retirement
plan news

JULY/AUGUST 2007

Changes to the Distribution Notice

Named after the Internal Revenue Code Section that requires it, the 402(f) notice is also called the rollover notice, distribution notice, or special tax notice. It explains the direct rollover rules, the mandatory 20% tax withholding rules, and various other tax rules applicable to distributions from retirement plans.

Participants or beneficiaries must receive this notice before *any* distribution is made, and it is frequently included with the package of forms sent when a distribution is being requested.

In the past, the IRS has provided plans with a model 402(f) notice, updating it from time to time. (The last update was 2002.) The notice is again in need of updating to reflect changes brought about by the Roth 401(k) contribution option and the Pension Protection Act of 2006 (PPA).

Changes related to the Roth 401(k). The 402(f) notice must give an explanation of the tax scenarios that are possible with distributions from a designated Roth 401(k). This includes tax and withholding rules that apply if Roth funds are distributed before they are "qualified," rollover rules for Roth amounts to another Roth 401(k) or Roth IRA, and an explanation of the rules for tracking the five-taxable-year period when a rollover occurs.

Changes related to PPA. The sweeping pension reform legislation calls for many changes. Here are some that apply to the 402(f) notice.

Time frame. Prior to PPA, 402(f) notices had to be provided between 30 and 90 days before a distribution could be made. To allow for easier administration, PPA lengthened the time frame to between 30 and 180 days.

403(b) arrangements and after-tax amounts. The distribution notice must disclose that after-tax amounts in a qualified plan now may be rolled over to a 403(b) arrangement — and vice versa.

Exceptions to the 10% penalty. There are two new exceptions to the 10% penalty on distributions before age 59½ that must be added to the notice. The first applies to reservists who perform active duty for more than 179 days between September 11, 2001, and December 31, 2007. The second exception applies to public safety employees who are at least age 50 and receive distributions from governmental defined benefit plans to pay health insurance premiums.

Nonspouse beneficiary rollover. An explanation of the new rules permitting a nonspouse beneficiary to roll over a deceased participant's assets into an inherited IRA must be added. The explanation must include a discussion of

a nonspouse beneficiary's distribution option to directly roll over the amount to an inherited IRA and take distributions using the five-year rule or the life expectancy rule.

Governmental plans. The notice must explain that up to $3,000 of distributions

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Changes to the Distribution Notice (Continued from page 1)

made by a governmental defined benefit plan to a public service employee and used to purchase certain health and long-term care insurance for the employee and his or her dependents may be excluded from income.

Changes related to IRS Notice 2007-7. The IRS notice describes additional disclosure information that will help participants decide what to do with the funds in their retirement plans after terminating their jobs. The information must be plainly written and must include the following:

- ***Defined benefit plans*** must include an explanation of how much larger an employee's benefit will be if distribution is postponed and the money is left in the plan.
- ***Defined contribution plans*** must include an explanation of the plan's investment options, including any investment or plan fees involved if distribution is postponed.

In addition, the notice must also include the portion of the summary plan description that contains any special rules that may materially affect a participant's decision to postpone distribution.❖

Interim Final Guidance on QDROs

The Pension Protection Act of 2006 (PPA) clarified certain circumstances under which a qualified domestic relations order (QDRO) may occur. And it called for the Department of Labor (DOL) to issue regulations regarding those changes.

Here are the interim final rules the DOL has issued along with two examples.

1. A QDRO may be issued subsequent to a QDRO or to revise another QDRO.
2. A QDRO may be issued after the parties divorce.
3. A QDRO may be issued after the participant's annuity starting date.
4. A QDRO may be issued after the participant's death.

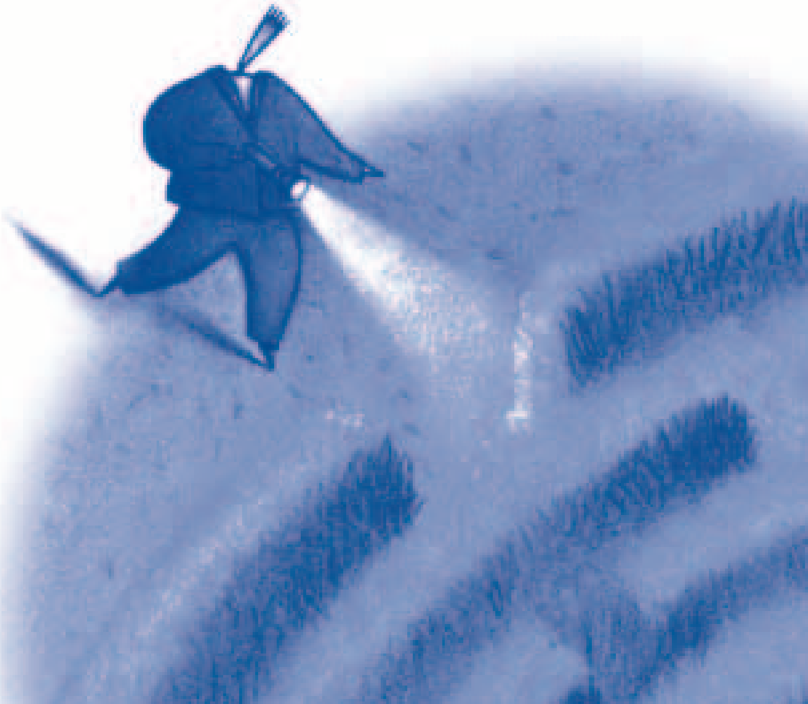
Note that a QDRO still *may not* require the plan to provide a form or type of benefit or option that is not available in the plan.

Example 1: Participant and Spouse divorce, and a domestic relations order is qualified by the plan. The QDRO allocates a portion of Participant's benefits to Spouse as the alternate payee. But before benefit payments begin, Participant and Spouse seek and receive a second domestic relations order that reduces the benefits to be paid under the QDRO. The second order may be treated as a QDRO.

Example 2: Participant and Spouse A divorce. The QDRO allocates a portion of Participant's benefits to Spouse A as the alternate payee. Participant goes on to marry Spouse B, and they also divorce. Participant's 401(k) plan administrator subsequently receives a domestic relations order pertaining to Spouse B, which assigns Spouse B a portion of Participant's 401(k) benefits not already allocated to Spouse A.

Note: While properly providing that a QDRO for Spouse B cannot touch amounts provided to Spouse A, this example does not address the decision in a recent Ninth Circuit Court of Appeals case that allowed a QDRO for Spouse B to reduce benefits going to children under the first QDRO.

The final rules will be effective 30 days after they are published in the Federal Register. We will let you know of any changes when the rules are finalized. ❖



Final 415 Regulations

Section 415 of the Internal Revenue Code addresses contribution and benefit limits for qualified retirement plans. Among other changes, the final regulations address post-severance compensation and clarify that, in certain situations, elective deferrals may still be made after the compensation cap is reached during the year.

Post-severance compensation. For years, guidance has been needed on the ability to use post-severance compensation for qualified plan purposes. Under the proposed regulations, employers could choose to treat post-severance payments as compensation if:

- The payments were paid within 2½ months following severance from employment, and
- The payments were either:
  - (1) Compensation for services performed (during regular hours or for overtime or shift differential work), commissions, bonuses, or other similar compensation, provided the amounts are the same as the employee would have received if he/she continued working; *or*
  - (2) Amounts paid for accrued bona fide sick, vacation, or other leave the employee would have been entitled to if he/she had continued working.

The final regulations change the deadline for post-severance payments to *the later of* 2½ months after severance or the end of the limitation year in which severance occurred. So, for example, if an employee severs service March 31, and the limitation year ends December 31 (i.e., nine months later), severance paid during those nine months may be used for qualified plan purposes.

Under the final regulations, regular compensation amounts in (1) above are, by 415 definition, automatically included in the plan's definition of compensation if paid within the appropriate time frame. However, post-severance payments in (2) above are *not included* in compensation unless specifically elected by the employer as a plan document choice.

Coordination with 401(k) and 457 rules. The final regulations also amend the 401(k) and 457 regulations to mandate that post-severance payments may only be deferred to the extent they are deemed compensation under Section 415.

Coordination with Section 401(a)(17). The final regulations say plans cannot consider compensation in excess of the maximum compensation limit (Section 401(a)(17) limit), i.e., $225,000 in 2007. However, the regs clarify how the annual compensation cap coordinates with the percentage of compensation method of deferring. The examples illustrate how this operates.

Example 1: X earns $250,000 and defers 6%. X's deferrals for the year are limited to $13,500 (6% × $225,000).

Example 2: Y, on the other hand, doesn't defer any pay. By the end of November, his compensation is $300,000, and he will receive a bonus of $200,000 in December. Y can defer up to $15,500* (the 402(g) annual deferral limit in 2007) of the bonus *regardless* of the fact that Y's compensation will exceed the annual 401(a)(17) limit.

Example 3: Z decides to divide $15,500* by the number of pay periods in a year and defer a fixed dollar amount each payday. Even if Z is over the compensation cap before the year is out, it won't matter because her deferrals are based on a fixed amount instead of a percentage.

Effective date. In general, the final 415 regulations are effective as of limitation years beginning on or after July 1, 2007. Thus, for plans with calendar-year limitation years, the effective date will be January 1, 2008.

Plan amendment deadline. Calendar-year plans with calendar-year limitation years must be amended by the filing deadline (including extensions) for the 2008 tax year. For example, the amendment deadline for a 401(k) plan maintained by a C corporation is March 15, 2009, plus extensions. ❖

* $20,500 if participant is eligible to make catch-up contributions

recent developments

Update on Deduction Rules. Employers maintaining both defined benefit (DB) and defined contribution (DC) plans are subject to the 25% combined plan deduction limit for 2006 and 2007. However, they may make a contribution of up to 6% of compensation to their DC plan without the amount being counted toward the 25% limit. Recent IRS guidance clarified that when the plan year and the employer's taxable year are not the same, the employer has three alternatives for determining the allowable deduction: the plan year beginning in the taxable year, the plan year ending in the taxable year, or a weighted average of the two.

Effective for plan years starting in 2008, employers with DB plans covered by the Pension Benefit Guaranty Corporation (PBGC) are no longer subject to the 25% combined DB/DC deduction limit. They may take a deduction for the minimum DB funding amount (even when it exceeds 25% of compensation) *and* a deduction of up to 25% of compensation for the DC plan. Plans not covered by the PBGC will remain under the combined limit plus the 6% in effect as of 2006 and 2007.

Note: With limited exceptions, most DB plans are covered by Title IV of ERISA and the PBGC. The exceptions are plans of "professional service employers" with 25 or fewer active participants and plans covering only substantial owners and no common-law employees.

Schedule P Discontinued. For years, filers of Form 5500 could attach a Schedule P, which started a three-year statute of limitations for the return. The form was unusual in that the institution holding the assets for the plan had to sign it and often actually completed it for the employer. Schedule P has been eliminated. The statute of limitations will now automatically be set at three years.

Final 409A Regulations Issued. The long awaited final 409A regulations for nonqualified plans have been issued. These regulations bring together interim guidance from the last 2½ years. The 397 pages of regulations are being pored over by practitioners. Documents will need to be compliant before the effective date of January 1, 2008. ❖

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