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Employee Benefits | A Littler Mendelson Newsletter

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IRS Releases First Pension Protection Act Guidance

By Steven J. Friedman and Lisa C. Chagala

On January 10, 2007, the IRS released Notice 2007-7, which provides guidance relating to several key provisions of the Pension Protection Act of 2006 (PPA). The guidance primarily relates to distributions from retirement plans. In this newsletter, we discuss the most salient features of this guidance and its effect on the following areas:

- Hardship Distributions For Nonspouse Beneficiaries
- Nonspousal Plan Rollovers to IRAs
- Shorter Required Vesting Schedule For Employer Non-elective Contributions
- Notice and Consent Rules Related to Distributions
- Interest Rates Used in Computing DB Plan Benefit Limits

Hardship Distributions For Nonspouse Beneficiaries

Contributions to 401(k), 403(b), 457(b) and deferred compensation plans can only be distributed upon certain events, one of which is an employee hardship. Although different standards may apply with respect to different types of plans, a hardship distribution can only be made on account of an immediate and heavy financial need of the employee and if it is necessary to satisfy the financial need.

Prior to the PPA, a hardship distribution could only be taken for a hardship event that affected the participant, his or her spouse and/or dependents. The PPA broadened this group to include a participant's beneficiary (the beneficiary is the person who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance upon the death of the participant). This new development is significant for those whose beneficiaries are not family members.

Notice 2007-7 clarifies that under 401(k) and 403(b) plans, a plan may permit hardship distributions for a beneficiary's medical, tuition or funeral expenses. For 457(b) and deferred compensation plans governed by Internal Revenue Code Section 409A, plans may treat a beneficiary the same as a spouse for purposes of the hardship distribution rules.

This feature is optional; plans are not required to treat a participant's beneficiary as the participant's spouse or dependent for purposes of determining whether a participant has suffered a hardship or unforeseen financial emergency. This feature was effective under the PPA as of August 17, 2006.

Nonspousal Plan Rollovers to IRAs

Before the enactment of the PPA, a nonspouse beneficiary could not roll over a distribution from a participant's 401(k), 403(b) or 457(b) plan to an individual retirement account (IRA) without incurring significant taxes and penalties.

The PPA provided that a nonspouse beneficiary may roll over all or part of a distribution from a participant's account to an IRA. In such cases, the rollover will not be subject to the taxes and penalties that applied before the enactment of the PPA. This development presents an important estate planning opportunity because, prior to the PPA, a nonspouse beneficiary commonly was required to receive the entire plan account immediately or within five years of the participant's death. Now, the nonspouse beneficiary may directly transfer the funds to an IRA and receive a distribution over the beneficiary's life expectancy. Notice 2007-7 clarifies that this is an optional provision. It also permits the 401(a), 403(b) or 457(b) plan making the distribution to offer "direct rollovers" into the IRA directly from the plan. In addition, the Notice clarifies that a distribution to the nonspouse beneficiary is not subject to the notice requirements that apply to other distributions that are eligible for rollover treatment.

The Notice provides that a trust may qualify as a nonspouse beneficiary, so that a rollover may be made to an IRA on behalf of a trust as the participant's named beneficiary. Once the rollover is made, the IRA is treated as an inherited IRA and must be distributed in accordance with the minimum distribution rules applicable to inherited IRAs (i.e., either distribution within five years of the participant's death, or the distribution commencing within one year of the participant's death and paid out over the beneficiary's life expectancy).

These new rules may be applied to distributions made after December 31, 2006.

Shorter Required Vesting Schedule For Employer Non-Elective Contributions

Before the enactment of the PPA, a plan met minimum vesting requirements if employer non-elective contributions vested in accordance with a 5-year cliff vesting schedule, a 3-to-7 year graded vesting schedule or a more favorable vesting schedule.

The PPA requires faster vesting for non-elective employer contributions for plan years generally beginning after December 31, 2006. Specifically, employer non-elective contributions must vest in accordance with a 3-year cliff vesting schedule, a 2-to-6 year graded vesting schedule or a more favorable vesting schedule. In what may be a significant planning opportunity for employers, Notice 2007-7 permits a plan to maintain one vesting schedule for contributions made for plan years prior to the 2007 plan year and another schedule for contributions made for the 2007 plan year and later years.

The Notice also clarifies that the new vesting schedule need not apply to contributions made during 2007 that relate to the 2006 plan year if such contributions are not contingent on any event occurring after the 2006 plan year.

Notice and Consent Rules Relating to Distributions

The PPA allows plan sponsors to provide notices to plan participants advising them of their rights in connection with plan distributions as early as 180 days prior to a plan distribution (as opposed to 90 days under pre-PPA rules). The PPA required changes in the content of these notices, commonly known as "402(f) notices." Notice 2007-7 clarifies that these rules apply only to notices issued after the 2006 plan year. It provides that notices are required to be revised in a "good faith" manner currently, even though clarifying regulations have yet to be issued.

Interest Rates Used in Computing DB Plan Benefit Limits

Section 415 of the Internal Revenue Code places limits on benefits payable from a defined benefit plan. Because the normal form of plan benefits in a defined plan is a life annuity, actuarial adjustments are required to apply these limits to lump sum distributions. The PPA provided mandatory guidelines for setting interest rate assumptions used in computing limitations on defined benefit plan lump sums.

Notice 2007-7 provides that plans may be amended retroactively to the January 1, 2006 effective date of these rules without violating the anti-cutback rules contained in Code Section 411(d)(6). The Notice also provides correction methods for plans to use if a distribution in excess of the section 415 limits was made in plan years that began in 2006.

For additional information regarding the PPA, please see Littler Mendelson's Employee Benefits ASAP newsletters of October 2006, entitled "Comprehensive Pension Reform Becomes Law: A Look At Changes Primarily Affecting Defined Benefit Plans" and "Comprehensive Pension Reform Becomes Law: A Look At Changes Primarily Affecting Defined Contribution Plans." Please contact any of the attorneys in the Littler Mendelson Employee Benefits Practice Group for more information relating to these rules.

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