

# Pension ANALYST

Important Information

Distributions

March 2007



## IRS Provides Guidance on New Distribution Rules

**WHO'S AFFECTED** 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, section 457(b) plans and section 409A nonqualified deferred compensation plans.

**BACKGROUND AND SUMMARY** The Pension Protection Act of 2006 (PPA) includes several provisions relating to payments made from various types of pension and deferred compensation plans. Many of these provisions became effective for distributions made on or after August 17, 2006. On January 10, 2007, the IRS released Notice 2007-7, providing guidance regarding the following provisions:

- The extension of the maximum period for providing various notices, from 90 days to 180 days;
- The additional information that must be provided in the notice of a participant's right to defer receipt of a distribution;
- The ability for non-spouse beneficiaries to make direct rollovers to IRAs;
- The availability of hardship or unforeseeable emergency distributions on account of a beneficiary's expenses;
- The accelerated vesting requirement that applies to employer nonelective contributions to qualified defined contribution plans;
- The revised interest rate that must be used to determine maximum lump sum benefits payable from defined benefit plans for plan years beginning in 2006;
- A special exception to the application of the 10% penalty tax on early distributions for payments made by defined benefit plans to qualified public safety employees who have reached age 50; and
- The ability for governmental plans to make tax-free direct payments to pay qualified health insurance premiums for eligible retired public safety officers.

Some of these provisions are automatic and do not require plan sponsors to make plan amendments. Other provisions require plan sponsors to make plan design changes and eventually amend their plans. The final group of provisions are optional and will require plan amendments only if plan sponsors choose to adopt them.

**ACTION AND NEXT STEPS** Plan sponsors should review the information contained in the publication and identify the provisions that apply to their plans. Sponsors that want to adopt any optional provisions should complete the appropriate Administrative Directives to provide direction for plan administration until their plans are formally amended. In general, PPA plan amendments do not have to be adopted until the last day of the 2009 plan year (2011 plan year, for governmental plans).

Employers that offer section 403(b) programs that are not subject to ERISA should also review the information contained in this publication to become familiar with the provisions that may affect their programs. Prudential will provide additional information in the near future regarding the specific impact of these provisions on your programs.

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## Automatic Provisions

### Special Age Exception to Early Distribution Penalty Tax

A 10% early distribution penalty tax applies to distributions made from qualified defined benefit and defined contribution plans and section 403(b) arrangements, unless an exception applies. One exception to this penalty tax is for single sum payments made to participants who separate from service after reaching age 55. PPA added a special exception for payments made by governmental defined benefit plans to “qualified public safety employees” who separate from service after reaching age 50. This new exception applies to distributions made on or after August 17, 2006.

Notice 2007-7 defines a qualified public safety employee as an employee of a State, county, city, or other political subdivision of a State, whose principal duties include services requiring specialized training in police protection, firefighting services or emergency medical services. To qualify for this penalty tax exception, the employee must:

- Receive the distribution from a governmental defined benefit plan after separating from service with the employer maintaining the plan; and
- Separate from service during or after the calendar year in which he reaches age 50.

This exception is automatic. Plan sponsors do not have to amend their plans to reflect this provision. Benefit payors may report these distributions on Form 1099-R using either distribution code 1 or code 2. Prudential Retirement used code 1 when reporting distributions made in 2006 that may have been eligible for this exception and will continue to use code 1 for reporting future distributions that may be subject to this exception.

## Required Provisions

### Revised Interest Rate for Lump Sum Payments from Defined Benefit Plans

Retirement benefits paid by defined benefit plans to plan participants are subject to annual limits. The standard annual benefit limit (\$175,000 for 2006; \$180,000 for 2007) must be adjusted if a participant chooses a form of payment other than a single life annuity or a Qualified Joint and Survivor Annuity (QJSA). If a participant receives a lump sum payment (or certain other forms of payment), the plan must use a specified interest rate to determine the maximum benefit payment amount.

Effective for distributions made in plan years beginning after December 31, 2005, PPA requires plans to use a new interest rate assumption for purposes of determining the maximum benefit payable in a lump sum payment, which may be higher than the rate used before the enactment of PPA. As a result, lump sum payment amounts may be lower.

As a result of the retroactive effective date, plan sponsors may need to work with their plan's enrolled actuary to review lump sum payments made in 2006 and determine if any overpayments were made. If overpayments are discovered, plan sponsors will need to take corrective action. IRS Notice 2007-7 provides three methods for correcting these types of excess payments. These three correction methods are described in detail in our February 2007 *Compliance Bulletin* titled "[IRS Provides Options for Correcting Defined Benefit Plan Excess Payments Resulting from PPA Interest Rate Change.](#)"

The change in this interest rate assumption is required and must be applied for all 2007 benefit calculations. However, plan sponsors do not have to amend their plans to reflect this change (retroactive to 2006) until the end of the 2009 plan year. If Prudential calculates benefit payment amounts under your plan, we will automatically apply the PPA rules for calculating lump sum payments. If you discover that overpayments were made in 2006, which must now be corrected, please contact your Prudential Retirement representative to make sure that the appropriate actions are taken in a timely manner.

### Accelerated Vesting for Employer Nonelective Contributions

Nonelective contributions, profit-sharing contributions, and money purchase pension contributions made to defined contribution plans and section 403(b) plans that are subject to ERISA are subject to more rapid vesting requirements beginning in 2007. These contributions must now vest at least as rapidly as they would under either a three-year cliff vesting schedule or a six-year graded schedule that provides for vesting in 20% increments beginning with the employee's second year of service.

IRS Notice 2007-7 confirms that while PPA may require a vesting schedule change, that change is still subject to the three-year election rule. Under this rule, any participant who has at least three years of vesting service must be allowed to elect to continue to have his vesting percentage calculated under the old formula. However, if a participant makes this election, his vesting percentage must, at all times, satisfy the new minimum vesting rules as well. Essentially, a participant making this election must be given the better of the two percentages provided by the old and new schedules. However, if a participant does not make this election, he will simply be switched over to the PPA schedule.

*For example, pre-PPA, Plan A applied a five-year cliff vesting schedule, with 0% vesting for the first four years of service, to nonelective contributions. To comply with PPA, the plan sponsor decides to adopt the six-year graded schedule.*

*Participant X, who has four years of service as of December 31, 2006, elects to remain subject to the old schedule because he will become 100% vested in Year 5, rather than having to wait*

*until Year 6 for 100% vesting under the PPA schedule. To satisfy the anticutback rule, Participant X must now be treated as 60% vested, as required under the PPA schedule.*

*Participant Y also has four years of service as of December 31, 2006, but does not elect to remain subject to the old schedule. As a result, he must now be treated as 60% vested, but in Year 5 he will only be 80% vested.*

To avoid the complexities of this transformation, the Notice confirms that two other design options are available, which do not require plans to offer special vesting elections to any participants. One option would be to apply a melded vesting schedule, providing the best of both the pre-PPA and PPA schedules, to all participants. Alternatively, separate vesting schedules may be applied to pre-PPA contributions and post-PPA contributions, as long as those contributions are separately accounted for. When a plan maintains dual vesting schedules, a contribution or forfeiture that is contingent on the occurrence of an event after 2006 is treated as being made after 2006 and is subject to the PPA vesting rules.

*For example, Plan B provides for the reallocation of forfeited nonelective contributions. Participant Y was partially vested when he terminated from employment in 2006. He does not take a distribution from the plan, so his non-vested account balance will become a forfeiture once he incurs a five-year break-in-service. Since that five-year break is an event that occurs after 2006, his forfeitures will be reallocated to other participants' PPA nonelective contribution source where it will be subject to the PPA vesting schedule.*

By now, most plan sponsors that need to revise their vesting schedules have chosen their PPA vesting schedules and have decided whether to apply the new schedule to all contributions or to just post-2006 contributions. Plan sponsors must be sure to let Prudential know how they have chosen to comply with the new rules, so that Prudential can properly administer their plans until those plans are formally amended. If Prudential provides document services for your plan, Prudential will also reflect your elections in your PPA amendments in 2009, and in any revised Summary Plan Description (SPD) or Summary of Material Modifications (SMM).

### **Content of Notice of Participant's Right to Defer Distribution**

Qualified defined benefit and defined contribution plans, and section 403(b) plans that are subject to ERISA minimum vesting rules must provide certain participants with a notice of the participant's right to defer receipt of a distribution. This notice must be provided when a participant's consent to a distribution is required. In general, participant consent is required when the value of his vested accrued benefit or account balance is at least \$5,000, and the participant has not reached normal retirement age under the plan. Effective for years beginning after December 31, 2006, PPA requires these notices to describe the consequences of a participant's failing to defer receipt of a distribution, and requires the IRS to issue appropriate regulations.

Notice 2007-7 clarifies that the revised content requirement applies to notices provided in *plan years* beginning after December 31, 2006. In addition, the Notice confirms that plan administrators are required to make a reasonable attempt to comply with the new rules with respect to notices provided before the 90<sup>th</sup> day following the issuance of revised regulations.

PPA did not establish a deadline for the IRS to publish the revised regulations regarding the content of these notices. As a result, it may be some time before those regulations are published, since the IRS will likely be focusing on those pieces of guidance that are subject to set deadlines. In the interim, Prudential will be revising the notice packages we provide to participants in defined benefit plans that use our distribution Outsourcing services and to participants in defined contribution plans and section 403(b) plans that are

covered by ERISA and that use our Personal Retirement Services, to satisfy the “reasonable compliance” requirement.

## Optional Provisions

### 180-Day Maximum Notice Period

Plans must provide various notices to participants who are eligible to receive distributions. All qualified plans, section 403(b) arrangements, and governmental section 457(b) plans must provide a notice discussing rollover options, often referred to as the “402(f) Notice.” As discussed above, qualified defined benefit and defined contribution plans, and section 403(b) plans that are subject to ERISA minimum vesting rules must also provide certain participants with a notice of their right to defer receipt of a distribution. Finally, most defined benefit plans and some defined contribution and section 403(b) plans must provide Qualified Joint and Survivor Annuity (QJSA) notices. Governmental plans, non-electing church plans and profit sharing plans that are not subject to the spousal consent rules do not have to provide QJSA notices.

PPA extended the maximum time for providing these notices, from 90 days to 180 days before the distribution or annuity starting date. This change was made based on the perception that 90 days was often not enough time for an employee to evaluate his payment options, make a selection, and notify the plan.

The IRS Notice clarifies that the 180-day timing rule is optional and may only be applied to notices distributed in plan years beginning after December 31, 2006, regardless of the actual annuity starting date. *For example, if a participant in a defined benefit plan that has a calendar plan year is considering a retroactive annuity starting date of September 1, 2006, the 180-day maximum timing rule may be applied if the notices are being provided in 2007.*

Some plan documents describe the notice timing rules. As a result, sponsors of such plans that wish to apply the new timing rules will have to amend their plans to do so. While these plan amendments do not have to be adopted until 2009 (2011, for governmental plans), plan sponsors that wish to apply the new rules will have to revise their administrative procedures and distribution forms and letters accordingly.

Prudential Retirement will continue to follow the 90-day rule for defined benefit plans that use our distribution Outsourcing services and for defined contribution plans (including section 403(b) and section 457(b) plans) that use our Personal Retirement Services, unless a plan sponsor notifies us that the plan will be amended to apply the new rules. Plan sponsors should complete the appropriate sections of the Administrative Directives to notify us of notice timing changes to be made to their [defined benefit](#) or [defined contribution](#) plans.

If Prudential provides document services for your plan, you will need to let us know if you adopt a change to your notice timing so that we can reflect it in your PPA amendments in 2009 or 2011, as appropriate, as well as in a related SPD or SMM.

### Non-Spouse Beneficiary Rollovers

PPA allows non-spouse beneficiaries to make a direct rollover of a death benefit payment from a qualified defined benefit or defined contribution plan, section 403(b) arrangement, or governmental section 457(b) plan to an IRA. These direct rollovers are available for distributions made after December 31, 2006.

IRS Notice 2007-7 clarifies several points about this provision:

- Plans are not required to offer these direct rollover distributions.

- A distribution is eligible for direct rollover only if it would be an eligible rollover distribution if it were made to a participant or a participant's spouse. As a result, a payment that is one of a series of substantially equal periodic payments, a corrective distribution, or a minimum required distribution (MRD) is not eligible for direct rollover.
- The right to make this type of direct rollover does not have to be disclosed in the 402(f) Notice.
- If a plan permits this type of direct rollover and a non-spouse beneficiary chooses to take a cash distribution, the payment made to the beneficiary is not subject to mandatory 20% federal income tax withholding but is subject to 10% elective withholding.
- If a beneficiary chooses not to make a direct rollover, he cannot later rollover any portion of the distribution to an IRA (i.e., "60-day rollovers" are not permitted).
- The IRA must be treated as an inherited IRA. As a result, no other contributions may be made to that IRA. In addition, the MRD rules that would have applied under the terms of the original plan must be applied by the IRA. *For example, if an employee dies before his required beginning date and the five-year rule applies, the entire amount is eligible for direct rollover in the year of the employee's death and the following four years. In the fifth year, no amount is eligible for rollover and any amount already rolled over to an IRA must be paid out by December 31 of that year.*

Plan sponsors that use Prudential's defined benefit distribution Outsourcing services or our defined contribution Personal Retirement Services and want to offer the direct rollover option to non-spouse beneficiaries, must notify us of this election. We will provide revised distribution forms that discuss this new option. If a direct rollover is elected, we will notify the receiving IRA provider that the rollover is being made by a non-spouse beneficiary. Plan sponsors should complete the appropriate sections of the Administrative Directives to notify us that their [defined benefit](#) plans or [defined contribution](#) plans will offer non-spouse beneficiary rollovers.

Plan sponsors will also have to amend their plan documents to reflect this new rollover option, if they decide to offer it. If Prudential provides document services for your plan, you will need to notify us if you adopt this provision so that we can reflect it in your PPA amendments in 2009 or 2011, as appropriate, as well as in a related SPD or SMM.

### **Hardship and Unforeseeable Emergency Distributions**

Elective deferral contributions made to a 401(k) plan or a section 403(b) arrangement may be distributed on account of an employee's hardship. Deferral contributions to a section 457(b) plan or section 409A nonqualified deferred compensation plan may be distributed as the result of an unforeseeable emergency. PPA expanded the availability of these distributions and directs the IRS to issue regulations allowing distributions to be made if a participant's beneficiary incurs an event that would qualify as a hardship with respect to the participant's spouse or dependent. This expanded availability was effective August 17, 2006.

IRS Notice 2007-7 provides some limited guidance with respect to these new hardship and unforeseeable emergency distribution rules. The IRS clarifies that withdrawals may now be made available if an employee's "primary beneficiary" incurs certain medical, tuition or funeral expenses. A primary beneficiary 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 upon the death of the participant.

Applying this guidance, it appears that a beneficiary's expenses are eligible for hardship withdrawal only if the employee specifically named him one of his beneficiaries. The individual does not have to be the participant's sole beneficiary, but does need to be a primary beneficiary, rather than a contingent beneficiary.

The individual cannot be the participant's beneficiary simply by the operation of the plan's default beneficiary hierarchy.

This new hardship withdrawal provision is specifically available under the 401(k) safe harbor rules, but may also be incorporated under "facts and circumstances" hardship withdrawal provisions. While it is an optional provision, some plan sponsors may find that it is automatically offered under their 401(k) plan documents, if the document contains a catch-all provision that permits safe harbor hardship withdrawals under "other circumstances as permitted by law or regulations."

In situations where plan sponsors do have a choice whether to offer these new withdrawal provisions, they may find it appropriate to delay action until the IRS issues additional guidance. The limited guidance provided by the IRS does not indicate how a plan should handle changes in beneficiary designations (e.g., should or could a plan require an individual to be an employee's primary beneficiary for a specified period of time before or after a hardship withdrawal is taken) and there is some potential for abuse of these provisions. Plan sponsors should review their plan documents to determine if this new provision is automatically covered. If it is not automatically covered, the plan sponsor should consult the document provider to determine if it will be an automatic or optional provision or if a modified version of this provision may be offered. If Prudential provides document services for your plan, you must notify us if you adopt this provision so that we can reflect it in your PPA amendments in 2009 or 2011, as appropriate, as well as in a related SPD or SMM. Plan sponsors that use Prudential's Outsourcing Services and want to offer these withdrawals must notify us by making the appropriate election in the [Administrative Directive](#) and provide the criteria to be used in approving related withdrawal requests.

### **Tax-Free Direct Payments of Health Insurance Premiums**

Effective for distributions made on or after January 1, 2007, PPA allows eligible retired public safety officers to receive tax-free distributions from qualified defined benefit and defined contribution plans, section 403(b) arrangements, and governmental section 457(b) plans for the payment of qualified health insurance premiums. Premiums may be for accident or health insurance or for long-term care insurance for the retired public safety officer, his spouse, or his dependents. The maximum annual amount of these tax-free distributions is \$3,000, which is not indexed for inflation.

The IRS Notice clarifies that an employee is an "eligible retired public safety officer" only if he separated from service due to disability or after reaching normal retirement age, as a public safety officer with the employer that maintains the governmental plan from which the distributions are being made. "Public safety officers" include:

- Law enforcement officers;
- Firefighters;
- Chaplains; and
- Members of a rescue squad or ambulance crew.

To qualify for the favorable tax treatment, the eligible retired public safety officer must elect to have an amount subtracted from his or her plan distributions to pay qualified health insurance premiums. These premium payments must be issued directly to an accident or health insurance plan provided by a state-regulated insurance company. Payments cannot be sent to a self-insured plan. When applying the \$3,000 limit on these nontaxable distributions, distributions received from all eligible government plans are aggregated. If the participant dies, his beneficiaries are not eligible to continue making these tax-free payments from their distributions from the plan.

A participant's benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment provided the participant separates from service as a public safety officer, due to disability or upon reaching normal retirement age.

IRS Notice 2007-7 does not provide guidance regarding the tax-reporting of these transfers. Until the IRS provides further guidance, Prudential does not expect to reduce amounts it reports as taxable on Form 1099R to reflect any transfers. As a result, affected participants should plan to take the appropriate deduction when filing their federal tax returns.

Plan sponsors should complete the appropriate sections of the Administrative Directives to notify us that they want to offer this transfer option under their plans. Upon receipt of a signed Directive, we will provide forms to be used by participants who want to initiate such transfers.

In addition, plan sponsors will have to amend their plan documents to reflect this new rollover option, if they decide to offer it. If Prudential provides document services for your plan, you will need to notify us if you adopt this provision so that we can reflect it in your PPA amendments in 2011.

## Next Steps

We have created a ["Guide to Selected PPA Distribution Provisions Effective in 2006 and 2007,"](#) which summarizes the guidance provided in IRS Notice 2007-7 and discussed in this publication. Plan sponsors are encouraged to review this chart and identify those provisions that affect their plans and the actions that they may need to take to implement these changes.

As noted above, plan sponsors should use the appropriate "Administrative Directives" to identify those provisions that they wish to incorporate in their plans. When completed, these forms should be sent to your Prudential Retirement representative so that appropriate actions may be taken. Sponsors of defined benefit plans are always encouraged to consult their plan's enrolled actuary before making plan design changes.

### **Pension Analyst by Prudential Retirement**

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