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January 16, 2007

IRS Releases Guidance on Pension Protection Act Distribution Provisions

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 2-07
BROKER/DEALER ADVISORY COMMITTEE No. 3-07 RE: IRS RELEASES GUIDANCE ON PENSION PROTECTION ACT DISTRIBUTION PROVISIONS

The IRS has released Notice 2007-7, [1] which provides guidance in the form of questions and answers to various tax provisions in the Pension Protection Act of 2006 (PPA), [2] most of which relate to distributions from qualified plans and IRAs.

Notice 2007-7 provides guidance on the following PPA provisions:

- Interest rate assumptions for adjusting the IRC § 415(b) limit for lump sum distributions from defined benefit plans (PPA § 303)
- Expansion of hardship criteria to include hardships to a participant's beneficiary (PPA § 826)
- Early distributions from government defined benefit plans to certain public safety employees (PPA § 828)
- Rollovers to nonspouse beneficiaries (PPA § 829)
- Distributions from qualified plans to pay for accident or health insurance for certain public safety employees (PPA § 845)
- Faster vesting of employer non-elective contributions to defined contribution plans (PPA § 904)
- Lengthening of the notice and consent period for qualified plan distributions from 90 to 180 days (PPA § 1102)
- Distributions from IRAs to charitable organizations (PPA § 1201)

Much of Notice 2007-7 responds to requests for priority guidance from the Institute and others on these provisions. [3]

Hardship Criteria (Q&A-5)

The PPA requires Treasury, by February 13, 2007, to modify the rules regarding hardship distributions in Code § 401(k)(2)(B)(i)(IV), and similar rules for 403(b), 457(b), and 409A plans, to provide that if an event would constitute a hardship if it occurred with respect to a participant's spouse or dependent, then such event will constitute a hardship if it occurs to a person who is a beneficiary under the plan with respect to the participant.

Notice 2007-7 states that a 401(k) plan that permits hardship distributions of elective contributions to a participant only for expenses described in Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B) may, beginning August 17, 2006, permit distributions for expenses described in Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B)(1), (3), or (5) (relating to medical, tuition, and funeral expenses, respectively) for a primary beneficiary under the plan. [4] For this purpose, a "primary beneficiary under the plan" is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant. The notice says "similar rules" apply to § 403(b) plans. The notice also covers distributions on account of an "unforeseeable financial emergency" under Code §§ 457(d)(1)(A)(iii) and 409A(a)(2)(A)(vi), Treas. Reg. § 1.457-6(c)(2)(i) and Proposed Treas. Reg. § 1.409A-3(g)(3)(i).

Nonspouse Direct Rollovers (Q&As 11-19)

Effective for distributions after December 31, 2006, PPA provides that if a direct trustee-to-trustee transfer of any portion of a distribution from an eligible retirement plan is made to an IRA established for a nonspouse beneficiary, the transfer is treated as a direct rollover of an eligible rollover distribution for purposes of Code § 402(c) and the IRA is treated as an inherited IRA under Code § 408(d)(3)(C).

Notice 2007-7 clarifies that not just qualified plans can offer a direct rollover under this provision, but so can § 403(a) and 403(b) plans, and governmental § 457(b) plans. IRS states that a plan is not required to offer a direct rollover to nonspouse beneficiaries. However, the offering of a direct rollover is a "benefit, right or feature" that must be offered on a nondiscriminatory basis under § 401(a)(4). In addition, the plan is not required to provide a 402(f) notice and is not required to impose mandatory 20% withholding under § 3405(c).

The IRA that will receive the direct rollover must be established in a manner that identifies it as an IRA with respect to the deceased individual and identifies the deceased individual and beneficiary, for example "Tom Smith as beneficiary of John Smith." If a trust is the designated beneficiary of the deceased participant, the plan may make a direct rollover to an IRA with the trust identified as beneficiary. The beneficiaries of the trust are treated as having been designated as beneficiaries of the decedent for purposes of the distribution period under § 401(a)(9), provided the trust meets the requirements of Treas. Reg. § 1.409(a)(9)-4 Q&A-5. [5]

Finally, Notice 2007-7 explains how the required minimum distribution rules in Code § 401(a)(9) apply to nonspouse beneficiaries both when the participant dies before his or her required beginning date, and on or after his or her required beginning date. For example, the notice explains that if the participant dies on or after his or her required beginning date, the required minimum distribution (which would not be eligible for rollover by the nonspouse) for the year of death is the same as the amount that would have applied if the employee were still alive and elected the direct rollover.

Faster Vesting of Employer Nonelective Contributions (Q&As 28-30)

The PPA amended the minimum vesting requirements of Code § 411(a) to require faster vesting of employer nonelective contributions, generally to bring those requirements in line with the faster vesting of matching contributions required by EGTRRA. The change is effective for contributions for plan years beginning on or after December 31, 2006.

Notice 2007-7 explains the interaction of the new minimum vesting and the requirements of Code § 411(a)(10). A participant who has at least 3 years of service, and thus is subject to Code § 411(a)(10)(B), must be provided at all times a vesting percentage that (a) is no less than the minimum under the new PPA vesting schedule and (b) is no less than the vesting percentage determined without regard to the plan amendment adopted to comply with the PPA. [6]

The IRS explains that the plan may continue to use the pre-PPA vesting schedule for nonelective employer contributions for plan years beginning before January 1, 2007. A contribution actually made in 2007 or later is treated as “for a plan year” that begins before January 1, 2007, if it is allocated under the terms of the plan as of a date in that plan year and is not subject to any conditions [7] that have not been satisfied by the end of that plan year. [8]

Notice and Consent Period for Distributions (Q&As 31-33)

The PPA requires Treasury to modify the notice and consent periods for distributions in its regulations under Code §§ 402(f), 411(a)(11), and 417 by substituting 90 days with 180 days.   The PPA also requires Treasury to modify its regulations to provide that a description of a participant’s right to defer a distribution must also include a description of the consequences of failing to defer receipt. The provision is effective for “years beginning after December 31, 2006.”

Notice 2007-7 states that the PPA's changes apply to notices issued in plan years that begin after December 31, 2006, without regard to the annuity starting date (or distribution date in the case of defined contribution plans).

IRS states that the PPA also modifies the "maximum QJSA explanation period" under Treas. Reg. § 1.411(d)-3(g)(9), even though PPA did not specifically mention this regulation. Therefore, amendments made to eliminate optional forms of benefit under Treas. Reg. § 1.411(d)-3(c) and (f) without violating the anti-cutback rules will be subject to the new 180 day period for amendments adopted in a plan year that begins after December 31, 2006.

IRS confirms that plans will need to revise the consent notice under § 411 prior to issuance of final regulations by Treasury. Pursuant to Section 1102(b)(2)(B) of the PPA, IRS states that a plan will not be treated as violating the new notice rules if the plan makes a reasonable attempt to comply, for any notice provided prior to the 90th day after issuance of regulations reflecting the PPA. In the case of a defined contribution plan, IRS states that a plan will be treated in good faith compliance if the new description is written in a manner reasonably calculated to be understood by the average participant and includes the following information:

- A description of the investment options available under the plan (including fees) that will be available if distributions are deferred and
- the portion of the summary plan description that contains any special rules that might materially affect a participant's decision to defer.

Distributions from IRAs to Qualifying Charitable Organizations (Q&As 34-44)

PPA creates a new IRA distribution called a "qualified charitable distribution" (QCD) which is, generally, a distribution from an IRA (other than a SEP or SIMPLE IRA) owned by an individual after the individual has attained age 70 ½ made directly to certain charitable organizations. A QCD is excludable from income, but (a) only to the extent it would otherwise have been includable, [9] (b) only to the extent it otherwise would qualify for a deduction under Code § 170 (without regard to the percentage limitations of Code § 170(b)), [10] (c) only to the extent it does not exceed $100,000. The provision is effective for distributions in 2006 and 2007. [11]

Notice 2007-7 clarifies that QCDs may be made from Roth IRAs and deemed IRAs. With regard to the SEP and SIMPLE IRA exclusion, IRS states that only "ongoing" SEP IRAs and SIMPLE IRAs are excluded. An "ongoing" SEP or SIMPLE IRA is defined as one maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made.

IRS clarifies that the $100,000 limit applies to the aggregate of QCDs during the year from all IRA owned by an individual. For married individuals filing jointly, the limit is $100,000 per individual IRA owner. IRS clarifies that a QCD can be made from IRA maintained for a beneficiary after the death of the IRA owner provided the beneficiary has attained age 70 ½ before the distribution is made.

IRA custodians and trustees do not need to impose withholding under Code § 3405 because the IRA owner is treated as having elected out of withholding under § 3405(a)(2). [12]   IRS states that a trustee or custodian may rely upon reasonable representations made by the IRA owner as to whether a distribution is a QCD. A distribution will be considered to be “direct” if a check payable to the charitable organization is delivered to the IRA owner (and then by the owner to the charitable organization).

There was some concern that, if an individual made the QCD to a charity to fulfill a preexisting pledge, it could be treated as a prohibited transaction under Code § 4975. IRS states in Notice 2007-7 that the Department of Labor (which has jurisdiction over § 4975(d)) has advised Treasury and the IRS that a direct payment to a § 170(b)(1)(A) organization will be treated as being received by the IRA owner, and thus exempt from the prohibited transaction excise tax under § 4975(d)(9).

Distributions to Certain Public Safety Employees (Q&As 6-10, 20-27)

Notice 2007-7 includes guidance on Section 828 of the PPA (regarding distributions after age 50 from government defined benefit plans to certain public safety employees) and Section 845 (regarding distributions from qualified plans to pay for accident or health insurance for certain public safety employees). With respect to Section 828, IRS confirms that distributions from governmental defined contribution plans are not eligible for the exemption from the 10% penalty, even with respect to amounts attributable to rollovers from a defined benefit plan.

Distributions to pay for accident or health insurance (including long-term care insurance) under Section 845 of the PPA may be made from governmental defined contribution plans. Notice 2007-7 provides guidance on eligibility and tax treatment.

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endnotes

[1] A copy of Notice 2007-7 is available here: http://www.irs.gov/pub/irs-drop/n-07-07.pdf.

[2] See Memorandum to Pension Members No. 48-06, Federal Legislation Members No. 5-06 and 529 Plan Members No. 13-06 [20250], dated August 4, 2006.

[3] In particular, based on member input, the Institute's list of highest priority guidance items for Treasury and IRS included rollovers to nonspouse beneficiaries, faster vesting of employer nonelective contributions, and qualified charitable distributions.

[4] In other words, modifying a plan to take advantage of the new PPA hardship rule is optional.

[5] Treas. Reg. § 1.409(a)(9)-4 Q&A-5 generally sets forth the requirements for a trust designated as beneficiary of a deceased participant to pass through the § 401(a)(9) distribution period to the beneficiaries of the trust.

[6] This guidance addresses narrow situations in which a plan switches from a cliff to graded vesting schedule. Offering the participant the election required by Code § 411(a)(10)(B) could result in the participant making a choice that violates the new PPA minimum vesting rule. Notice 2007-7 deals with the problem by essentially requiring the plan to ignore an election that would violate the PPA.

[7] Other than, presumably, the vesting requirement.

[8] This rule also applies to forfeitures and ESOP suspense account allocations.

[9] For an IRA with both taxable and non-taxable amounts, new Code § 408(d)(8)(D) contains a special rule for determining the amount that would otherwise be includible.

[10] IRS clarifies that a QCD is not itself considered a charitable contribution under Code § 170, and therefore would not be taken into account in determining the amount that may be deducted for other charitable contributions. However, if the IRA owner makes a distribution intended to be a QCD that fails to qualify, the distribution is considered a distribution includable in income and a contribution to the charitable organization under the rules in § 170(b).

[11] Notice 2007-7 clarifies that a distribution made during 2006 but before August 17, 2006 that satisfies the requirements of Code § 408(d)(8) is eligible for treatment as a QCD.

[12] The 2006 version of Form 1099 does not require any special reporting of QCDs by IRA custodians and trustees. See Memorandum to Pension Members No. 63-306 [20490], dated October 18, 2006.

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