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Pension ANALYST

Important Information | Distributions | May 2008

IRS Provides Guidance on 2008 Distribution Rules

<u>WHO'S AFFECTED</u> This guidance applies to sponsors of and participants in qualified defined benefit and defined contribution plans, including multiemployer plans, governmental plans, and church plans that do not elect to be covered by ERISA (“non-electing church plans”). It also applies to section 403(b) arrangements, and governmental section 457(b) plans.

<u>BACKGROUND AND SUMMARY</u> The Pension Protection Act of 2006 (PPA) includes several provisions relating to payments made from various types of pension plans that became effective for distributions made on or after January 1, 2008. On March 5, 2008, the IRS released Notice 2008-30, providing guidance regarding the following provisions:

- Rollovers to Roth IRAs;
- Payment of gap period income on excess deferrals;
- Qualified Optional Survivor Annuities (QOSAs); and
- Calculation of lump sum benefits in defined benefit plans.

<u>ACTION AND NEXT STEPS</u> Plan sponsors should review the information contained in this publication and identify the provisions that apply to their plans. Sponsors of defined benefit plans should always consult the plan’s enrolled actuary before making plan design changes, since such changes may affect plan funding.

IN THIS ISSUE

Rollovers to Roth IRAs

Beginning January 1, 2008, certain distributions may be rolled over from qualified plans, section 403(b) arrangements, and governmental section 457(b) plans ("eligible plans") to Roth IRAs, even if the amounts distributed are not Roth deferral contributions. IRS Notice 2008-30 makes important distinctions between rollovers made by participants and spousal beneficiaries and those made by non-spouse beneficiaries. It also provides important guidance regarding rollovers made in 2008 and 2009, when an individual's income may limit his ability to make a rollover to a Roth IRA.

Rollovers by Participants and Spousal Beneficiaries

An eligible rollover distribution that is payable to a participant or spousal beneficiary may be directly or indirectly rolled over to a Roth IRA. The new IRS guidance confirms that plans *must* allow participants and spousal beneficiaries to make direct rollovers to Roth IRAs. While the guidance does not specifically address 402(f) Notice requirements, it is reasonable to assume that the availability of these rollovers must be disclosed in those notices. Prudential is currently revising our 402(f) Supplement to help explain these new rules and the taxation implications of these rollovers.

In general, an eligible rollover distribution that is directly rolled over to a Roth IRA is considered taxable income, but is not subject to 20% mandatory federal income tax withholding. However, the participant or beneficiary may elect voluntary federal withholding on this type of rollover. A direct rollover of designated Roth 401(k) or 403(b) contributions to a Roth IRA is never taxable.

A spousal beneficiary who makes a rollover to a Roth IRA may elect to treat the Roth IRA as his own IRA or as an inherited IRA. If it is treated as an inherited IRA, no other contributions may be made to that IRA and the minimum required distribution rules that would have applied under the terms of the original plan must be applied by the IRA.

Rollovers by Non-Spouse Beneficiaries

Distributions to non-spouse beneficiaries may only be directly rolled over to a Roth IRA. However, plans are not required to offer these direct rollovers. Consistent with the treatment of general non-spouse beneficiary rollovers, it would appear reasonable to assume that the right to make this type of direct rollover does not have to be disclosed in the 402(f) Notice.

A distribution that is directly rolled over to a Roth IRA by a non-spouse beneficiary is not subject to mandatory withholding. However, the beneficiary may elect voluntary withholding.

A non-spouse beneficiary who makes a rollover to a Roth IRA *must* treat the Roth IRA as an inherited IRA.

If a plan sponsor directs or has directed Prudential to permit non-spouse beneficiary rollovers, we will assume that non-spouse beneficiaries are allowed to make direct rollovers to Roth IRAs. If Prudential provides document services for the plan, we will include this provision in the appropriate plan amendment or restatement. Plan sponsors that have not directed us to permit non-spouse beneficiary rollovers may do so at any time by completing the appropriate Administrative Directive document, which may be obtained from your Prudential Retirement representative.

Rollovers Made in 2008 and 2009

For tax years beginning before January 1, 2010, an individual may not make a rollover from an eligible plan (including designated Roth 401(k) or 403(b) contributions) to a Roth IRA if his modified adjusted gross income (MAGI) exceeds $100,000, or he is married and files a separate federal tax return. If a beneficiary wants to make a direct rollover to a Roth IRA, his own MAGI and tax filing status determine his eligibility to make the rollover. The new IRS guidance also clarifies that the plan administrator is not responsible for assuring that the distributee is eligible to make a rollover to a Roth IRA.

Tax Reporting Direct Rollovers

IRS representatives have also informally clarified that two Forms 1099-R will have to be issued when a distribution is directly rolled over to a Roth IRA and voluntary withholding is elected. In these situations, one Form 1099-R will report the amount rolled over. The second Form will report the amount of taxes withheld. Prudential handles this tax reporting for plans that use our benefit payment services.

Gap Period Income on Excess Deferrals

In its final regulations relating to designated Roth accounts, the IRS included a requirement that distributions of excess deferrals from 401(k) plans or 403(b) arrangements include gap period income. “Gap period income” is the earnings on the distribution amounts from the end of the calendar year in which the contributions were made through the date the distribution is made. This rule applies to excess deferrals for tax years beginning on or after January 1, 2007.

The new IRS guidance confirms that plans *must* pay gap period income on excess deferrals attributable to tax years beginning on or after January 1, 2007, despite the fact that the pending PPA technical corrections bills would repeal this requirement. Prudential has been automatically calculating and paying gap period income on excess deferrals distributed after December 31, 2007.

Originally, most 401(k) plan sponsors were required to adopt plan amendments reflecting this gap period income requirement by the later of the due date for filing the employer’s tax return for the 2007 tax year, or the last day of the 2007 plan year. However, the IRS has extended the deadline for adopting these amendments. The revised amendment deadline is the last day of the first plan year beginning on or after January 1, 2009.

Amendments for Individually-Designed Plans

Individually-designed plans that must be submitted for Economic Growth and Tax Relief Reconciliation Act of 2006 (EGTRRA) determination letters in Cycle B (ending January 31, 2008) or Cycle C (ending January 31, 2009) must reflect the gap-period income requirement in their restated documents. Sponsors of plans that were submitted to the IRS for determination letters before March 24, 2008, which do not contain these provisions, will be asked to amend their plans accordingly in order to receive determination letters.

If Prudential provides document services for your individually-designed plan, we will prepare the appropriate plan amendments. For Cycle A, D and E plans that have not already been amended, we will prepare interim amendments that plan sponsors may adopt by the new 2009 deadline. For Cycle B and C plans filed with the IRS before March 24, 2008, we will prepare the appropriate amendments upon request by the IRS. Cycle C plan restatements prepared after March 24, 2008, will include the gap period income provisions.

Amendments for Volume Submitter Plans

Employers that use the Prudential volume submitter document will need to adopt the appropriate plan amendment in addition to approving the recently-approved EGTRRA document. We will contact you with additional information regarding this process.

Amendments for Prototype Plans

Prudential will timely adopt the necessary amendment for our recently-approved EGTRRA prototype document. As a result, adopting employers generally will not need to adopt individual amendments to their plan in order to have fully-compliant documents.

Qualified Optional Survivor Annuities

In general, effective for plan years beginning after December 31, 2007, defined benefit plans, money purchase pension plans, and some profit sharing plans must provide both a qualified joint and survivor annuity (QJSA) and a qualified optional survivor annuity (QOSA). The QOSA is a joint annuity, for the life of the participant and his spouse, with a continuation of either 50% or 75% of the amount payable to the participant. The QJSA and QOSA requirements do not apply to governmental plans or to church plans that do not elect to be covered by ERISA.

The new IRS guidance clarifies several aspects of this new requirement, including the basic QOSA requirements and applicability, effective dates, administrative issues, and plan amendment deadlines.

Basic QOSA Requirements

A plan must offer a QOSA with:

- A 75% survivor annuity, if it currently provides a QJSA with less than 75% continuation; or
- A 50% survivor annuity, if it currently provides a QJSA with a 75% or greater continuation.

If a plan's QJSA is more valuable than the plan's single life annuity form of payment, the QOSA must only be actuarial equivalent of the single life annuity, not the QJSA. The QOSA requirement *does not* apply to preretirement death benefits provided under a Qualified Preretirement Survivor Annuity (QPSA).

QOSA Effective Dates

In general, the QOSA rules apply to distributions with *annuity starting dates* in plan years beginning after December 31, 2007. If a plan is maintained pursuant to one or more collective bargaining agreements ratified on or before August 17, 2006, the QOSA rules apply to distributions with annuity starting dates during plan years beginning on or after the earlier of (1) the later of (a) January 1, 2008, or (b) the date the last collective bargaining agreement expires, or (2) January 1, 2009.

If a participant elects a retroactive annuity starting date, the QOSA rules apply if the first actual benefit payment date occurs in a plan year in which the QOSA rules are effective (generally, after December 31, 2007). It appears that if a participant's annuity starting date was not retroactive but occurred in a year preceding the effective date of the QOSA rules and payments do not begin until after the QOSA effective date, the QOSA rules *do not* apply.

Administrative Issues

If a plan provided a pre-PPA form of payment that met the basic QOSA requirements and does not eliminate that form of payment, it may simply be treated as the QOSA. The plan sponsor does not need to amend the plan document to formally designate that form of payment as the QOSA. In addition, administrative procedures, including distribution notice and consent forms, do not need to be revised to identify that form as the QOSA.

In general, a plan's relative value explanation of available forms of payment does not need to specifically identify the QOSA.

If a participant wants to receive a form of payment other than the QJSA or QOSA, he must waive the QJSA and his spouse must consent to that waiver. It does not appear that the participant must also formally waive the QOSA, or obtain spousal consent to the non-QOSA form of payment. In addition, if the QOSA is the actuarial equivalent of the QJSA, a participant's spouse *does not* need to consent to the participant's election to take the QOSA instead of the QJSA. However, if the QOSA is not the actuarial equivalent of the QJSA, the spouse must consent to the participant's election of the QOSA form of payment.

Plan Amendment Requirements

Plans must be administered in accordance with the QOSA rules for plan years beginning on and after January 1, 2008. However, the deadline for adopting plan amendments reflecting these provisions, if necessary, is the last day of the first plan year beginning on or after January 1, 2009.

If Prudential provides administrative services for your defined benefit plan or benefit outsourcing services for your defined contribution plan, we will comply with the QOSA requirements in making plan distributions as of the appropriate effective date for your plan, and as indicated in the appropriate Administrative Directive.

If we provide document services for your individually-designed or volume submitter plan, we will prepare the appropriate plan amendments for your adoption by the plan amendment deadline described above. Prudential will timely adopt the necessary amendments to our approved EGTRRA prototype plan, on behalf of all adopting employers. As a result, adopting employers generally will not need to adopt individual amendments to their plans.

Calculation of Lump Sum Benefits

For plan years beginning on or after January 1, 2008, PPA defines the "applicable interest rate" used to determine lump sum benefits in defined benefit plans as the adjusted first, second and third segment rates. It also requires the use of a new mortality table to make these determinations. The IRS guidance provides some special rules regarding the adoption of plan amendments to reflect these new requirements.

Until the applicable PPA amendment deadline (in general, the last day of the first plan year beginning on or after January 1, 2009), a plan may provide lump sum payments that are equal to the greater of (1) the amount calculated using the pre-PPA statutory interest rate and mortality table or (2) the amount calculated using the post-PPA statutory interest rate and mortality table.

A plan may provide a greater-of calculation for a specific period of time that is shorter than the entire PPA amendment period, as long as the plan amendment is adopted by the PPA amendment deadline.

If a plan is amended first to provide a greater-of calculation and later to calculate lump sums using only the PPA statutory interest and mortality assumptions, the PPA extended amendment deadline does not apply to the second amendment. The second amendment must be adopted under standard amendment timing rules and is subject to standard anti-cutback prohibitions. However, amendments adopted on or before ***June 30, 2008***, are disregarded for purposes of applying this rule.

The anti-cutback rule does not apply if a plan that calculates non-lump sum forms of benefits by reference to the pre-PPA statutory interest rates and/or mortality tables applicable to lump sum distributions is amended during the PPA amendment period to replace those assumptions with the PPA statutory assumptions.

Plan sponsors should consult their plan's enrolled actuary to determine if changes are needed to comply with the new PPA interest rate and mortality assumption requirements. If changes are needed and Prudential provides document services for your plan, you will need to inform us of those changes. We will then draft the appropriate plan amendments for you to adopt before the applicable amendment deadline noted above.

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