

TCRS 2007-02: Internal Revenue Service (IRS) Notice 2007-7

The Treasury Department and the IRS recently issued Notice 2007-7 providing extensive guidance on distributions and vesting under the Pension Protection Act of 2006 (PPA).

This TCRS release will focus on the following key provisions of Notice 2007-7 which affect qualified defined contribution plans:

- Expanded hardship distributions for a participant's beneficiary. PPA allows a 401(k) plan that permits hardship distributions of elective contributions for certain expenses to also permit hardship distributions for certain expenses of a participant's beneficiary.
- Rollovers from qualified plans to IRAs for non-spouse beneficiaries. PPA allows non-spouse beneficiaries to make a direct rollover of a distribution from a qualified plan to an IRA established to receive the distribution.
- Accelerated vesting schedule for nonelective employer contributions. PPA requires the vesting schedule currently applicable to employer matching contributions (i.e., as favorable as a 3-year cliff or a 6-year graded) to also apply to employer nonelective contributions.
- Expansion of notice period with respect to the notice and consent period for distributions. PPA directs the IRS to modify existing regulations to extend the 90-day threshold to 180 days for certain notices and to revise the content requirement of the distribution notice relating to the participant's right to defer receipt of a distribution.

Expanded Hardship Distributions for the Participant's Beneficiary

- Provision is optional
- Effective for hardship distributions made on and after August 17, 2006
- Allowed only for plans that use the IRS safe harbor hardship definition for a "deemed immediate and heavy financial need"
- Limited to the hardship of a primary beneficiary
- Must be for medical, tuition and funeral expenses only
- Plan must still satisfy all other hardship distribution requirements

Rollovers from Qualified Plans to IRAs for Non-Spouse Beneficiaries

- Provision is optional
- Effective for rollovers made on and after January 1, 2007
- Must be a direct rollover, i.e. the 60-day rollover rule may not be used
- The amount rolled over is not taxable to the non-spouse beneficiary in the year of the rollover
- The rollover must be made to an IRA and the IRA will be treated as an inherited IRA
- The inherited IRA must identify by name both the deceased participant and the beneficiary
- A distributing plan may make a direct rollover to an IRA even though the participant's beneficiary is a trust so long as the trust beneficiaries are individuals. The IRA must name the trust as the beneficiary.
- Notice 2007-7 clarifies that a distribution, including a rollover, from a qualified plan to a non-spouse beneficiary is not subject to the eligible rollover rules, therefore, the rollover is not subject to the automatic rollover rules, the mandatory withholding rules or the section 402(f) notice. But, a non-spouse beneficiary who receives a cash payment of the death benefit is subject to the elective withholding rules.
- Notice 2007-7 provides that the minimum distribution rules applicable to distributions from the inherited IRA of a non-spouse beneficiary are those that would have applied under the plan and not the rules applicable to the inherited IRA. Note, however, the exception to this rule contained in the paragraph below, as further clarified by the IRS on February 13.

- If a participant dies before his required beginning date, the required minimum distributions for purposes of determining the amount eligible for rollover with respect to the non-spouse beneficiary depends on whether the five-year payout rule or the life expectancy rule is applicable.
 - Under the five-year payout rule, the participant's benefit is not required to be distributed until the fifth calendar year following the year of the participant's death. Thus, for the first 4 years after the year of the participant's death, a non-spouse beneficiary may directly roll the participant's entire benefit to the inherited IRA. On and after January 1 of the fifth year following the year of the participant's death, amounts paid to the non-spouse beneficiary cannot be rolled over.
 - Under the life expectancy rule, there is a minimum required distribution in the year following the year of the participant's death and each year thereafter. Because these amounts are required minimum distributions, they cannot be rolled over to an IRA. However, distributions that exceed the required minimum distribution amount for any year (including any undistributed amounts for prior years) are eligible to be rolled over.

On February 13, the IRS stated that, despite a plan provision for the five-year rule, the non-spouse beneficiary is permitted to treat the plan as using the life expectancy rule both for determining the amount eligible for rollover and for determining the required minimum distributions under the inherited IRA, but only if the rollover is accomplished prior to the end of the year following the year of the participant's death.

- If the participant dies on or after his required beginning date, the required minimum distribution for any year after the participant's year of death must be determined using the applicable distribution period that would have applied under the plan as though the rollover had not occurred
- Amounts representing the deceased participant's remaining required minimum distribution under the plan in the year of death are not eligible for rollover. Similarly, in the years following death, any amounts determined to be the required minimum distribution amounts are not eligible for rollover to an IRA. All other amounts in excess of the required minimum distribution (includes the amount required for the current year and in any prior years) may be rolled directly to an IRA.
- Notice 2007-7 provides that the opportunity to make a direct rollover is a benefit, right or feature that is subject to the general nondiscrimination rules. Therefore, if a plan offers the rollover option to non-spouse beneficiaries, it must do so in a nondiscriminatory manner.

Accelerated Vesting Schedule for Employer Nonelective Contributions

- This provision is mandatory for employer nonelective contributions made for plan years beginning on and after January 1, 2007
- Notice 2007-7 clarifies that the accelerated vesting schedule applies to contributions made for plan years beginning in 2007 and after. For example, a contribution that is made during 2007 for the 2006 plan year (based on 2006 service, compensation, and allocation conditions), is not subject to the accelerated vesting schedule, even though the contribution was made after the PPA vesting provision became effective for the plan. Forfeiture allocations follow the same rule.
- The current rule that requires participants with at least 3 years of service be permitted to elect to have their vesting computed using the pre-amendment vesting schedule applies to the PPA accelerated vesting change as well. However, this election need not be provided if no participant's vesting percentage at any time under the plan, as amended by PPA, is less than the vesting percentage under the plan before the amendment by PPA.
- Separate vesting schedules for employer nonelective contributions (e.g. profit sharing contributions) may be maintained for pre and post PPA employer nonelective contributions, provided the plan properly accounts for contributions subject to each schedule. Although PPA allows for this flexibility, adopting separate schedules could complicate plan administration and could be confusing to some participants. Plan sponsors are encouraged to carefully consider the cost of adopting separate vesting schedules (including the impact this may have on plan forfeitures) and compare those with the benefits of simpler employee communication and administration.

Expansion of Notice and Consent Period for Certain Distributions

- Effective for plan years beginning on and after January 1, 2007 and applies to notices issued in those plan years without regard to the annuity starting date
- Applies to plans that are required to comply with the notice requirements of Code sections (i) 402(f), dealing with the required explanation for eligible rollover distributions, (ii) 411(a)(11), dealing with the notice of the right to defer receipt of distributions and (iii) 417, dealing with the consent requirements for distributions subject to the qualified joint and survivor annuity provisions
- The right to defer notice must include a description of the consequences of failing to defer receipt of a distribution
- Notice 2007-7 provides that plan sponsors should make a reasonable attempt to comply with the new PPA notice requirements with respect to notices issued prior to the 90th day after the issuance of regulations
- Prior to issuance of regulations, Notice 2007-7 provides a “safe harbor” that would be considered a “reasonable attempt” to comply with the description of the consequences of failing to defer. For a defined contribution plan, such a description must include the following information:
 - A description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred, and
 - The part of the summary plan description that contains any special rules which may materially affect a participant’s decision to defer.

TRS’ Response

TRS has updated its hardship, rollover and distribution forms to reflect the new PPA requirements and these forms are now available for client use.

TRS has assessed the PPA accelerated vesting requirements and we have determined that these changes will not directly impact the majority of our clients until early 2008. During the 4th quarter of 2007, we will be communicating with clients affected by the change to discuss the steps they must take to comply with the PPA accelerated vesting requirements. TRS has identified those clients immediately affected by this provision and we are currently working with them to implement this change.