

# retirement

## plan news

MARCH/APRIL 2007

### PPA Changes for 2007

Keeping up with changing regulations can be a full-time job for plan sponsors and administrators — especially when there are sweeping legislative changes, as there were following the passage of the Pension Protection Act of 2006 (PPA).

This article addresses several PPA provisions that became effective the first day of the 2007 plan year. It includes highlights of IRS guidance on certain distribution and vesting rules that was issued right before this newsletter went to press. Many of these rules will be covered in more detail in future issues.

**Top-heavy Vesting for All Employer Contributions.** Beginning in 2002, plans had to fully vest employer matching contributions within six years if using a graded vesting schedule or three years if using a cliff vesting schedule. PPA extends this requirement to *other* employer contributions in defined contribution plans (except those necessary to pass nondiscrimination testing, such as safe harbor contributions, which are 100% vested). The updated vesting schedule will apply to contributions made to employees who work at least one hour in a plan year beginning after December 31, 2006. While pre-2007 contributions may technically remain on the old vesting schedule, for ease of administration, plan sponsors may want to apply the graded or cliff vesting schedule to an affected participant's entire account balance.

Although PPA indicates that amendments are not required until the 2009 plan year, the amendment process could be accelerated if the IRS issues guidance requiring the adoption of an interim

amendment in 2007. A plan will be operated under the PPA vesting rules starting with plan year 2007 contributions even if it is not amended.

**Nonspouse Inherited Rollover.** Beginning in 2007, nonspouse beneficiaries of participants in qualified retirement plans may directly roll over a deceased participant's plan balance to an inherited IRA. The title of the IRA must include the name of the deceased: for example, "James Doe as beneficiary of Henry Doe." Plans do not have to offer this option. Such a rollover is a direct rollover only for purposes of the rollover rules, which means that the distribution is not subject to the 20% mandatory withholding or to the 402(f) notice rules. If the beneficiary is a trust, and the trust meets certain requirements, then the beneficiary of the trust may roll over the inherited plan balance to an IRA.

Required minimum distribution requirements apply to the inherited IRA. The rules for determining the required minimum distributions under the plan with



respect to a nonspouse beneficiary also apply under the IRA. Thus, if a participant dies before his or her required beginning date, and the five-year rule applied to a nonspouse designated beneficiary under the plan, then the five-year rule applies for purposes of determining

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required minimum distributions under the IRA. IRS guidance states that, under the five-year rule, a direct rollover must be made by the end of the fourth year after the year the participant died.

If the life expectancy rule applied to a nonspouse designated beneficiary under

the plan, then the required minimum distribution under the IRA must be determined using the distribution period that would have applied under the plan. Similarly, if a participant dies on or after his or her required beginning date, the required minimum distribution under the IRA for any year after the year of death must be determined using the applicable distribution period that would have been used under the plan.

This is effective for distributions occurring after December 31, 2006. A participant's date of death is not addressed in the IRS guidance. Thus, it appears that a beneficiary who receives a distribution after December 31, 2006, is eligible to roll over an inherited plan balance, regardless of when the participant died.

### **Beneficiary Hardship Distributions.**

Under PPA, a qualified plan may make a hardship distribution to provide relief for a participant's beneficiary. A 401(k) plan

that permits hardship distributions may, beginning August 17, 2006, permit distributions for expenses relating to medical, tuition, and funeral expenses for a primary beneficiary under the plan. 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 under the plan to all or a portion of the participant's account balance upon the participant's death.

A plan utilizing these expanded hardship provisions must still satisfy all the other hardship requirements, such as the requirement that the distribution be necessary to satisfy an immediate and heavy financial need. ❖

**Correction:** The November/December 2006 issue of this newsletter stated that the PPA bonding increase provision was effective with the 2007 plan year. **The increase is effective with the 2008 plan year.**

## Plan Statement Guidance from the DOL

The DOL has issued guidance for defined contribution plans to use to create good faith benefit statements that are PPA compliant. This guidance may be used until regulations are finalized.

**Participant Directed Plans.** Plans with participant directed individual accounts must provide benefit statements at least once each quarter. Under PPA, the statements must now include an explanation of investment risk and diversification, and an explanation of any limitations or restrictions imposed "under the plan." The DOL has provided model language and posted a page with investing information on its website — [www.dol.gov/ebsa/investing.html](http://www.dol.gov/ebsa/investing.html). According to the guidance, quarterly statements are to be provided 45 days after the end of each quarter, starting with March 31, 2007.

**Employer Directed Plans.** Employer directed plans must provide statements annually. The first annual statement for calendar year plans must be provided no later than 45 days after December 31, 2007.

**Statement Delivery.** Statements may be provided electronically if the IRS electronic notice rules are followed. Participants must be provided with a paper copy at no charge if requested. Plan sponsors may use multiple documents or sources to provide benefit statement information as long as participants and beneficiaries are told, in writing, how and when all the information will be provided. ❖



## A Closer Look at Two PPA Changes

The retirement industry has had several months to absorb the highlights of the far-reaching Pension Protection Act of 2006 (PPA). Now it's time for a closer look at some of the changes. This article focuses on the new PPA rules regarding the divestiture of publicly traded employer stock held in certain retirement plans, and the new contribution deduction limit for employers that sponsor both defined benefit and defined contribution plans.

### Divestiture of Employer Stock in Non-ESOP Plans.

Beginning with the 2007 plan year, certain plans holding publicly traded employer stock must permit participants to *immediately* sell employer securities purchased with elective deferrals (or other employee contributions) and diversify the proceeds into other plan investments. If the employer securities were purchased with employer contributions, the plans must allow participants to sell the securities after completing three years of service. There is a three-year phase-in period for plans that hold employer stock purchased with employer contributions to allow for market stability.

Traditional Employee Stock Ownership Plans (ESOPs) that do not have employee contributions, matching contributions, or employer contributions that relate to 401(k) testing are not impacted by these new rules.

Employers must provide participants with a notice informing them of their right to divest themselves of employer-owned securities 30 days before the participants are eligible to sell the securities. To implement this new law, employers must provide this notice no later than 30 days before the beginning of the plan year. **Note:** The deadline for the January 1, 2007 notice was extended to January 31, 2007, because the IRS model notice was released so close to the mailing deadline.

**DB/DC Deduction Limit.** When an employer maintains both a defined contribution and a defined benefit plan, there is a combined contribution deduction limit. The limit is the *greater of 25%* of compensation paid to all participants in both plans, or the amount necessary to satisfy the minimum DB plan funding requirements. Prior to PPA, if the minimum funding requirement exceeded the 25% limit, no deduction



was allowed for DC plan contributions. PPA modifies the limit, opening the door for higher employer deductions.

Under PPA, effective for 2008, when an employer sponsors both plans, and the DB plan is covered by the Pension Benefit Guaranty Corporation (PBGC), the 25% combined deduction limit no longer applies. Employers may take a deduction for the minimum funding amount (even when it exceeds 25% of compensation) *and* a deduction for up to 25% of compensation for the DC plan. If the DB plan is *not* covered by the PBGC, the employer is still subject to the 25% deduction limit for combined plans.

Additionally, effective as of 2006 under PPA, all employers may make a contribution of up to 6% of compensation to a DC plan without the amount being counted toward the 25% limit. Employee elective deferrals continue to be excluded from the deduction limit. ❖

**Example:** A doctor age 59 sponsors a defined benefit plan and a deferral only 401(k) plan that covers her and two nonhighly compensated employees. She adds a dollar-for-dollar safe harbor matching contribution on the first 6% of salary deferred. (Note: The DB numbers are hypothetical and are not based on actuarial calculations.)

	Compensation	Age	DB Amount	Employee Deferral	Employer Match
Doctor	\$225,000	59	\$68,000	\$20,500	\$13,500
NHCE 1	\$45,000	35	\$7,000	\$2,700	\$2,700
NHCE 2	\$30,000	27	\$3,000	\$1,800	\$1,800
<b>Totals</b>	<b>\$300,000</b>		<b>\$78,000</b>	<b>\$25,000</b>	<b>\$18,000</b>

Before PPA, the maximum tax deduction would have been \$78,000 — the amount required to fund the DB plan. After PPA, that deduction increases to \$96,000.

# recent developments

## ■ Determination Letter

**Submissions for 2007.** Under IRS Rev. Proc. 2005-66, the qualified plans that must be submitted for IRS review between February 1, 2007, and January 31, 2008, include preapproved defined benefit plans (i.e., prototype and volume submitter plans), cycle “B” individually designed plans (i.e., those of sponsors with employer identification numbers ending in 2 or 7), and nongovernmental multiple employer plans.

■ **Charitable Donations from IRAs.** More details have come to light on this hot topic. An IRA owner age 70½ or older may directly transfer — tax free — up to \$100,000 to an eligible charitable organization during the 2007 tax year. (This

transfer was also available in the 2006 tax year.) In addition, such direct transfers count as required minimum distributions (RMDs). Eligible IRA owners may take advantage of this provision regardless of whether they itemize their deductions. To qualify, the funds must be transferred *directly* by the IRA trustee to the eligible charity. These donated amounts are not taxable — but they also do not qualify for the charitable tax deduction. Not all charities are eligible recipients: Donor-advised funds and supporting organizations are ineligible, and distributions to these charities are fully taxable.

Distributions from employer sponsored retirement plans are *not* eligible for this treatment. An individual

required to take a minimum distribution from a qualified plan may not roll over his or her RMD amount to an IRA to take advantage of this provision.

## ■ Electronic Employee

**Communications.** Employee benefit plans are required to inform participants, in writing, of their rights under the plan. The IRS has issued final regulations for using electronic media to satisfy these requirements. The new regulations update those first issued in 2000 and coordinate IRS notice and consent rules with the Electronic Signatures Global and National Commerce (E-SIGN) Act. The final regulations apply to notices and participant elections made on or after January 1, 2007. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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