

Pension
ANALYST

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IRS Provides Options for Correcting Defined Benefit Plan Excess Payments Resulting from PPA Interest Rate Change

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.

PPA Changes Required Interest Rate Assumption

Effective for distributions made in plan years beginning after December 31, 2005, the Pension Protection Act of 2006 (PPA) requires plans to use an interest rate assumption for purposes of determining the maximum benefit payable in a lump sum payment that is the greatest of:

- 5.5%;
- The rate that produces a benefit of not more than 105% of the benefit calculated using the minimum value lump sum interest rate; or
- The interest rate specified in the plan.

IRS Notice 2007-7 confirms that this provision applies to payments made in plan years beginning after December 31, 2005, including payments made before the enactment of PPA. However, this requirement does not apply to plans that terminated on or before August 17, 2006, the date PPA was enacted.

Impact of Retroactive Effective Date

As a result of this retroactive effective date, plan sponsors should work with their plan's enrolled actuary to review lump sum payments made in 2006 and determine if any overpayments were made (most likely to highly compensated employees or longer-service employees).

In reviewing 2006 payments, plan sponsors should keep in mind that a payment made in February 2006 from a plan that has a calendar plan year would be subject to the new rule. However, a payment made in February 2006 from a plan that has a plan year beginning on July 1 would not be subject to the PPA rule.

If overpayments are discovered, plan sponsors will need to take corrective action. The IRS Notice provides three methods for correcting these types of excess payments. All three methods apply principles described in the IRS' Employee Plans Compliance Resolution System (EPCRS).

Specific Correction Options Available

Method One: Excess payment made before September 16, 2006, and corrected by March 15, 2007. Under this correction method, the plan does not have to recover the excess payment from the participant. However, the plan sponsor must notify the participant that the excess payment amount is not eligible for rollover and the plan must issue two Form 1099-Rs to the participant to replace the original Form 1099-R that had been distributed earlier this year. The first Form 1099-R will show only the amount that would have been distributed if the benefit had been adjusted using the interest assumptions required by PPA. The second Form 1099-R will show only the excess amount that was distributed, and must identify this amount as an excess distribution. The participant must include the excess amount in his gross income in 2006, but this amount is not subject to the 10% early distribution penalty tax.

Method Two: Excess payment made at any time in 2006, and corrected by December 31, 2007. The plan must try to recover the excess payment, plus interest, from the participant. If the participant does not repay the full overpayment amount and related interest, the plan sponsor must contribute the difference to the plan. The plan sponsor must notify the participant that the excess payment is not an eligible rollover distribution. The plan does not have to provide any special or revised Forms 1099-R to reflect this change in treatment, but an affected participant may need to consult a tax advisor to determine if it has any impact on his 2006 or 2007 tax returns.

Method Three: Excess payment made at any time and corrected after December 31, 2007. The plan must first meet the [EPCRS self-correction eligibility requirements](#) and then must try to recover the excess payment, plus interest, from the participant. If the participant does not repay the full overpayment amount and related interest, the plan sponsor must contribute the difference to the plan. The plan sponsor must notify the participant that the excess payment is not an eligible rollover distribution. The plan does not have to provide any special or revised Forms 1099-R reflecting this change in treatment, but an affected participant may need to consult a tax advisor to determine if it has any impact on his current or prior tax returns.

We understand that the IRS recognizes that these correction options may not be appropriate for excess payments made under other forms of payment that are subject to the required interest rate assumption rules (e.g., installment payments) and is working to develop appropriate correction options for those situations.

Required Actions

The change in this interest rate assumption is required and must be applied for all 2007 benefit calculations. 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. ***You must notify us by March 9, 2007, if you are making corrections using "Method One," so that we can produce the related Forms 1099-R by March 15, 2007.***

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 provides document services for your plan, we will automatically include this revised provision in your PPA plan amendment.

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