

# Employee Benefits Law Update

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## New IRS Rules on the Pension Protection Act

On January 10, 2007 the Internal Revenue Service (“IRS”) issued Notice 2007-7 to give guidance on small but important parts of the Pension Protection Act (“PPA”). The notice likely requires changes in plan administration and documentation and offers some options to plan sponsors. Employers will need to consider taking action as soon as reasonably possible.

### 1. SECTION 415(b) LIMITS—MANDATORY—EFFECTIVE 1/1/2006

- This applies to all defined benefit qualified plans.
- A special rule is available for re-doing 2006 calculations by the **end of February, 2007**. See below.
- PPA changes the interest rate used to calculate actuarial equivalencies for purposes of the 415(b) limits.
- Based on experience to date, the change to 415 should have a minimal effect on benefits for many plans but it is very important that the calculations be correct. Employers should talk to their plan’s actuary to ensure that they are up to speed on this issue.
- The new interest rate is the greater 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 “applicable rate” in section 417(e)(3) were used, or (iii) the rate specified in the plan.
- Plan amendments can be made by the end of 2009. But the plans must be operated in accordance with the rules starting on January 1, 2006.
- If it turns out that benefits in excess of the limits were paid because of this change, the excess payment must be corrected.

A special correction is available for distributions made before September 1, 2006 that are over the 415(b) limits because of the new rules **if** corrected by March 15, 2007. As described by the Notice, a plan is only required to issue two separate 1099Rs to the affected individuals. One is for the amount that was within the “new” 415 limits. The other is for the excess. The excess cannot be rolled over. Unstated is that the individual will have to un-roll any such amount if he/she previously rolled over what is now “excess”. If the March 15, 2007 date is not met, the standard EPCRS correction is required, which requires repayment of the excess or reduction of future payments to recoup the excess.

### 2. HARDSHIP DISTRIBUTIONS—OPTIONAL—EFFECTIVE NOW

- This affects 401(k) plans and perhaps nonqualified deferred compensation plans.
- Employers should decide if they want to offer this benefit under their plans. If so, the plans should be amended and participants should be notified as soon as possible about the change.
- Hardship distributions to a participant may now be made if related to the medical, tuition and funeral expenses of a “primary beneficiary.” A primary beneficiary is any individual who is named as a beneficiary under the plan and has an unconditional right to all or part of the participant’s account balance on his/her death.
- This expanded rule also is available for “unforeseeable emergencies” of the beneficiary under a nonqualified deferred compensation plan that allows for such distributions.
- Note that this seems to invite a bit of game playing. For example, a participant could name an individual as

a beneficiary of a miniscule part of his/her account and this rule would apply for that beneficiary. But also note that the participant will be taxed on the distribution and will be subject to the 10% extra penalty tax in many situations.

### 3. DIRECT ROLLOVER BY NONSPOUSE BENEFICIARY —OPTIONAL—EFFECTIVE NOW

- This affects all qualified plans.
- Employers need to decide if they want to offer this benefit under their plans. If so, the plans should be amended and participants should be notified about when the change will be effective.
- All qualified plans can offer a direct rollover (of a distribution that qualifies for a rollover) to nonspouse beneficiaries. The rollover must be to an IRA that is set up as an “inherited IRA.”
- This benefit must be made available on a nondiscriminatory basis.
- This rollover is only for exclusion of income and is not subject to the usual notice requirements or the mandatory withholding requirements. An employer that decides to offer this benefit for nonspouse beneficiaries may have to develop notice materials.
- The person who rolls over to an IRA will be subject to very complex minimum distribution requirements. The person who makes the rollover will be responsible for compliance, not the sponsor of the distributing plan.

### 4. VESTING

The PPA requires either 100% vesting after three (3) years or graded vesting starting at two (2) years and moving to 100% after six (6) years. The vesting rules generally require plans that change the vesting rules to offer participants an election between the old and new vesting schedules. The Notice clarifies that since the change to the vesting schedule required by

PPA only enhances the vesting (i.e. participants’ vesting percentage after the change won’t be less than before the change), if that’s the only change, no election need be provided.

### 5. NOTICES RE DISTRIBUTIONS—MANDATORY— EFFECTIVE 1/1/2007

- This affects all qualified plans.
- Plan sponsors should take action as soon as reasonably possible regarding notices and should check with their TPAs and/or actuaries to determine the extent of their assistance with compliance.
- The new rule requires that the notice regarding the ability to defer receipt of a benefit (the 411 notice) must describe the consequences of failing to defer a distribution.
- A plan sponsor is “OK” under these rules if it makes a “reasonable attempt” to comply until 90 days after regulations are issued under the new rules.
- To be “reasonable,” the notice given by the plan sponsor must include the following information: (i) for a DB plan, how much larger benefits will be if receipt is deferred; (ii) for a DC plan, the investment options available (including fees) if distributions are deferred; (iii) the portion of the SPD that contains any special rules that might materially affect a participant’s decision to defer. Of course, the notice must be written so it is “reasonably calculated to be understood by the average participant.”
- For the notice regarding a DB plan, employers can use a description that includes the financial effect of deferring a distribution using the same rules that now exist for giving information about the financial effect and relative value of optional forms of distribution. See Treas. Reg. § 1.417(a)(3)-1(d)(2)(i).
- The new rule also gives extra time to provide distribution and form of benefit notices. The maximum period to give notice before distribution begins is 180 days instead of 90 days.

## 6. CHARITABLE CONTRIBUTIONS FROM IRA'S

- The PPA allows certain charitable contributions to be made directly from IRAs without taxation to the IRA owner. Of course, there are limits and complicated rules. But this is from an IRA, not from a qualified plan. So, this does not directly affect plan sponsors. To the extent that the employer gets questions on this benefit, you may wish to refer the individual to his/her tax advisor.

To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

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