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Legal Alert: IRS Publishes PPA Distribution Guidance "Grab Bag"

January 17, 2007

On January 2, 2007, the IRS published Notice 2007-7 (the "Notice"), containing an assortment of guidance items related to distribution provisions in the Pension Protection Act of 2006 ("PPA") (P.L. 109-280). The Notice covers the following topics:

- Interest rate assumptions for lump sum distributions;
- Hardship distributions;
- Early distributions to public safety employees;
- Rollovers for nonspouse beneficiaries;
- Distributions to pay for accident or health insurance for public safety officers;
- Vesting of nonelective contributions;
- Notice and consent period for distributions; and
- Distributions from IRAs to charitable organizations.

Each of these provisions under the PPA has a 2007 effective date; therefore, the provisions of the Notice are effective immediately.

Interest Rate Assumptions for Lump Sum Distributions

Under Internal Revenue Code ("Code") section 415(b)(2)(B), defined benefit distributions payable as a lump sum must be adjusted to an actuarially equivalent straight-life annuity in order to determine whether the distribution exceeds the annual benefit limitations. The interest rate assumptions used in this calculation are critical; the greater the interest rate that is used in this adjustment, the smaller the benefit that can be distributed in an alternate form without violating the section 415(b) limitations. Congress and Treasury have spent several years trying to find an interest rate assumption that produces a lump sum benefit that accurately reflects the value of the actuarially equivalent annuity without overstating that benefit. The PPA attempts to find this balance by providing that the applicable interest rate assumption must not be less than the greatest of (i) 5.5%, (ii) the rate that provides a benefit of not more than 105% of the benefit that would be provided if the 30-year Treasury bond rate were used to determine the benefit, or (iii) the rate specified under the plan. This change applies to distributions made after December 31, 2005; as a result a lump sum distribution made in 2006 before the enactment of the PPA may have exceeded the section 415(b) limit when this limit is calculated under the new law.

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It is important to note that the PPA changes to these rules do not affect how benefits are to be calculated generally; rather they affect only the calculation of the limit applicable under section 415(b). Accordingly, these changes are likely to result in an excess distribution only under certain circumstances, such as a long-service highly compensated participant whose accrued benefit in the form of a straight-life annuity is close to the unadjusted section 415 limit, or a participant who receives a distribution at a young age or with a young beneficiary so that the impact of the adjustment is greater than in the case of a typical plan participant.

The Notice provides for three methods for correcting such "excess distributions." Under the first method, excess distributions made prior to September 1, 2006 may be corrected using the Employee Plans Compliance Resolution System ("EPCRS") method for correcting an excess section 415(b) distribution, with certain modifications, provided the correction is completed by March 15, 2007. Unlike under the usual EPCRS correction method, excess contributions are not returned to the plan; instead, excess amounts are distributed to the participant (but are not eligible for rollover). In addition, the plan issues two Forms 1099-R to the participant: the first including the amount that should have been distributed under the new PPA rules, and the second including any excess amounts, coded as an excess distribution but not subject to the 10% early distribution penalty.

The other two correction methods are available to all excess distributions, regardless of when they were made. Under the second method, if the correction is completed by December 31, 2007, the plan may use the EPCRS method to correct the distribution, returning the excess amounts to the plan. This method applies even if the plan does not meet the usual requirements for correction under EPCRS. Finally, the third method allows a plan to correct the excess distribution using the EPCRS section 415(b) correction methods even after December 31, 2007, if the plan meets the EPCRS eligibility requirements.

Hardship Distributions

The PPA mandated that Treasury modify the rules regarding hardship distributions from plans subject to Code section 401(k), 403(b), 457(b) or 409A to permit these plans to treat a hardship or unforeseeable financial emergency of a participant's beneficiary (in addition to the participant, his or her spouse and his or her dependents) as a permissible distribution event. Under the Notice, 401(k) and 403(b) plans that permit hardship distributions only for safe harbor events may (but are not required to) permit hardship distributions for a beneficiary's medical, tuition or funeral expenses, provided that all other criteria for receiving a hardship distribution are satisfied. In addition, the Notice provides that section 457(b) and section 409A plans may (but are not required to) treat a participant's beneficiary under the plan in the same manner as it treats the participant's spouse or dependent in determining whether an unforeseeable emergency has occurred. This change will be reflected in the upcoming final section 409A regulations.

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Early Distributions to Public Safety Employees

The PPA provides that certain public safety employees may receive a distribution from a governmental defined benefit plan as early as age 50 without incurring a 10% early withdrawal penalty. The Notice clarifies the definition of a public safety employee, sets out detailed criteria for employees to qualify for this exception to Code section 72(t), and addresses issues relating to rollovers and reporting.

Rollovers for Nonspouse Beneficiaries

The PPA allows nonspouse beneficiaries to roll over inherited distributions directly into an IRA. The Notice provides that a section 401(a), 403(b) or 457(b) plan can offer a direct rollover of a distribution to a nonspouse beneficiary, but is not required to do so. The Notice clarifies that a distribution to a nonspouse beneficiary is not treated as an eligible rollover distribution under the Code (*i.e.*, no special tax notice is required and the distribution is not subject to a mandatory 20% withholding if it is not directly rolled over). Also, the Notice includes rules for determining the minimum required distribution amount under these circumstances.

Distributions to Pay for Accident or Health Insurance for Public Safety Officers

Under the PPA, an eligible retired public safety officer may exclude amounts distributed from an eligible government plan to the extent such amounts are used to pay qualified health insurance premiums. The Notice defines certain key terms for purposes of this provision and provides for detailed eligibility rules and exclusion limits.

Vesting of Nonelective Contributions

The PPA provides for accelerated vesting requirements for employer nonelective contributions; specifically, the PPA requires vesting to occur under a three-year cliff or a two-to-six-year graded vesting schedule (rather than the existing five-year cliff or three-to-seven-year graded vesting schedules) with respect to nonelective contributions made for plan years beginning after December 31, 2006. The Notice makes clear that the accelerated vesting schedule applies only to these contributions; in contrast, previous changes to the vesting rules under the Code have applied to all contributions allocated to a participant’s account, regardless of when they were made. A plan can use a bifurcated vesting schedule that applies the new vesting rules only to contributions subject to the new rules or a single schedule that applies to all contributions. The Notice applies the existing Code requirements so that, if a plan is amended to comply with these new rules, a participant with at least three years of service may elect to have the plan’s existing vesting schedule to continue to apply, but the amendment cannot reduce the

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participant's vested percentage. After the amendment, the participant must at all times have a vested percentage that is equal to or greater than the vested percentage required under the new rules and the percentage determined under the terms of the plan before the amendment. For example, if the plan currently has a five-year cliff vesting schedule and adopts a two-to-six-year vesting schedule for post-2006 contributions, the participant must be fully vested in all contributions after completing five years of service, but must be vested in the contributions made for years after 2006 in accordance with the graded schedule. The Notice also provides that contributions made based on compensation and service in 2006 may vest under the pre-PPA vesting schedule, even if the contribution is not allocated until 2007, as long as the contribution is not contingent on the occurrence of an event after 2006.

Notice and Consent Period for Distributions

The PPA extends the maximum period during which certain notice and consent requirements relating to distributions must be satisfied. Specifically, the notice and consent period relating to qualified joint and survivor annuities, and the period during which the tax notice required under Code section 402(f) may be given, now extends to 180 days (rather than 90 days) before the commencement of the distribution. Also, under the PPA, the notice given to obtain the participant's (and, if applicable, the participant's spouse's) consent to distribution must include a statement of a participant's right to defer distribution and a description of the consequences of failing to defer receipt of a distribution. The Notice clarifies that the new rules apply only to notices issued in plan years that begin after December 31, 2006. A new notice is not required with respect to a distribution with an annuity starting date in 2007 if notice had already been provided in 2006. Given the provision's effective date, employers are only required to make a reasonable attempt to comply with the requirement until 90 days after regulations are issued. The Notice also provides for certain safe harbor language for complying with the new requirement.

Distributions from IRAs to Charitable Organizations

Under the PPA, in taxable years 2006 and 2007, an IRA owner may exclude from income any minimum required distribution that is contributed directly to certain charities (a "qualified charitable distribution"). The Notice specifies that that the $100,000 annual limit for qualified charitable distributions applies per individual IRA owner, even if the owner has multiple IRAs or is married. Qualified charitable distributions are not deductible under the charitable contribution rules of Code section 170. The Notice provides that a charitable contribution made directly from an IRA that attempts, but fails, to meet the qualified charitable distribution rules will be included in the IRA owner's gross income, subject to the charitable deduction rules.

The Notice also clarifies that a qualified charitable distribution may be taken from any type of IRA (except an ongoing SEP or SIMPLE IRA) and will not be subject to withholding.

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An IRA owner may make the contribution to the charity by delivering a check from the IRA made payable to the charity, or the IRA trustee may make a distribution directly payable to the charity. If the trustee makes the distribution directly, the Department of Labor has advised Treasury and the IRS that the distribution will not constitute a prohibited transaction.

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