



Put on Notice-IRS Explains PPA Provisions
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IRS Issues Notice to Explain PPA Distribution Provisions

The IRS issued this week Notice 2007-7 which details changes that were made in the Pension Protection Act of 2006 for various types of plan distributions. We'll look at some of these provisions in this week's podcast.

Hardship Distribution Provision (Act Section 826)

The following provision was contained in the Pension Protection Act of 2006 that does not modify any IRC section, but rather contains the following direction to the IRS:

ACT SEC. 826. MODIFICATIONS OF RULES GOVERNING HARDSHIPS AND UNFORSEEN FINANCIAL EMERGENCIES.

Within 180 days after the date of the enactment of this Act, the Secretary of the Treasury shall modify the rules for determining whether a participant has had a

hardship for purposes of section 401(k)(2)(B)(i)(IV) of the Internal Revenue Code of 1986 to provide that if an event (including the occurrence of a medical expense) would constitute a hardship under the plan if it occurred with respect to the participant's spouse or dependent (as defined in section 152 of such Code), such event shall, to the extent permitted under a plan, constitute a hardship if it occurs with respect to a person who is a beneficiary under the plan with respect to the participant. The Secretary of the Treasury shall issue similar rules for purposes of determining whether a participant has had --

826(1) a hardship for purposes of section 403(b)(11)(B) of such Code; or

826(2) an unforeseen financial emergency for purposes of sections 409A(a)(2)(A)(vi), 409A(a)(2)(B)(ii), and 457(d)(1)(A)(iii) of such Code.

Section III of the above notice deals with this issue. Q-5 provides that if the plan allows distributions only for expenses described in Reg. §1.401(k)-1(d)(3)(iii)(B), can permit distributions for expenses described in §1.401(k)-1(d)(3)(iii)(B)(1), (3) or (5) for a primary beneficiary. Those provisions are:

(1) Expenses for (or necessary to obtain) medical care that would be deductible under section 213(d) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);

...

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post- secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2) and (d)(1)(B));

...

(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(d)(1)(B));

The notice defines a *primary beneficiary under the plan* as an “an individual 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 under the plan upon the death of the participant.” The notice makes it clear the plan adopts these requirements (so a plan will need to be amended) and that it must still satisfy the other requirements.

The notice also goes on to deal with the concept of the “unforeseeable financial emergency” coverage under §457(b) and §409A to allow such plans to treat the primary beneficiary in the same manner as a spouse or dependent for purposes of such emergency. The notice specifically states that these rules will be reflected in the long awaited final regulations under §409A.

Designated Nonspouse Beneficiary Rollover

Section 829 of the Act added new §402(c)(11) to the IRC to allow for rollovers from qualified plans to what will be a new type of “inherited” IRA for nonspouse beneficiaries. Previously only a spouse could rollover distributions from a qualified plan to an IRA, while other beneficiaries could only get a “stretch out” for the inherited plan balance via the plan. Since many plans force out such amounts following the death of the participant (since the plan has little interest in dealing with beneficiaries for decades), the lack of an option to transfer the balance to an IRA meant that nonspouse beneficiaries generally got hit with the tax on the entire balance very shortly after the death of the participant.

(11) Distributions to inherited individual retirement plan of nonspouse beneficiary

(A) In general

If, with respect to any portion of a distribution from an eligible retirement plan of a deceased employee, a direct trustee-to-trustee transfer is made to an individual retirement plan described in clause (i) or (ii) of paragraph (8)(B) established for the purposes of receiving the distribution on behalf of an individual who is a designated beneficiary (as defined by section 401(a)(9)(E)) of the employee and who is not the surviving spouse of the employee--

(i) the transfer shall be treated as an eligible rollover distribution for purposes of this subsection,

(ii) the individual retirement plan shall be treated as an inherited individual retirement account or individual retirement annuity (within the meaning of section 408(d)(3)(C)) for purposes of this title, and

(iii) section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan.

(B) Certain trusts treated as beneficiaries

For purposes of this paragraph, to the extent provided in rules prescribed by the Secretary, a trust maintained for the benefit of one or more designated beneficiaries shall be treated in the same manner as a trust designated beneficiary.

The provision applies to distributions after December 31, 2006.

The Notice explains that the distribution has to satisfy the general rules for an eligible rollover distribution and is made to a designated beneficiary that satisfies the rules found at Reg. §1.401(a)(9)-4. The distribution must be made directly to the IRA via a trustee-to-trustee transfer, pursuant to the rules found at Reg. §1.401(a)(31)-1, Q&A-3 and 4. It's useful to review the mechanical guidance in this area since this is the only method allowed for this transfer:

Q-3: What is a DIRECT ROLLOVER that satisfies section 401(a)(31), and how is it accomplished?

A-3: A direct rollover that satisfies section 401(a)(31) is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee. A direct rollover may be accomplished by any reasonable means of direct payment to an eligible retirement plan. Reasonable means of direct payment include, for example, a wire transfer or the mailing of a check to the eligible retirement plan. If payment is made by check, the check must be negotiable only by the trustee of the eligible retirement plan. If the payment is made by wire transfer, the wire transfer must be directed only to the trustee of the eligible retirement plan. In the case of an eligible retirement plan that does not have a trustee (such as a custodial individual retirement account or an individual retirement annuity), the custodian of the plan or issuer of the contract under the plan, as appropriate, should be substituted for the trustee for purposes of this Q&A-3, and Q&A-4 of this section.

Q-4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

A-4: Providing the distributee with a check and instructing the distributee to deliver the check to the eligible retirement plan is a reasonable means of direct payment, provided that the check is made payable as follows: [Name of the trustee] as trustee of [name of the eligible retirement plan]. For example, if the name of the eligible retirement plan is "Individual Retirement Account of John Q. Smith," and the name of the trustee is "ABC Bank," the payee line of a check would read "ABC Bank as trustee of Individual Retirement Account of John Q. Smith." Unless the name of the distributee is included in the name of the eligible retirement plan, the check also must indicate that it is for the benefit of the distributee. If the eligible retirement plan is not an individual retirement account or an individual retirement annuity, the payee line of the check need not identify the trustee by name. For example, the payee line of a check for the benefit of distributee Jane Doe might read, "Trustee of XYZ Corporation Savings Plan FBO Jane Doe."

The notice goes on to note the type of plans that can offer this rollover option, which includes:

- Qualified plans described in §401(a) (generally what we consider qualified plans)
- Annuity plans (§403(a) or (b))
- Eligible government plans (§457(b))¹

The IRA must be established and titled as an IRA of the *deceased individual* and identifies both the decedent and the beneficiary. The notice gives the example of "Tom Smith as beneficiary of John Smith."² It may take a while before all of the custodians out

¹ Notice 2007-7, Q&A-11 and 12

² Notice 2007-2, Q&A-13

there understand these issues on this matter, so you should take some care to assure this is properly handled, otherwise the client could end up with an excess contribution to his own IRA.

If the beneficiary is a trust, and the beneficiaries of the trust meet the requirements of §401(a)(9)(E), the plan may make a direct rollover to an IRA on behalf of the trust.³

Plans are not required to offer this option at all, but if the plan does offer it it must offer it on a nondiscriminatory basis.⁴ As is normally true, a plan will need to be amended to offer this option—so you can't assume that your client inheriting a balance from a qualified plan will have this option open. As well, if you advise an entity that sponsors such a plan, you may need to inquire if their plan has been or will be modified to incorporate this provision if it would have an impact on the owners' own planning.

The notice goes on to note that this distribution is not subject to the mandatory direct rollover offering requirement of §401(a)(31) (that is, the plan doesn't *have* to offer this option, as noted above), the notice requirements of §402(f) or the mandatory withholding requirements of §3405(c). As well, it notes that if the amount is actually distributed to the nonspouse beneficiary, it is not eligible to be rolled over—so the client must be aware that he/she cannot take a check (the same problem we have with inherited IRAs in general).⁵

In Q&A-17, the notice outlines the required minimum distribution rules if the participant dies before his/her required beginning date per §409(a)(9)(C), while Q&A-18 describes the situation if the employee dies after that date. As you would expect, in the first case the beneficiary falls under the five year rule or the life expectancy rule, while in the second case we see similar rules to those for an inherited IRA in such a case. The amount of the employee's required minimum distribution for the year is not eligible for rollover treatment, while the rest can be rolled over. In the following year, you would use the standard rules found in Reg. §1.401(a)(9)-5 Q&A-5.

Revised Notices for Plan Distributions

Congress also changed the rules related to required notices from plans related to distributions. If you advise clients with plans, you need to be sure they are aware that notices need to be revised to comply with this provision. The provision provides:

1102(a) EXPANSION OF PERIOD. --
(1) AMENDMENT OF INTERNAL REVENUE CODE. --
* * *
(B) MODIFICATION OF REGULATIONS. --

3 Notice 2007-7, Q&A-16

4 Notice 2007-7, Q&A-14

5 Notice 2007-7, Q&A-15

The Secretary of the Treasury shall modify the regulations under sections 402(f), 411(a)(11), and 417 of the Internal Revenue Code of 1986 by substituting "180 days" for "90 days" each place it appears in Treasury Regulations sections 1.402(f)-1, 1.411(a)-11(c), and 1.417(e)-1(b).

(2) AMENDMENT OF ERISA. --

(A) IN GENERAL. --

Section 205(c)(7)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1055(c)(7)(A)) is amended by striking "90-day" and inserting "180-day".

(B) MODIFICATION OF REGULATIONS. --

The Secretary of the Treasury shall modify the regulations under part 2 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 relating to sections 203(e) and 205 of such Act by substituting "180 days" for "90 days" each place it appears.

(3) EFFECTIVE DATE. --

The amendments and modifications made or required by this subsection shall apply to years beginning after December 31, 2006.

(b) NOTIFICATION OF RIGHT TO DEFER. --

(1) IN GENERAL. --

The Secretary of the Treasury shall modify the regulations under section 411(a)(11) of the Internal Revenue Code of 1986 and under section 205 of the Employee Retirement Income Security Act of 1974 to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

(2) EFFECTIVE DATE. --

(A) IN GENERAL. --

The modifications required by paragraph (1) shall apply to years beginning after December 31, 2006.

(B) REASONABLE NOTICE. --

A plan shall not be treated as failing to meet the requirements of section 411(a)(11) of such Code or section 205 of such Act with respect to any description of consequences described in paragraph (1) made within 90 days after the Secretary of the Treasury issues the modifications required by paragraph (1) if the plan administrator makes a reasonable attempt to comply with such requirements.

Notice 2007-7 clarifies that the extended period applies to notices *distributed* after December 31, 2006. As well, even though regulations have not yet been issued to implement Act §1102(b)'s requirement to explain the consequences of failing to defer, a plan will nevertheless need to comply with those requirements for notices provided in plan years beginning after December 31, 2006. Q&A-33 gives general guidance on the nature of the description that should be incorporated for new notices in order for the plan administrator to be deemed to have made a reasonable attempt to comply with these requirements. Such disclosure would give the following information:

- *Defined Benefit Plan*: a description of how much larger benefits will be if the commencement of distributions is deferred
- *Defined Contribution Plan*: a description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred; and the portion of the summary plan description that contains any special rules that might materially affect a participant's decision to defer.

Direct Charitable Contributions

Finally, the Notice describes the new option available for 2006 and 2007 for certain individuals to directly transfer funds from their IRA to a charity and not have to include the distribution in income. The notice starts out by pointing out the exclusion is only to those who have attained age 70 ½, is made directly to the certain charitable organizations, the distribution would have otherwise been includable in gross income and would have otherwise qualified as a charitable contribution under §170 without regard to the percentage limitations of §170(b).

The limitation of \$100,000 is per owner, not per IRA. As well, a married couple filing a joint return may each make the full \$100,000 contribution presuming both are otherwise eligible to take advantage of this provision.⁶ The notice reiterates the requirement that the organization receiving the contribution be one described in §170(b)(1)(A) other than supporting organizations described in §509(a)(3) or donor advised funds described in §4966(d)(2).⁷

Question 36 deals with implementing the restriction that these distributions cannot come from a SEP or SIMPLE-IRA account. Generally the law doesn't create a special class of IRAs known as "SEP-IRA's" (though many custodians do), rather the law generally allows an IRA to receive in addition to the standard contributions amounts deferred for the employee under an employer sponsored simplified employee pension plan, so this provision created a bit of confusion. Even though there is a special class known as SIMPLE-IRAs, the special treatment goes away over time.

In dealing with this issue, the notice describes what will be considered an "ongoing" SEP-IRA or SIMPLE-IRA. Put simply, an IRA will be "tainted" if an employer

⁶ Notice 2007-7, Q&A-34

⁷ Notice 2007-7, Q&A-35

contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contribution would be made.⁸ This would appear to create a situation where the IRA could be retroactively fouled up if a contribution for the 2006 tax year was deposited into the account in 2007, since such a contribution would be for the plan year ending within 2006. Similarly, even if a contribution is made, it appears the problem could be avoided by simply doing a transfer from the "tainted" IRA to another IRA account and then moving those funds to the charity, since it does not appear the SEP or SIMPLE "taint" carries over (though in the latter case, the SIMPLE-IRA has to have been around long enough to qualify for rollover to standard IRA accounts).

If a beneficiary is over 70 ½, even an inherited IRA can qualify for this benefit per Q&A-37. As well, Q&A-38 clarified that even if the distribution was made before the effective date of PPA 2006 (August 17, 2006), it would still qualify (though it would still have to meet all of the requirements for such a distribution—so most likely this would impact taxpayers who jumped the gun and made such a transfer after Congress passed the law, but before the President signed the bill).

The amount is, not suprisingly, not eligible for a charitable contribution under §170⁹ and is not subject to withholding.¹⁰

The IRS clarifies that a check can be issued from the IRA *payable to the charitable organization* and then delivered by the IRA owner to charity.¹¹ Note the italicized portion of the above sentence—what will not work is a check issued in the name of the owner of the account that he/she deposits into a checking account and then writes a check for an identical amount to the charity. That distinction could be lost on a client, to the client's detriment.

The distribution does satisfy the minimum distribution requirements of §§408(a)(6), 408(b)(3) and 408A(c)(5)¹²--thus providing some real opportunities for clients that are currently taking only a minimum distribution they don't really financially need to take and who regularly make significant charitable contributions. Advisers should consider pointing this option out to such clients if they did not do so before the end of 2006, so they can take advantage of this option in 2007.

The IRS notes that if a transfer fails to qualify, it will be treated as a distribution to the account holder and a related charitable contribution, with the appropriate tax treatment for each. That could happen if you discover the taxpayer had not attained age 70 ½ or that the charity to which the transfer was made was not an eligible charity under these rules (such as a disqualified supporting organization).

The IRS also notes that the Department of Labor has advised them that a distribution will

8 Notice 2007-7, Q&A-36

9 Notice 2007-7, Q&A-39

10 Notice 2007-7, Q&A-40

11 Notice 2007-7, Q&A-41

12 Notice 2007-7, Q&A-42

be treated as receipt by the IRA owner under §4975(d)(9) and thus will not be prohibited transaction. That will be true even if the IRA owner has an outstanding pledge to the charity in question.¹³ That clarification is important, since participation by an IRA in a prohibited transaction would cause a deemed distribution of the entire balance of the IRA—not a good result.

Other Provisions in the Notice

Not discussed in this podcast, but contained in Notice 2007-7, is guidance on the limitation related to interest assumption under §417(e)(3) (Section 303 of the Act), special exemption from the 10% excise tax on premature distributions for qualified public safety employees (Section 828 of the Act), exclusion from income of distributions from certain government plans used to pay qualified health insurance premiums of an eligible retired public safety officer (Section 845 of the Act) and revised vesting periods for qualified plans (Section 904 of the Act). If you have issues in these areas, be sure to consult the Notice in detail.

¹³ Notice 2007-7, Q&A-44