100 or fewer participants can distribute the notice when they file the annual Form 5500 with the IRS. Effective in 2008, the Department of Labor will be required to display information from the Form 5500 annual report in electronic form within 90 days after receiving it, and companies that maintain an intranet site for employees must display the Form 5500 information on that site. A simplified Form 5500 will be made available for plans with 25 or fewer participants.

Under prior law, employers were required to file an additional form (called a "4010 filing," after ERISA §4010) if the plan's aggregate unfunded vested benefits exceeded $50 million. Beginning in 2008, the PPA amends ERISA §4010(b)(1) to require this filing of financial and actuarial information for any PBGC-insured plan that has a funding percentage of less than 80%.

The PPA requires plan sponsors to provide participants in defined contribution plans with quarterly benefits statements if the investments are participant-directed and annual statements if the investments are not participant-directed. Participants in defined benefit plans must receive a benefit statement at least once every three years.

Distress and involuntary terminations. In the event that a defined benefit plan terminates while it is underfunded (a distress termination under ERISA §4041(c)) or is subject to an involuntary termination under ERISA §4042, the plan sponsor must provide to plan participants the same information that the plan is required to submit to the PBGC — subject to confidentiality limitations — within 15 days of the PBGC filing. This requirement applies to notices of intent to terminate and involuntary termination determinations.

Diversification requirements. The PPA requires defined contribution plans that hold publicly traded employer securities to allow participants to diversify account balances invested in those securities and to offer participants at least three alternative investments. All participants must be allowed to diversify out of employer stock purchased through their own elective deferrals and after-tax contributions. Participants with three or more years of service must be allowed to diversify the investment of employer contributions made on their behalf. This rule will be phased in over three years for securities acquired before 2007, except for participants who are age 55 or older and who have three years of service, for whom it applies immediately. These provisions do not apply to employee stock ownership plans (ESOPs) that have no elective deferrals, after-tax employee contributions, or matching contributions and that are not part of another qualified plan. The new diversification rules are effective for plan years beginning after 2006, or a later date for collectively bargained plans.

Indian tribal governments. The PPA provides that a plan is to be treated as a governmental plan if it is maintained by an Indian tribal government or a subdivision, agency, or instrumentality of a tribal government. To be treated as a

governmental plan, and thus not subject to ERISA, all of the participants must be employees whose services are substantially in the performance of essential governmental functions, but not in the performance of commercial activities, whether or not those activities are essential government functions.

Saver's credit. The Retirement Savings Tax Credit — also called the "saver's credit" — is a nonrefundable tax credit available to low- and middle-income taxpayers who contribute to a qualified retirement savings plan. The maximum credit is 50% of contributions up to $2,000, which would result in a tax credit of $1,000. The saver's credit was created by the EGTRRA of 2001 and was scheduled to expire after 2006. Section 812 of PPA bill makes the Retirement Savings Tax Credit permanent and section 833 of the law amends IRC §25B to index the eligible income levels to inflation in increments of $500.[16]

Phased retirement. The PPA provides that, beginning in 2007, a defined benefit plan may allow in-service distributions to a participant who has reached age 62, even if normal retirement age is later than age 62.

Hardship distributions. The PPA requires the Secretary of the Treasury to issue regulations permitting hardship withdrawals for a person who is the participant's beneficiary under the plan, even if that beneficiary is not the participant's spouse or dependent.

Distributions to qualified reservists. The PPA allows IRAs and §401(k) plans to make distributions to "qualified reservists" called up to active duty for 180 days or longer. The 10% tax on distributions before age 59½ would not apply to these distributions. During the two years immediately following the period of active duty, the reservist can redeposit into an IRA an amount equal to the qualified reservist distribution. This provision applies only if the reservist is called up to active duty after September 11, 2001, and before December 31, 2007.

Distributions to public safety employees. Effective on enactment of the new law, public safety employees are exempt from the 10% tax on distributions before age 59½ if the distribution is made after a separation from service that occurs at age 50 or later. In addition, after 2006, retired public safety employees can exclude from income up to $3,000 per year in distributions from governmental plans used to purchase health insurance or long-term care insurance.

Nondiscrimination testing for governmental plans. Effective upon enactment, all governmental plans, including federal, state, and local plans, are exempt from nondiscrimination testing. Under prior law, only state and local governmental plans were exempted.

Retiree health benefits. The PPA amends IRC §420 to expand the ability of defined benefit plan sponsors to transfer surplus plan assets to retiree health plans.

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[16] For more information, see CRS Report RS21795, *The Retirement Savings Tax Credit: A Fact Sheet*, by Patrick Purcell.

Split tax refunds. The PPA provides that beginning in 2007, taxpayers can direct the IRS to deposit tax refunds directly into an IRA, subject to the annual maximum contribution.

Indexing of IRA limits. The PPA indexes to inflation the gross income levels for making deductible IRA contributions and for making contributions to a Roth IRA.

Tax-free IRA distributions for charitable contributions. In 2006 and 2007, IRA owners age 70½ and older can receive up to $100,000 tax-free from an IRA if it is contributed to a charitable organization.

Plan amendments. Plan amendments to implement the PPA are to be made by the end of the 2009 plan year. Governmental plans have an additional two years to make amendments.

Glossary

At-risk plan. Under the Pension Protection Act, a plan is considered to be at risk of default on its obligations if it fails to meet at least one of two tests. Under the first test, a plan is deemed to be at risk if it is less than 70% funded under the "worst case scenario" assumptions that (1) the sponsor is not permitted to use credit balances to reduce its cash contributions and (2) employees will retire at the earliest date they are eligible and will choose the form of benefit that is most expensive to the plan. If a plan does not pass this test, it will be deemed at risk of default unless it is at least 80% funded under standard actuarial assumptions.

Cash balance plan. A cash balance plan is an employer-sponsored retirement plan that has some characteristics of both defined benefit and defined contribution (DC) plans. The employer credits each employee with a specific percentage of pay each year and applies interest to these amounts at a rate of interest that the employer chooses. The benefit is therefore defined as an "account balance," as in a DC plan. A cash balance plan differs from a DC plan, however, in that the employer retains control of the funds held by the plan and chooses how to invest these funds. The account balance in a cash balance plan is merely an accounting of the employee's accrued benefit under the plan. It is not an individual account owned by the employee. Because the employee is required to receive a benefit that is no less than the amount of pay credits and interest credits that have been applied to his or her "account," cash balance plans are legally defined benefit plans and are insured by the Pension Benefit Guaranty Corporation.

Credit balance. A credit balance is a credit against a plan sponsor's required minimum contribution to a defined benefit plan in the current year as a result of having contributed more than the required minimum amount in a past year.

Critical status. Under the Pension Protection Act (PPA), a multiemployer plan is considered to be in critical status if (1) it is less than 65% funded and is projected to have a funding deficiency within five years or to be unable to pay benefits within seven years; (2) it is projected to have a funding deficiency within four years or to be unable to pay benefits within five years, regardless of its funding percentage; or (3)

it has liabilities for inactive participants that exceed its liabilities for active participants, its contributions are less than carrying costs, and a funding deficiency is projected within five years. Plans in critical status are subject to special requirements under the PPA to ensure that they improve their funding.

Defined benefit plan. A defined benefit (DB) plan is an employer-sponsored retirement plan in which employee benefits are based on factors such as length of service and average salary. Benefits in a DB plan are prefunded and pension assets are held in a trust fund under the control of the employer. By law, defined benefit plans must offer benefits in the form of an annuity, although they also may offer optional forms of payment, such as a lump-sum distribution. In a DB plan, the employer bears the investment risk. If the pension trust is not adequately funded to pay the benefits promised, the employer may be required to contribute more money to the plan. Defined benefit plans are insured by the Pension Benefit Guaranty Corporation.

Defined contribution plan. A defined contribution (DC) plan is an employer-sponsored retirement plan in which the employer contributes a specific dollar amount or percentage of pay into a retirement account for the employee. In some DC plans, such as §401(k) plans, the employee also defers some of his or her salary into the account. In participant-directed plans, the employee controls how the money in the retirement account is invested. In a DC plan, the employee bears the investment risk. The benefit under the plan is whatever amount is held in the retirement account, which depends on the amounts contributed and investment gains and losses. Defined contribution plans are *not* insured by the Pension Benefit Guaranty Corporation.

Distress termination. The sponsor of a defined benefit plan that does not have enough money to pay the full benefits it owes to participants and beneficiaries may terminate the plan if the sponsor is financially distressed and is unable to fund the plan. The PBGC will then take over the plan as trustee and use its own assets and any remaining assets in the plan to pay pension benefits to current and future retirees within the legal limits. The PBGC also will try to collect additional funds from the employer and will share a portion of its recoveries with participants and beneficiaries. The PBGC has legal authority to perfect liens on property of sponsors that are not in bankruptcy, but it does not have preferred standing among creditors of plan sponsors that have entered bankruptcy proceedings.

Endangered status. Under the Pension Protection Act, a multiemployer plan is considered to be endangered if it is less than 80% funded *or* if the plan is projected to have a funding deficiency within seven years. A plan that is less than 80% funded *and* is projected to have a funding deficiency within seven years is considered to be seriously endangered. Endangered and seriously endangered plans are subject to special requirements under the PPA to ensure that they improve their funding.

Funding target. Under the Pension Protection Act, a plan's funding target is equal to the present value of all benefits already accrued by plan participants as of the beginning of the plan year. A fully funded plan is one in which the plan's assets are at least equal to the funding target plus the plan's target normal cost for the current year.

Involuntary termination. An involuntary termination is a termination of an underfunded pension plan that is initiated by the PBGC to protect the interests of plan participants.

Multiemployer plan. A multiemployer plan is a collectively bargained plan maintained by more than one employer, usually within the same or related industries, and a labor union. These plans also are sometimes referred to as "Taft-Hartley plans," after the Taft-Hartley Act of 1947 (P.L. 80-101).

Nonqualified retirement plan. Nonqualified plans are designed to provide benefits to company owners, executives, and highly compensated employees. Unlike qualified plans, nonqualified plans are not required to cover rank-and-file employees, and neither the amount that can be contributed to the plan nor the amount of benefits that they can pay are limited by law. Because nonqualified plans are not required to meet the standards set in law for qualified plans, they do not receive the preferential tax treatment that is accorded to qualified plans. Moreover, any assets that are set aside to prefund benefits under a nonqualified plan are subject to the claims of the plan sponsor's creditors in the event that the plan sponsor enters bankruptcy.

Pension Benefit Guaranty Corporation (PBGC). The PBGC is a government-sponsored corporation created by the Employee Retirement Income Security Act (ERISA) of 1974 to insure the benefits promised to workers in private-sector defined benefit pension plans. The PBGC receives no appropriations from Congress. It is funded by mandatory insurance premiums paid by private-sector employers that sponsor defined benefit pensions and by investment earnings on the assets it holds in its trust fund. The PBGC has no authority to establish the amount of its premiums, which are set in law by Congress. The maximum benefit guaranteed by the PBGC also is established by law and is indexed annually to national average wage growth.

Qualified retirement plan. A plan that meets requirements specified in the Internal Revenue Code with respect to eligibility, participation, and benefits is qualified to receive preferential tax treatment. Specifically, in a qualified plan (1) the employer can deduct from income the amount that it contributes to the plan as a business expense, (2) the amount that the employer contributes to the plan on behalf of plan participants is not treated as income to the participants, and (3) the investment earnings of a qualified pension trust are not taxed as income to either the employer or the plan participants. A qualified retirement plan may be either a defined benefit plan or a defined contribution plan. Assets held in trust by a qualified retirement plan are protected from creditors' claims if the plan sponsor enters bankruptcy.

Smoothing. Plan sponsors attempt to reduce year-to-year fluctuations in the value of plan assets and plan liabilities by averaging ("smoothing") asset values and the interest rate used to calculate plan liabilities over longer periods. Under the Pension Protection Act (PPA), asset values may be averaged over a 24-month period, but the resulting value may be no less than 90% and no more than 110% of the assets' current market value. Under the PPA, the interest rates used to calculate the present value of plan liabilities will be derived from a two-year weighted average of interest rates on investment-grade corporate bonds.

Standard termination. ERISA allows the sponsor of a fully funded defined benefit pension plan to terminate the plan if the sponsor wishes to do so. A termination of a fully funded plan is called a standard termination. As of the date of the termination, benefit accruals cease and all participants are fully vested in their accrued benefits. The sponsor purchases annuities from an insurer to pay benefits under the plan and the PBGC's insurance coverage of the plan ends.

Target normal cost. Under the Pension Protection Act, a defined benefit plan's target normal cost for a year is the present value of benefits expected to be accrued in the current year, including benefits that are attributable to increases in compensation.

Yield curve. A yield curve is a graph showing the relationship between the interest rate of a bond and the time to maturity, when the lender must be repaid. Long-term interest rates usually are higher than short-term interest rates because the lender is taking on the risks of default by the borrower and devaluation of currency through the effects of inflation for a longer period. Therefore, if interest rates are plotted on the vertical axis and time to maturity is plotted on the horizontal axis, the yield curve typically slopes upward, moving from left to right.