

## Client Alert

# Internal Revenue Service Issues More Pension Protection Act Guidance

The Pension Protection Act of 2006 (PPA 2006) made significant changes to the laws governing employee benefit plans. Many of these changes are effective as early as January 1, 2007. The Internal Revenue Service (IRS) has just issued guidance on a number of PPA 2006 changes affecting defined benefit pension plans and 401(k) savings and other defined contribution plans. *As noted below, immediate action may be required for some defined benefit pension plans.*

Here is a brief summary of the new guidance.

### **Special Correction Methods for Defined Benefit Plans and the New Interest Rate Assumption Under Section 415(b)**

PPA 2006 made a change to the interest rate assumption to be used under Section 415(b)(2)(E) of the Internal Revenue Code (Code). This assumption is used when adjusting a benefit to its actuarially equivalent straight life annuity. Unfortunately, this change was retroactively effective for distributions made in plan years beginning after December 31, 2005 (January 1, 2006 for many plans), even though PPA 2006 was not enacted until August 17, 2006. As a result, defined benefit plans may have made distributions during the first eight months of 2006 using the wrong interest rate assumption, resulting in some distributions being greater than they should have been (referred to in the new guidance as a "Section 303 Excess Distribution").

The new guidance makes clear that Section 303 Excess Distributions violate Code Section 415(b), but provides three ways in which the violation can be corrected. The first method is the simplest and is the method we recommend.

- The first correction method applies to Section 303 Excess Distributions made before September 1, 2006. ***This method may only be used for corrections made on or before March 15, 2007.*** Under this correction method, the plan would issue two Forms 1099-R to a participant who received a Section 303 Excess Distribution. The first Form 1099-R would include only the amount of the distribution that would have been permissible under the PPA 2006 amendment to Code Section 415(b)(2)(E). The second Form 1099-R would include only the amount of the actual excess distribution and would indicate to the participant that that excess amount is not an eligible rollover distribution and must be included in the participant's gross income for 2006.
- The second correction method applies to any Section 303 Excess Distribution (even if made on or after September 1, 2006). ***This method may only be used for corrections made on or before December 31, 2007.*** This option allows the plan to use the correction method for Code Section 415(b) failures contained in the IRS' amnesty program known as the Employee Plans Compliance Resolution System (EPCRS), even if the plan does not otherwise satisfy the requirements for using EPCRS. This correction method requires the plan to take reasonable steps to recoup any overpayment (plus earnings that otherwise would have accrued) and to make up any difference to the plan to the extent the plan is unable to recoup the required amount.

- The third correction method also applies to any Section 303 Excess Distribution. ***This method may be used at any time, even for corrections made after December 31, 2007.*** This option is similar to the second option, but is only permitted to the extent that the plan satisfies all the requirements for correcting a failure under EPCRS.

Defined benefit plans do not need to be formally amended to comply with this change until the last day of the first plan year beginning on or after January 1, 2009, although those plans must be operated currently as if the amendment were already in effect.

### **Faster Vesting of Employer Non-Elective Contributions**

Beginning with contributions for plan years that begin after December 31, 2006, employer non-elective contributions cannot be subject to a vesting schedule that is longer than a three-year cliff or six-year graded schedule. Those schedules were already the maximum schedules for employer matching contributions before PPA 2006 was enacted. Employer non-elective contributions for earlier plan years may continue to be subject to up to five-year cliff or seven-year graded vesting schedules. A plan is permitted to have bifurcated vesting schedules (that is, separate schedules for pre-2007 and post-2006 amounts) for employer non-elective contributions, as long as the plan separately accounts for the two separate amounts. The rules for vesting under defined benefit plans were not changed by PPA 2006.

- ***Important note for ESOPs.*** This rule does not take effect immediately for an ESOP that had an outstanding loan on September 26, 2005 for the purpose of acquiring qualifying employer securities. For such an ESOP, this rule is not effective until the earlier of (1) the date on which the ESOP loan is fully repaid, or (2) the date on which the ESOP loan, as of September 26, 2005, was scheduled to be fully repaid.

### **Hardship Distributions Related to a Participant's Beneficiary**

Many defined contribution plans permit participants to take "hardship" distributions. Many of the safe harbor hardship definitions relate to the participant's spouse or dependents. Safe harbor plans may now be amended to extend the definition of certain hardships to the participant's "primary beneficiary under the plan" (who may be someone other than the participant's spouse or dependent). This new rule also applies to 403(b) plans, and to distributions due to an unforeseeable financial emergency under 457(b) plans and to plans subject to Code Section 409A. This change is voluntary and plans are not required to make the change.

### **Rollovers by Non-Spouse Beneficiaries**

PPA 2006 permits a plan to allow a non-spouse beneficiary to roll over a distribution into an "inherited IRA." This must be done via a direct trustee-to-trustee rollover. Before the enactment of PPA 2006, only a spouse beneficiary could roll over a distribution and avoid immediate taxation. The new guidance contains specific rules as to how the IRA must be established and named, and how the minimum distribution requirements apply to the amounts rolled over by the non-spouse beneficiary. This change is voluntary and plans are not required to provide rollover rights to non-spouse beneficiaries.

### **New Rules for Pre-Distribution Notices**

Before PPA 2006 was enacted, a plan was required to provide a participant with a pre-distribution notice no more than 90 days before the date the distribution was set to begin. For plan years beginning in 2007 and later, such a notice may be provided as many as 180 days before the date the distribution is set to begin.

PPA 2006 also modifies the content of the pre-distribution notice. Specifically, in addition to notifying the participant of his or her right to defer receipt of the distribution, the notice must now inform the participant of the consequences of failing to defer such receipt. Until regulations are issued, good faith compliance is required. The new guidance includes safe harbor guidance as to what constitutes good faith compliance.

### **Other Items Covered by the New Guidance**

The new guidance also provides guidance about (1) distributions to charities from an IRA owned by an individual who is 70½ or older, (2) distributions to a qualified public safety employee from a governmental defined benefit plan, and (c) distributions from certain governmental plans to pay for qualified health insurance premiums of eligible retired public safety officers.

For a link to the new IRS guidance on PPA 2006, [click here](#) or go to [www.chadbourne.com/PPA.htm](http://www.chadbourne.com/PPA.htm).

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